The Triumph of Broken Promises:
Oil, Finance, and the End of the Cold War

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Michael Frederic Bartel
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Abstract

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Michael Frederic Bartel, Ph.D.
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This dissertation puts forth a new interpretation of the collapse of communism and the end of the Cold War by examining the energy and financial markets that developed in the wake of the 1973-74 oil crisis. Drawing on newly released archival documents from both public and private archives throughout Europe and North America, it places the history of communist and capitalist states in the 1970s and 1980s in comparative perspective. The intertwined histories of oil, sovereign debt, and austerity touched every society on both sides of the Iron Curtain after the oil crisis. Energy and financial markets forced governments to impose economic and social restraint on their own societies, so the survival of political regimes and governing ideologies in both East and West came to depend on governments' ability to impose discipline. Governments that could successfully impose discipline without inviting a destabilizing social backlash survived; those that could not, collapsed. Thus, this dissertation proposes that the end of the Cold War was fundamentally different from its beginning. The competition between democratic capitalist states and state socialist regimes began as a race to expand the social contracts that prevailed in their societies, but it ended as a competition to discipline their respective social contracts. The Cold War, in other words, began as a race to make promises, but it ended as a race to break promises.

Explaining the peaceful and abrupt end of the Cold War has long been a significant challenge for historians. Some have focused their explanations on the unique role played by

Soviet General Secretary Mikhail Gorbachev and, to a lesser extent, U.S. President Ronald Reagan. Others have focused on the role of civil society and non-violent protest in spurring the revolutions of 1989. In contrast, this dissertation contends that the peaceful end of the Cold War was primarily the product of socialist states' desire to gain political legitimacy through democratic elections in order to implement economic and social discipline. Through detailed case studies of the collapse of the communist regimes in the Soviet Union, Poland, Hungary, and East Germany, this work demonstrates that the pressure to implement austerity in communist states significantly explains why communism collapsed and the Cold War ended peacefully.

Biographical Sketch

Michael Frederic "Fritz" Bartel was born and raised in Milwaukee, Wisconsin. He attended the University of Toronto, and graduated in 2010 with a Honours Bachelor of Arts Degree with High Distinction in History and International Relations. He enrolled in Cornell University as a graduate student in the History Department in 2011, and he defended his dissertation in May 2017. He will graduate with a Doctorate of Philosophy from Cornell in August 2017.

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Acknowledgements

Over the course of writing this dissertation, I have accrued as many debts as the governments I have studied. Much as they did, I have told myself (and those to whom I became indebted) that I was putting the borrowed time, money, or expertise toward enlightened ends. Unlike the subjects of my study, I hope that I have actually done so, and my creditors can see in the document that follows a handsome return on their investment.

I could not have asked for a better group of teachers and scholars to form my dissertation committee. Each member added unique and important insights to my own thinking as it rapidly evolved over the course of the project. I have viewed Fred Logevall as an exemplary scholar and writer since I was an undergraduate, and to have him as my doctoral advisor was the height of good fortune. Where other advisors surely would have resisted my attempts to roam expansively (and often confusedly) over diverse subjects, geographies, and time periods in search of this dissertation, he welcomed it. I thank him for his confidence in me and his expert guidance of the project. Holly Case has a uniquely powerful and creative mind, and I was privileged to learn from her on countless occasions over the course of this project. Holly was always generous with her time, insightful in her commentary, and keen to push the boundaries of my thinking in new and fascinating ways. This dissertation is certainly bigger in scope and more in interesting in content because of her manifold contributions to it. For much of my time working on this project, I felt (as many other scholars have) that I was merely catching up on things Peter Katzenstein had long since learned. It quickly became clear to me that such a position was an excellent one for a young scholar to be in. Whatever precision and insight the argument of this dissertation holds, much of it is a product of Peter's consistent request (no, demand) that I be more clear about what, exactly, *I* was trying to say among the crowded field of scholars who had come before me. Finally, Louis Hyman enthusiastically welcomed me into the History of Capitalism community, and connected me early and often with key resources in financial history. Though this dissertation does not meet Louis's pioneering vision of writing "history from the bottom up, all the way to the top," it is much better for having been subjected to his unique critique.

Numerous organizations provided financial support to make the research required for this project possible. The Marion and Frank Long Fellowship from Cornell University's Reppy Institute for Peace and Conflict Studies supported a year of research in Washington, D.C., during which I stumbled upon the documents in the International Monetary Fund's archive that set this project in motion. The German Academic Exchange Service (DAAD) supported a very pleasant and productive year of research in Germany, where I found the East German archival records that form the basis of this dissertation's commentary on the Eastern Bloc. My host professor at the Goethe-Universität Frankfurt am Main, Werner Plumpe, enthusiastically supported this project and introduced me to an important community of German scholars from whom I have learned a great deal. The National Fellowship at the University of Virginia's Miller Center supported the final year of research and writing that brought this dissertation to completion. Daniel Sargent, my "dream mentor" during that wonderful program, not only inspired this project through his own research on the history of international economics and politics in the 1970s, but also provided expert commentary on the entire dissertation once it was completed.

Lastly, there has always been my family. My mom and dad, Ellen and Mike Bartel, have supported me through thick and thin, and there was plenty of both on the long road through graduate school. Their love sustained me during these years, as it has during all the years of my life. My dad deserves special gratitude for editing every word of every chapter in this dissertation before it was submitted. Over a lifetime of friendship, my brother, Mitch, has influenced me in ways that go far beyond this dissertation, but he supported and influenced this effort too.

Most important, however, has been my wife, Amanda. If, for some very strange reason, a future historian wanted to write a history of this history – the story of how this dissertation was written – he or she would not have to search very hard to find the thesis: Fritz met Amanda, and everything else – from the first vague inklings of what this project could be to the last lines of this dissertation's conclusion - started falling into place. Through her love, commitment, editing, and contributions to endless hours of discussion about Cold War politics and economics, Amanda added more to this project than I can ever fully know or say. Lucky for me, this stage of this project has come to an end, but our lives together are only just beginning.

“Individuals can be expected to restrain the exercise of their individual power in the interest of protecting the fabric of their society if, but only if, they believe the society as a whole to be a just one.”

- Fred Hirsch[1]

[1] Fred Hirsch, *The Social Limits of Growth* ((Cambridge, MA, 1976), p. 152.

Introduction:

Making and Breaking Promises

As Christmas came to Eastern Europe in 1989, those who had long lived under the yoke of communism had many reasons to celebrate. In quick and unexpected succession, the authoritarian governments that had ruled over the region since shortly after the Second World War had peacefully collapsed. Dignified citizens who had resisted communism's countless injustices had begun to take their place in the governing chambers of Warsaw, Budapest, and Prague. On the night of November 9th, the Berlin Wall had fallen, vanquishing the most oppressive symbol of Europe's division and Eastern Europe's captivity. East German citizens that had been separated for four decades from their freer and richer countrymen in West Germany had begun to use a new slogan of unity - "*Wir sind ein Volk*" (We are one people) – and German reunification looked to be a real possibility for the first time since the early postwar years. In Moscow, Soviet General Secretary Mikhail Gorbachev's launch of glasnost and perestroika had transformed Soviet society, set Eastern Europe free to choose its own fate, and allowed all Europeans to imagine a future in which they lived in one "common European home" rather than two antagonistic blocs. Taken together, the evidence of political progress was so swift and overwhelming that observers had begun to speak of 1989 as an *annus mirabilis*, a year of miracles. In a New Year's Day speech to the Czechoslovak nation, Václav Havel, the former playwright and dissident and now, astonishingly, the newly elected president of the country, distilled the meaning of the preceding year to a simple, yet powerful, sentence. “People,” he told a massive crowd gathered in central Prague, “your government has returned to you.”[2] After decades of stolid oppression, winds of hope and renewal were in the air.

But Laszlo Kezdi did not care. The collapse of communism and the birth of electoral democracy in Eastern Europe may have been momentous events in the grand schemes of postwar European history and Cold War politics, but they were little solace for Kezdi, a Hungarian pensioner living in Budapest, as he watched his economic security evaporate before his eyes. The Hungarian government was making daily life across the country worse with each passing day, and Kezdi could feel it. Government officials had announced that pensioners would be receiving a Christmas bonus of 2,000 forints, the national currency, but the temporary cash infusion paled in comparison to the rising cost of everything in Hungarian society. By December 15th, Kezdi was fed up, and he took to the pages of one of Hungary’s leading newspapers, *Magyar Nemzet* (Hungarian Nation), to express his displeasure in an open letter to the nation’s leading financial official. “Minister of Finance Laszlo Bekesi!” he began. “I am turning to you with the following respectful request: With the Christmas bonus of 2,000 forints…please also send me an appropriately long and sturdy rope as an extra gift. I do not think I need to detail what purpose this rope will serve. Allow me to describe the reason for my request.”[3]

In the paragraphs that followed, Kezdi detailed that he had “earned” his current state pension of 5,300 forints per month through 42 years of work. Additionally, “after thirteen years of patient waiting,” he had obtained a 52 square meter (560 square foot) cooperative apartment through a thirty-five year mortgage, which was subsidized by the government. Before 1989, all

[2] Quoted in Victor Sebestyen, *Revolution 1989* (New York, 2009), p. 404.
[3] “In Today’s Mail,” *Magyar Nemzet*, December 15, 1989, p. 6, translated in Joint Publication Research Service, Eastern Europe Report (JPRS-EER), JPRS-EER-90-005, p. 28-29.

the costs associated with the apartment – the "mortgage payments, required insurance, shared coop fees, gas, hot water, heating, and electricity" – came to 3,500 forints per month. That left him with 1,800 forints per month for food, medicine, transportation, and the general costs of life.

The times, however, were changing. Recently, the government had announced a plan to raise gas and electricity prices, which would cost Kezdi "at least an extra 500 forints per month." Officials had also announced plans to tax mortgages like Kezdi's that were subsidized by the government. This would cost him another 800 forints per month. "So far," Kezdi reminded his reader, "this adds up to 4,800 forints." But that was not all. The price of medicine was set to increase 80%, and the price of public transportation would soon go up 45%. This would mean another 200 forints out of Kezdi's pocket. "To sum up," he wrote, "from the monthly 5,300 forints I will have 300 forints left for food, clothes, and a decent human life." This was unacceptable. "I cannot imagine anyone who is able to live on 300 forints a month," he wrote. "I cannot bring myself to steal, rob or cheat; neither my parents nor my teachers taught me how to do these things; my pride does not allow me to beg." The grim prospects left him "no choice," he concluded, but to make his special request. "Respected Mr. Bekesi! Because of the above reasons, and to lighten the burden on the state budget, I repeat my request: Please issue the extra bonus, a strong rope, to me. Thank you in advance, Laszlo Kezdi."[4]

It was no accident that Kezdi's missive appeared at a time of profound political change. Austerity - broadly defined as government policies that *willfully* cause domestic economic hardship - was the cause of Kezdi's sarcastic anger, and it represented a potent political force that affected almost every society on both sides of the Iron Curtain in the last two decades of the

[4] Ibid, p. 29.

competition between democratic capitalism and state socialism.[5] Eight years earlier, in the richest country on earth, the Chairman of the United States Federal Reserve Paul Volcker had felt the brunt of a similar backlash. As his restrictive monetary policy forced the United States into the deepest recession of the postwar period in the early 1980s, construction workers and builders had expressed their anger by mailing the Fed Chairman unused two-by-fours from houses they could no longer build because his policies had wrought havoc on the real estate market. Car salesmen sent coffins to the Federal Reserve full of keys to unsold cars, and farmers blocked the Fed's front entrance with their tractors to protest the rising costs of doing business.[6] The stiff resistance to his policies led Volcker to retrospectively conclude that policymakers always try to avoid causing economic downturns because "that is when the political flak ordinarily hits."[7]

[5] In the interest of narrative, I will use terms such as "democratic capitalism" and "state socialism," "industrialized nations of the West," "state socialist countries of the East," Western bloc and Eastern Bloc, Western welfare states and late socialist regimes, interchangeably throughout the text. I do so with the recognition that there was a great deal of variation within "the West" and "the East," and that any term such as "welfare state," "democratic capitalist," or "late socialist regime" presupposes certain characteristics about nation-states within each bloc that were present in varying degrees in each state. This dissertation, however, is primarily interested in comparing the experience of the two blocs in the global economy of the 1970s and 1980s as a means of explaining the end of the Cold War, so terms that signify what united rather than divided each bloc will have to be used. Therefore, when using any term for the nations of "the West," I am referring to the nations of the Organization for Economic Cooperation and Development (OECD), which in this period included Australia, Austria, Belgium, Canada, Denmark, Finland, West Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. When using any term for the nations of "the East," I am referring to the Soviet Union and the so-called "CMEA six:" Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania.
[6] Kenneth Rogoff, *The Curse of Cash* (Princeton, NJ, 2016), p. 119.
[7] Paul Volcker and Toyoo Gyohten, *Changing Fortunes: The World's Money and the Threat to American Leadership* (New York, 1992), p. 166.

Despite their efforts at avoidance, leaders on both sides of the Iron Curtain were hit with the political flak of austerity many times in the 1970s and 1980s. Oil and financial markets largely determined why and when governments were forced to implement austerity in these years, so the history of oil and finance will anchor the narrative that follows.[8] The political effects of austerity varied widely from country to country, so this dissertation will also explore why the political consequences of austerity were sometimes as small as coffins full of car keys and other times, as in the late 1980s, large enough to topple longstanding social and political orders. The histories of oil, finance, austerity, and political change are, in short, deeply intertwined, and explicating their myriad interactions during the 1970s and 1980s is one subject of this dissertation. The other is the end of the Cold War. If this dissertation accomplishes its goal, it will demonstrate that these two subjects are in fact part of the same global history, and that the end of the Cold War was the most important political consequence of the global history of oil, finance, and austerity that unfolded after the oil crisis of 1973-74.

Perhaps, then, it is best to begin at the end, and identify that which is ultimately to be explained, namely, the end of the Cold War. What was it, and what is required to explain it?[9] I

[8] For nation-states that relied on the production of a single or a few natural resources, why and when their governments were forced to introduce austerity was also determined by the world market price of those natural resources, not just oil. Therefore, at the broadest level, why and when nations had to implement austerity was determined by commodity and capital markets. However, this dissertation will only focus on oil and capital markets because oil was the most important commodity for both the industrialized West and the state socialist regimes of the Eastern Bloc.

[9] Because of the breadth and complexity of the end of the Cold War, it has been the subject of numerous edited volumes that have sought to weave together the subject's many disparate parts. Most of these include very interesting essays that present new archival material and analytical insights. Among the best are Vladimir Tismaneanu, ed., *The Revolutions of 1989* (London, 1999); Silvio Pons and Federico Romero, eds., *Reinterpreting the End of the Cold War: Issues, Interpretations, Periodizations* (New York, 2005); Wolfgang Mueller, Michael Gehler, and Arnold Suppan, eds., *The Revolutions of 1989: A Handbook* (Vienna, AU, 2015); William Wohlforth, ed., *Cold War Endgame: Oral History, Analysis, Debates* (Univerity Park, PA,

believe the end of the Cold War comprised four distinct processes that unfolded at the end of the 1980s,[10] all of which are already the subject of significant popular and scholarly writing - the end of the nuclear arms race between the Soviet Union and the United States;[11] the end of the global ideological competition between democratic capitalism and state socialism;[12] the peaceful and

2003); Jeffrey Engel, ed., *The Fall of the Berlin Wall: The Revolutionary Legacy of 1989* (Oxford, UK, 2009); Mark Kramer and Vít Smetana, *Imposing, Maintaining, and Tearing Open the Iron Curtain: The Cold War in East-Central Europe, 1945-1989* (Lanham, MD, 2014); Richard K. Herrman and Ricahrd Ned Lebow, eds., *Ending the Cold War* (New York, 2004); Olav Njølstad, ed., *The Last Decade of the Cold War: From Conflict Escalation to Conflict Transformation* (London, 2004). Though not a collection of scholarly articles, but instead a collection of primary documents with two introductory essays, Thomas Blanton, Svetlana Savranskaya, and Vladislav Zubok, eds., *Masterpieces of History: The Peaceful End of the Cold War in Europe, 1989* (New York, 2010) is an extremely important contribution to our understanding of the end of the Cold War.

[10] Some may be inclined to include a fifth process, the breakup of the Soviet Union, in the end of the Cold War. But while the collapse of the state socialist regime in the USSR from 1985-1990 was an integral part of the end of the Cold War, the *breakup* of the Soviet Union in 1991 was not. As a geopolitical conflict, the Cold War had started over the Soviet-American contest to determine the fate of postwar Germany. Thus, it ended on October 3, 1990 when the German Democratic Republic was dissolved, and the newly reunited Germany emerged on fully Western terms - democratic, capitalist, and a member of NATO. The breakup of the Soviet Union, therefore, is not part of the end of the Cold War and not part of the dissertation that follows.

[11] Raymond Garthoff, *The Great Transition: American-Soviet Relations and the End of the Cold War* (Washington, DC, 1994); Don Oberdorfer, *The Turn: From Cold War to a New Era, the United States and the Soviet Union, 1983-1991* (Baltimore, MD, 1998); Jack Matlock, Jr., *Reagan and Gorbachev: How the Cold War Ended* (New York, 2004); Melvyn Leffler, *For the Soul of Mankind: The United States, the Soviet Union, and the Cold War* (New York, 2007); James Graham Wilson, *The Triumph of Improvisation: Gorbachev's Adaptability, Reagan's Engagement, and the End of the Cold War* (Ithaca, NY, 2014); Frances FitzGerald, *Way Out There in the Blue: Reagan, Star Wars, and the End of the Cold War* (New York, 2000); James Mann, *The Rebellion of Ronald Reagan: A History of the End of the Cold War* (New York, 2009); an important study that focuses on how changing international norms affected the end of the arms race is Matthew Evangelista, *Unarmed Forces: The Transnational Movement to End the Cold War* (Ithaca, NY, 2002).

[12] Robert English, *Russia and the Idea of the West: Gorbachev, Intellectuals and the End of the Cold War* (New York, 2000), and "Power, Ideas, and New Evidence on the Cold War's End: A Reply to Brooks and Wohlforth," *International Security* 26, No. 4 (Spring 2002); *Journal of Cold War Studies*, "Ideas, International Relations, and the End of the Cold War" (special issue), 7, 2, (Spring 2005). Sarah Snyder, *Human Rights Activism and the End of the Cold War: A Transnational History of the Helsinki Network* (Cambridge, UK, 2011); Daniel Thomas, *The*

democratic collapse of state socialist regimes in Eastern Europe (except for Romania) and the Soviet Union;[13] and the reunification of Germany.[14]

Two things immediately stand out about these four processes. First, they occurred both *within* and *between* nation-states. And second, they involved change in material and ideational structures or, put differently, *power* and *identity*. Each of the processes that comprised the end of the Cold War took place on a continuum of these four traits. A case such as the end of the arms race clearly depended on both diplomacy between the superpowers and domestic politics within

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Helsinki Effect: International Norms, Human Rights, and the Demise of Communism (Princeton, NJ, 2001).

[13] The classic account of the 1989 revolutions is Timothy Garton Ash, *Magic Lantern: The Revolution of '89 Witnessed in Warsaw, Budapest, Berlin, and Prague* (New York, 1990). A highly revisionist account is Stephen Kotkin, *Uncivil Society: 1989 and the Implosion of the Communist Establishment* (New York, 2009). Other monographs focused on explaining change across Eastern Europe in 1989 include Charles Gati, *The Bloc That Failed: Soviet-East European Relations in Transition* (Bloomington, IN, 1990); Gale Stokes, *The Walls Came Tumbling Down: The Collapse of Communism in Eastern Europe* (Oxford, UK, 1993); Padraic Kenney, *Carnival of Revolution: Central Europe 1989* (Princeton, NJ, 2002); Recent scholarly monographs on the collapse of various state socialist regimes include Gregory Domber, *Empowering Revolution: America, Poland, and the End of the Cold War* (Chapel Hill, 2014); Lazlo Borhi, *Dealing with Dictators: The United States, Hungary, and East Central Europe, 1942-1989* (Bloomington, IN, 2016); Mary Sarotte, *Collapse: The Accidental Opening of the Berlin Wall* (New York, 2014); Hans-Hermann Hertle, *Der Fall der Mauer: Die unbeabsichtigte Selbstaufloesung des SED-Staates* (Opladen, DE, 1996). Charles Maier, *Dissolution: The Crisis of Communism and the End of East Germany* (Princeton, NJ, 1997); for US policy toward the revolutions and German reunification, see Robert Hutchings, *American Diplomacy and the End of the Cold War* (Baltimore, MD, 1997); On the collapse of the Soviet regime, see Stephen Kotkin, *Armageddon Averted: The Soviet Collapse 1970-2000* (Oxford, UK, 2008); Christopher Miller, *The Struggle to Save the Soviet Economy: Mikhail Gorbachev and the Collapse of the USSR* (Chapel Hill, NC, 2016); Stephen Solnick's *Stealing from the State: Control and Collapse in Soviet Institutions* (Cambridge, MA, 1999), as well as many works discussed below.

[14] In this dissertation, I do not actually deal with German reunification, but I have a plan to do so for the book. I believe it is a process that very clearly fits within the argument I am making here. Works that have dealt with the history of German reunification so far include Phillip Zelikow and Condoleezza Rice, *Germany Unified and Europe Transformed: A Study in Statecraft* (Cambridge, MA, 1995); Mary Sarotte, *1989: The Struggle to Create Postwar Europe* (Princeton, NJ, 2014); the four volumes of the *Geschichte der Deutschen Einheit* (Stuttgart, DE, 1998, 1999); Angela Stent, *Russia and Germany Reborn: Unification, the Soviet Collapse, and the New Europe* (Princeton, NJ, 1999).

each state. It also depended on significant changes in the relative power of the superpowers and changes in how the Soviet leadership understood its place in the world. The revolutions of 1989 were a different mix of changes in power and identity both within and between nation-states. A perquisite for the revolutions' occurrence was the Soviet Union's decision to refrain from intervening to stop them (a change between states), but they were also crucially determined by developments within Eastern European states. The revolutions resulted from changes in material power (oil and capital markets, I will argue), but also from changes in how state socialist governments understood the socialist identity they had long espoused.

Thus, the first challenge of the history of the end of the Cold War is that it requires explanation of change across four areas – domestic and international, as well as power and identity. In the specific context of the end of the Cold War, I believe that this challenge means that explaining the end of the Cold War *as a geopolitical conflict* requires an explanation of the collapse of communism *as a system of governance*. The eminent Soviet expert Archie Brown has written, "It is impossible to understand how the Cold War came to an end…without an understanding of the Soviet domestic political context."[15] Indeed, but one must not stop there, as most scholars, including Brown, do. Revolutions are domestic processes, and the fact that there were many across Eastern Europe in 1989 indicates that the domestic context of Eastern European states must be taken into consideration as well. The necessity of including processes of domestic change means that any history of the end of the Cold War that only considers developments in international relations will be incomplete.[16] The same holds true for material

[15] Archie Brown, *Seven Years that Changed the World: Perestroika in Perspective* (New York, 2007), p. 253.
[16] This is the overriding limitation of strictly diplomatic histories and realist explanations of the end of the Cold War. For all of its new archival research and intricate detail, the most recent diplomatic history of the end of the Cold War, Robert Service's *The End of the Cold War, 1985-*

and ideational structures. Any explanation that considers only one or the other will be inherently limited.[17] The end of the Cold War occurred both within and between nation-states, and it involved changes in both power and identity. Therefore, its history must include explanations of change across all four of these areas.

The second, and most difficult, challenge of explaining the end of the Cold War is that it stands out in modern history for one very profound reason - at every step of the way, those in possession of imperial and authoritarian power *willingly* and *peacefully* gave it up. John Lewis Gaddis, the dean of Cold War historians, succinctly summarized just how confounding and unprecedented this development was in a 1999 essay. "Wars, hot or cold, do not normally end with the abrupt but peaceful collapse of a major antagonist," he wrote. "Such an event had to have deep roots, and yet neither our histories nor our theories came anywhere close to detecting these."[18] Neither history nor theory detected the end of the Cold War because nothing in modern history suggested anything like it was possible.[19] And yet, as the previous paragraph just

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1991 (New York, 2015), remains a history of great power diplomacy that cannot adequately explain the revolutions of 1989.

[17] This is the limitation of the long running debate between realists and constructivists within political science over the end of the Cold War. Both sides are convinced of the primacy of *either* material or ideational change, but have so far failed to convince the other side of how one influenced the other in the late Cold War. See Stephen G. Brooks and William Wohlforth, "Power, Globalization, and the End of the Cold War: Reevaluating a Landmark Case of Ideas," *International Security* 25, no. 3 (Winter 2000-2001), and Robert English, "Power, Ideas, and New Evidence on the Cold War's End: A Reply to Brooks and Wohlforth," *International Security*, Vol. 26, No. 4 (Spring, 2002), pp. 70-92.

[18] John Lewis Gaddis, "On Starting All Over Again: A Naïve Approach to the Study of the Cold War," in Arthur Rosenbaum and Chae-Jin Lee, eds., *The Cold War: Reassessments* (Claremont, CA, 1999), p. 3.

[19] Perhaps no better example of this came from Paul Kennedy, who in his sweeping and otherwise authoritative account of international politics in the modern period, *The Rise and Fall of the Great* Powers, concluded in 1987, just two years before the collapse of the Soviet empire, "There is nothing in the character or tradition of the Russian state to suggest that it could ever accept imperial decline gracefully. Indeed, historically, *none* of the overextended, multinational empires…the Ottoman, the Spanish, the Napoleonic, the British – ever retreated to their own

stressed, this exceptional development occurred both within and between nation-states. The Soviet Union retreated from its pursuit of global confrontation with the United States as well as its empire in Eastern Europe, and at the same time, political leaders throughout the Eastern Bloc gave up power peacefully within their own societies (with Nicolae Ceaușescu in Romania again serving as a brief exception). This unique and fundamental characteristic of the end of the Cold War is what made it so difficult to predict before it occurred and continues to make it so difficult to explain in retrospect. As Gaddis wrote in 1999, "Historians are still at the stage of saying, in effect: 'here's what happened, don't push us on why."[20] Of course, scholars have made great strides in understanding parts of the end of the Cold War since Gaddis's essay, but his words serve as warning. Explanations of the end of the Cold War that lack a compelling reason for why those in possession of imperial and authoritarian power consistently gave it up in the late 1980s will remain stuck at the stage Gaddis identified – fully capable of explicating what happened, but unable to explain why it happened.

A third challenge of the history of the end of the Cold War is that of timing. Gaddis, again, put it nicely. He titled his essay, "On Starting All Over Again: A Naïve Approach to the Study of the Cold War," and he set out to imagine how a Martian, with "no prior memory or knowledge or understanding of the Cold War," would view the conflict upon first learning about it. The first "naïve impression" a Martian would have, Gaddis posited, would be that "The Cold

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ethnic base until they had been defeated in a Great Power war, or (as with Britain after 1945) were so weakened by war that an imperial withdrawal was politically unavoidable." Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York, 1987), p. 514.

[20] He added, "The theorists' performance is even less impressive: I have the uneasy sense that international relations theory is still being taught pretty much as if the Cold War had never ended." Gaddis, "On Starting Over," p. 4.

War went on for a very long time, and then all of a sudden it went away."[21] Indeed, the question of why the Cold War persisted for four decades and then suddenly, in the late 1980s, disappeared is of predominant importance.[22] Thus, any compelling explanation of the end of the Cold War must attend not only to the question of why, but also why *then*?

The last challenge of the history of the end of the Cold War is to explain the character of its principal outcome: the emergence, with varying degrees of success and legitimacy, of market economies and electoral democracies in the nation-states that formerly comprised the Eastern Bloc. In retrospect, it is easy to take these outcomes for granted, but as the end of the Cold War unfolded, few believed them to be foregone conclusions. Francis Fukuyama's declaration in the summer of 1989 that the end of History had been reached and that the future would be dominated by capitalism and democracy was a bold (and in retrospect, unfounded) prediction, not a statement of the consensus viewpoint. The foreign policy of the George H.W. Bush administration, which tried to slow the pace of change in Eastern Europe for fear of what might come next, is a better guide to the thinking of the period. It speaks to the broader concern in both Western and Eastern capitals about the range of possible outcomes that could follow state socialism. Some believed market socialism was possible; others feared that reactionary nationalism was imminent.[23] Since market economies and electoral democracies were not

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[21] Gaddis, "On Starting All Over Again," p. 3.

[22] An innovative and forceful argument for why the Cold War persisted for so long is put forth in Campbell Craig and Fredrik Logevall, *America's Cold War: The Politics of Insecurity* (Cambridge, MA, 2009), where the authors argue that powerful entities within American government and society inflated the threat posed by the Soviet Union and communism because they had a vested interest in the Cold War's perpetuation.

[23] On the prospects of market socialism, see Johanna Bockman, *Markets in the Name of Socialism: The Left-Wing Origins of Neoliberalism* (Stanford, CA, 2011). On the foreign policy of the first Bush administration, see Beschloss and Talbott, *At the Highest Levels: The Inside Story of the End of the Cold War* (Boston, MA, 1993); James Baker with Thomas DeFrank, *The*

predetermined, why did they emerge? Answering this question is the final challenge of writing the history of the Cold War's end.

Therefore, explaining the end of the Cold War is, to say the least, a tall order. As I have defined it, the end of the Cold War as a geopolitical conflict was dependent on the collapse of communism as a system of governance. It involved four processes that occurred both within and between nation-states – the end to the nuclear arms race, the end of the ideological competition between democratic capitalism and state socialism, the peaceful and democratic collapse of state socialist regimes in the Eastern Bloc, and the reunification of Germany. These were changes in both power and identity, and explaining them requires answering three questions – Why did the holders of imperial and authoritarian power in the Eastern Bloc willingly give it up? Why did they do so at the end of the 1980s? And why did market economies and electoral democracies emerge from the ashes of state socialist regimes?

One way to address a tall order (particularly when writing a dissertation) would be to split it into many smaller ones, and tackle one or two components of the larger challenge. The foremost scholars of Cold War and European history, however, have not been calling for such an approach. Upon reviewing a large group of historical monographs that appeared to mark the twentieth anniversary of the revolutions of 1989, Timothy Garton Ash, one of the leading chroniclers of those momentous events, wrote that he came "away dreaming of another book: the global, synthetic history of 1989 that remains to be written." Besides stating that such a history would have to "empathiz[e] both with powerholders and with so-called ordinary people,"[24] he

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Politics of Diplomacy (New York, 1995); George Bush and Brent Scowcroft, *A World Transformed* (New York, 1998).

[24] Timothy Garton Ash, "1989!", *New York Review of Books*, Nov. 5, 2009, http://www.nybooks.com/articles/2009/11/05/1989/, Accessed April 20, 2017.

did not elaborate in any great detail on what a global “synthetic” history would entail. Gaddis’s essay from a decade earlier, however, provided a similar and more prescriptive call. The fact that the end of the Cold War “had to have deep roots” that scholars had missed led him to ask “What would it take…to achieve an interpretive breakthrough that would account for why the Cold War lasted so long but ended so abruptly – and so peacefully?” As a first practical suggestion, he wrote that historians would have “to back off from their preoccupation with particular trees to look at the forest as a whole.” Second, scholars would “have to abandon a definition of power that accords primacy to military capabilities.” And lastly, in a message intended for international relations theorists, Gaddis believed that scholars would “have to jettison the curious belief that there can ever be, in this complex and inter-related world, such a thing as an independent variable.”[25]

So, what has become of these new interpretive, “synthetic” approaches? Oddly, since Gaddis’s essay in 1999, it has not been international relations theorists, but rather historians, that have shown an inclination to reduce the end of the Cold War to an independent variable, though they do not usually refer to him as such. Mikhail Gorbachev looms ever larger in the historiography, and one gets the strong sense from the current scholarly literature that, like an independent variable, Gorbachev’s exogenous shock to Soviet society and the Cold War was the essential cause of the conflict’s end. In his 1996 monograph, *The Gorbachev Factor*, which defines the field to this day, the Soviet expert Archie Brown argued that Gorbachev was “a highly untypical product of the Soviet *nomenklatura*” who “did more than anyone else to end the Cold War between East and West.” With regard to the events of 1989, he went so far as to argue that they required “no elaborate explanation” because “the stimulus of radical reform in the

[25] Gaddis, “On Starting All Over Again,” p. 4-5.

Soviet Union, the new Moscow doctrine of freedom to choose, and *above all*, the growing (and accurate) perception that the Soviet Union would no longer intervene to uphold Communist party rule" were the "main factors" in explaining "the *timing* of the overthrow of Communist systems through East and Central Europe."[26] Since then, every leading historian of the end of the Cold War – Mark Kramer, Stephen Kotkin, Vladislav Zubok, Gaddis, Melvyn Leffler, Jacques Lévesque, Svetlana Savranskaya, Thomas Blanton, and many others – has echoed Brown's conclusion in their own work.[27] In each of the four processes I have identified as comprising the end of the Cold War, Gorbachev reigns supreme as an exceptional figure who drove history forward.[28]

This Gorbachev consensus has been used to reject the three most prominent competing explanations for parts of the end of the Cold War – that the cause for change came from the

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[26] Archie Brown, *The Gorbachev Factor* (Oxford, UK, 1996), pp. 316-17, 247.

[27] Kramer's scholarship has been the standard bearer, which others have followed, and thus it is worth quoting, "The sweeping political reforms launched by Gorbachev within the USSR and the bold changes he carried out in Soviet foreign policy helped generate unrest and instability in Eastern Europe," he writes. Kramer, "The Collapse of East European Communism and the Repercussions within the Soviet Union, Part 1," Journal of Cold War Studies, Vol. 5, No. 4 Fall 2005, pp. 178-256, quote at 180. This article, along with Kramer, "The Demise of the Soviet Bloc," *Journal of Modern History*, Vol. 83, No. 4 (Dec. 2011), pp. 788-854, are the definitive works to date on the Soviet role in 1989. Zubok concludes that "the Soviet endgame" can "be explained only by reference to Gorbachev's peculiar preferences and personality traits." Zubok, *A Failed Empire*, p. 335. Lévesque has argued "Soviet acceptance of the collapse of East European Communist regimes in 1989 must be considered the single most significant event leading to the end of the Cold War." Jacque Lévesque, "The East European Revolutions of 1989," in *The Cambridge History of the Cold War*, Vol. 3, p. 311. See also his *The Enigma of 1989: The USSR and the Liberation of Eastern Europe* (Berkeley, 1997). Gaddis, *The Cold War: A New Cold War History* (New York, 2006), p. 238. Melvyn Leffler, *For the Soul of Mankind* (New York, 2007), p. 448.

[28] On ending the arms race, recent scholarship has recognized Reagan's vision of a nuclear free world as important, but Gorbachev remains the primary force for change. See Wilson, *The Triumph of Improvisation*. On ending the ideological competition, see Robert English, *Russia and the Idea of the West*. On the collapse of state socialist regimes, see previous footnote, and on German reunification, see Sarotte, *1989*.

West, and specifically the administration of Ronald Reagan; that the cause for change came "from below," i.e. from the peoples of Eastern Europe; and that the cause for change came from a growing structural crisis within the Soviet Union in the early to mid-1980s that made Gorbachev's reforms unexceptional and even highly likely. First, besides adherents to the so-called Reagan victory school, few scholars – John Lewis Gaddis being a notable exception – hold the view that American policy caused the end of the Cold War in any significant way.[29] In a conclusion that represents the prevailing consensus, Melvyn Leffler has written, "Reagan's greatest contribution to ending the Cold War was not the fear he engendered but the trust he inspired" at the highest levels of the Soviet-American relationship. Nevertheless, "It was Gorbachev who ended the Cold War."[30] Second, an early wave of popular authors and social scientists argued that the revolutions of 1989 were, to a significant degree, the result of a broad push for freedom by the peoples of Eastern Europe.[31] In a conclusion that has gained the support of most scholars, Mark Kramer has rejected this 'revolution from below' narrative, writing, "What changed in 1989, compared to earlier crises in Eastern Europe, was not the depth of popular opposition to the Soviet-backed regimes. Instead, what changed was the whole thrust of Soviet policy in the region."[32] Third, proponents of realist international relations theory, most notably William Wohlforth, have argued that Soviet economic decline had reached such a severe

[29] Peter Schweizer, *Victory: The Reagan Administration's Secret Strategy that Hastened the Collapse of the Soviet Union* (New York, 1994); Schweizer, *Reagan's War: The Epic Story of his Forty-Year Struggle and Final Triumph Over Communism* (New York, 2002); Roger Robinson, Jr., "Reagan's Soviet Economic Take=Down Strategy: Financial and Energy Elements," in Douglas Streusand, ed., *The Grand Strategy That Won the Cold War: Architecture of Triumph* (Lanham, MD, 2016), pp. 159-74.
[30] Leffler, *For the Soul of Mankind*, p. 448.
[31] Garton Ash's *The Magic Lantern* was and remains the leading example of this interpretation. Sarotte's *Collapse* is a particularly strident recent restatement of this view with regard to the opening of the Berlin Wall.
[32] Kramer, "The Demise of the Soviet Bloc," p. 788.

point by the early 1980s that Soviet leaders had "few options" other than "engagement," "retrenchment," and "to sue for peace on the best possible terms."[33] Archie Brown has consistently criticized Wohlforth and his collaborators, calling their ideas "far-fetched in the extreme" and declaring it "quite wrong to imagine that the Soviet Union *was forced* to change its foreign policy comprehensively" because of economic factors.[34] Thus, pressures from the West, from below in Eastern Europe, and from within the Soviet economic system have been consistently discounted. The leading scholars in Cold War, Soviet, and European history have concluded that the end of the Cold War is scarcely thinkable without the exceptional "Gorbachev Factor."

On its face, this Gorbachev consensus explains a great deal of the end of the Cold War as I have defined it. Clearly, the Soviet General Secretary had an effect both within and between nation states as well as on the material power and socialist identity of the Eastern Bloc. He was central to the end of the Cold War as a geopolitical conflict and the collapse of communism as a system of governance. This means he played a role, sometimes a predominant one, in the four processes I have defined as comprising the end of the Cold War – ending the arms race, ending the ideological competition, the collapse of state socialist regimes in the Eastern Bloc, and the

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[33] Randall Schweller and William Wohlforth, "Power Test: Evaluating Realism in Response to the End of the Cold War," *Security Studies*, 9, 3 (2000), pp. 60-107, quote at p. 85. Wohlforth has a long line of publications defining and defending this position, including "Power, Globalization, and the End of the Cold War: Reevaluating a Landmark Case of Ideas," *International Security* 25, no. 3 (Winter 2000-2001), Stephen Brooks and William Wohlforth, "Economic Constraints and the End of the Cold War," in Wohlforth, ed., *Cold War Endgame: Oral History, Analysis, and Debates* (University Park, PA, 2003). and "No One Loves a Realist Explanation: The Cold War's End Revisited," *International Politics* Vol. 48: Nos. 4/5 (July/September 2011).

[34] Italics original, Brown, *Seven Years That Changed the World*, p. 247-248. Evangelista concurs in much more measured language. "The economic situation did not determine the nature of Gorbachev's initiatives. Economic conditions have always been poorly correlated with periods of Soviet retrenchment or moderation." Evangelista, *Unarmed Forces*, p. 377.

reunification of Germany. And when thought of as an exceptional, anomalous, or exogenous figure in Soviet and Cold War history, Gorbachev can answer at least two of the three questions I defined as essential to the end of the Cold War. Why did those who held imperial and authoritarian power willingly give it up throughout the Eastern Bloc? They did so because Gorbachev, as Jacques Lévesque concluded, was motivated by a "rarely" seen "idealistic view of the world…in which the image of the enemy was constantly blurring, to the point of making it practically disappear."[35] Without strong Soviet support, this line of reasoning continues, the authoritarians of Eastern Europe simply lost "heart" and gave up their power peacefully.[36] For the Gorbachev consensus, the question of timing takes care of itself. Why all this happened in the late 1980s requires "no elaborate explanation," as Brown put it, because that was when Gorbachev appeared on the scene. Jack Matlock, the American ambassador to the Soviet Union in the late 1980s and author of two highly regarded books on the end of the Cold War, has written, "To understand why the Cold War ended in 1989 rather that 2089…we must think about the decisions that actual people made. Impersonal social and economic trends may have molded the environment in which decisions were made, but it was decisions made by political leaders that determined the timing and character of events."[37] For those who study the emergence of market economies and electoral democracies in the former Eastern Bloc, Gorbachev alone does not explain everything because the leading figures of Eastern European civil society played an

[35] Lévesque, *The Enigma of 1989*, p. 252.
[36] "Heart" from Kramer, "Demise of the Soviet Bloc," p. 789. The argument that the Communist establishments of Eastern Europe simply gave up in 1989 is the thrust of Kotkin's *Uncivil Society*, where the author uses the mechanisms described in Stephen Solnick's *Stealing from the State: Control and Collapse in Soviet Institutions* (Cambridge, MA, 1999) to argue that the Eastern Europe experienced a political "bank run" in 1989 as members of the communist establishment fled the ruling coalition *en masse*. For reasons that will be made clear later in this dissertation, this mechanism for describing change in the Eastern Bloc is empirically incorrect.
[37] Jack Matlock, *Autopsy of an Empire*, p. 649.

essential role in constructing the post-communist systems. But even here, Gorbachev is viewed as the first cause without which nothing else was possible. Stephen Kotkin has written, "Freedom...came in varying degrees to the countries of Eastern Europe" after 1989, but "outcomes do not mean causation. The revolutions of 1989 did not happen *because* of a broad freedom drive." Rather, they were "precipitated by Gorbachev's unilateral removal of the Soviet backstop."[38]

There are two significant problems with this entire line of explanation, however. One is empirical, and the other is methodological. First, empirically, the dissertation that follows will demonstrate that the Gorbachev consensus is wrong about its most important point. *Mikhail Gorbachev did not cause the revolutions of 1989*.[39] That he did is perhaps the most fundamental causal assumption in the historiography of the end of the Cold War,[40] but it is not supported by

[38]Stephen Kotkin, *Uncivil Societies,* p. xvii. Scholars as varied as Tony Judt, Eric Hobsbawm, and Mark Kramer would agree. See Judt, *Postwar*, p. 695. Hobsbawm, *The Age of Extreme: A History of the World, 1914-1991* (New York, 1996), p. 487. Kramer, "The Demise of the Soviet Bloc," p. 788. Vladimir Tismaneanu shares this viewpoint to a certain extent as well. See "Rethinking 1989," in Tismaneanu, ed., *The End and the Beginning: The Revolutions of 1989 and the Resurgence of History* (Budapest, HU, 2012), p. 20.

[39] Stated more technically, Gorbachev may have been a necessary condition, but he was far from a sufficient condition, to cause the revolutions of 1989.

[40] Mark Kramer writes, "The sweeping political reforms launched by Gorbachev within the USSR and the bold changes he carried out in Soviet foreign policy helped generate unrest and instability in Eastern Europe." See, Kramer, "The Collapse of East European Communism and the Repercussions within the Soviet Union, Part 1," Journal of Cold War Studies, Vol. 5, No. 4 Fall 2005, pp. 178-256, quote at 180. Francesco Benvenuti and Silvio Pons have written, "the 'abdication of communist regimes in eastern Europe [was] an unforeseen, if eventually accepted, consequence of *perestroika*," in "The End of Soviet Communism: A Review," in *Reinterpreting the End of the Cold War*, p. 201. "Encouraged by Mikhail Gorbachev's policies of reform, rapprochement, and nonintervention, Hungary and Poland initiated democratic reforms in the summer of 1989," reads the opening line of James Davis and William Wohlforth, "German Reunification," in Richard Herrmann and Richard Ned Lebow, eds., *Ending the Cold War: Interpretations, Causation, and the Study of International Relations* (New York, 2004), p. 131. In her recent book, *The Collapse*, Mary Sarotte writes, "In both Warsaw and Budapest Gorbachev's actions provoked real change. In Poland, the independent Solidarity labor movement seized upon the new era of openness to convince the Polish ruling party to meet for

the archival record. In fact, as I will expand on in the conclusion, there is significant reason to think that all of the conditions for revolution in Eastern Europe would have been present in the late 1980s had Gorbachev never become General Secretary of the Soviet Union in 1985. And if it is true that Gorbachev did not cause the revolutions of 1989, then the question of what did cause them becomes wide open. To answer it, we must point out and move past the methodological problem with the reigning Gorbachev consensus. As long as Gorbachev remains the linchpin of the entire story, there is very little reason to explore the long-term causes of the end of the Cold War in any way that does not add to our understanding of Gorbachev himself or the "new thinking" he espoused.[41] Did the end of the Cold War have "deep roots," as Gaddis thought it must in 1999? Or was it merely a fortuitous confluence of events flowing from the unique influence of one man? In the shadow of the Gorbachev consensus, historians have settled for the conclusion that it must have been the latter.

But the end of the Cold War *did* have deep roots, and it is the task of this dissertation to explain them. Three of the leading scholars of Cold War, European, and Soviet history – Gaddis, Charles Maier, and Kotkin – have each in their own way laid out pieces of an approach to studying the deep roots of the end of the Cold War, and this dissertation will take up their agendas. First, the "naïve impressions" that Gaddis discovered led him to the following

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roundtable talks and to discuss possibilities for gradual democratization." Sarotte, Mary Elise (2014-10-07). *The Collapse: The Accidental Opening of the Berlin Wall* (Kindle Locations 778-780). Basic Books. Kindle Edition.

[41] And, indeed, these are the "long-term" subjects that have garnered scholars' attention. On the influence of human rights discourses on Gorbachev and the Eastern Bloc, see Snyder, *Human Rights Activism and the End of the Cold War* and Thomas, *The Helsinki Effect*. On the origins of the "new thinking," see English, *Russia and the Idea of the West* and Miller, *The Struggle to Save the Soviet Economy*, chapter 1 and 2. A notable and insightful exception is Yegor Gaidar, *The Collapse of an Empire: Lessons for Modern Russia*, Antonina Bouis, trans., (Washington, DC, 2007).

observation. "It is worth recalling that two of the most striking revolutions in the history of science – Darwin's and Einstein's – came with the recognition…that objects and organisms evolve, that structures and processes are related to one another." If historians thought in these terms, he wrote, it might lead them "to think of great powers as living organisms who have to stay healthy while adapting themselves to shifting environments. Some manage it, others do not."[42] This evolutionary approach helpfully draws our attention away from the old scholarly debate over how the Eastern and Western blocs perceived threats from each other, and instead draws it to how they perceived threats and pressures from their environment. Perhaps, then, thinking along with Gaddis, the end of the Cold War was the product of nation-states adapting (and failing to adapt) to changes in the international system, and the collapse of communism as a system of governance should be thought of as an extinction.[43]

The question then becomes what changes in the international system were driving nation-states' adaptation and what threats drove communism's extinction. Eight years before Gaddis called for an evolutionary approach to the end of the Cold War, Charles Maier was thinking in similar terms, and he specifically pinpointed the global economy as the driving force behind adaptation. "*Some of the crises of communism have also been crises for capitalism*," he wrote in a 1991 article laying out an agenda for future historians of the collapse of communism. "Each system paid for them in different ways. Comparative analysis helps." Both capitalism and

[42] Gaddis, "On Starting All Over Again," pp. 4, 8.
[43] It is noteworthy that the most recent and innovative treatments of American foreign relations in the 1970s and 1980s, Daniel Sargent's *A Superpower Transformed: The Remaking of the American Foreign Relations in the 1970s* (Oxford, UK, 2015) and Hal Brands's, *Making the Unipolar Moment: US Foreign Policy and the Rise of the Post-Cold War Order* (Ithaca, NY, 2016), respectively lay emphasis on how the United States had to "adapt" in the 1970s and then benefited from "deeply rooted international phenomena" in the 1980s. Extinction was precisely the term Ken Jowitt used to discuss the collapse of socialism. See Ken Jowitt, *New World Order: The Leninist Extinction* (Berkeley, CA, 1992).

communism, he wrote, "have been subject to severe long-term difficulties. The superiority of the Western economies lay not in their immunity to these systemic challenges, but in their capacity to overcome them." The collapse of communism, for Maier, "was a reaction to forces for transformation that have gripped West and East alike, but which Western Europeans (and North Americans) had responded to earlier and thus with less cataclysmic an upheaval."[44] In the years that followed, Maier expounded on this viewpoint in a highly regarded monograph on the collapse of East Germany.[45] But by 2010, he was still urging historians to investigate "what relationship the crisis that so lethally afflicted the European Communist regimes in the 1980s had to the crisis that Western economies had undergone from the late 1960s to the end of the 1970s." He noted that "most narratives make no connection between the two," but he nevertheless believed that they were "two phases of one epoch of unrest confronting the industrial world – capitalist and communist."[46]

So, too, does Stephen Kotkin. The noted Soviet historian began the first chapter of his history of the collapse of the Soviet Union, *Armageddon Averted*, not in Moscow or Leningrad, but in the industrial heartlands of the West - Bethlehem, Pennsylvania; Gary, Indiana; Sheffield, England; and the Ruhr Valley of West Germany. The oil crisis of 1973-74, he wrote, put "the entire fossil-fuel industrial economy" on a path "towards extinction." It caused a "wrenching of industries and communities" throughout the West, as factories closed by the thousands and millions of workers lost their jobs. But over the long term, these processes of economic

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[44] Italics original to the article. Charles Maier, "The Collapse of Communism: Approaches for a Future History," *History Workshop*, No. 31 (Spring, 1991), pp. 34-59.
[45] Maier, *Dissolution: The Crisis of Communism and the Collapse of East Germany*.
[46] Quotes from Maier, "Malaise: The Crisis of Capitalism in the 1970s," in Ferguson et. al. eds., *The Shock of the Global: The 1970s in Perspective*, p. 45.

adjustment constituted “a crossroads leading to a resounding triumph in the cold war [*sic*].”[47] Because of its own oil boom in the 1970s, the Soviet Union and its Eastern Europe satellites were temporarily exempt from this crisis in the West, “but [oil] merely delayed the inevitable” adjustment, Kotkin wrote. When economic reform began under Gorbachev, political collapse soon followed. Socialism, Kotkin concluded, “proved very good – too good – at putting up a rust belt; and, unlike a market economy, socialism proved very bad at taking its rust belt down.”[48]

Alongside the history of oil, Kotkin has also placed the end of the Cold War in the context of the Eastern Bloc’s reliance on Western capital markets.[49] In a 2009 book and 2010 book chapter, he argued that “The regimes [of Eastern Europe] lacked the political legitimacy to take the necessary hard measures of a structural [economic] adjustment, such as cutting off subsidies (that is, raising prices) and throwing people out of work in the worst-performing sectors.” As a result, “they needed continued access to Western capital markets…for their

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[47] Kotkin, *Armageddon Averted*, pp. 12-13, 15.
[48] Ibid, p. 17.
[49] Others scholars, less well known in Cold War history, have also ably investigated this economic history of Eastern European socialist regimes and their dependence on Western capital. For the region as a whole, see Derek Aldcroft and Steven Morewood, *Economic Change in Eastern Europe since 1918* (Aldershot, UK, 1995) and Ivan Berend, *From the Soviet Bloc to the European Union: The Social and Economic Transformation of Central and Eastern Europe Since 1973* (Cambridge, UK, 2009). For Poland, see Kazimierz Poznanski, *Poland’s Protracted Transition: Institutional Change and Economic Growth* (Cambridge, UK, 1996). For East Germany, see Hertle, *Der Fall der Mauer*; André Steiner, *Plans that Failed: An Economic History of the GDR* (New York, 2010); Jeffrey Kopstein, *The Politics of Economic Decline in East Germany, 1945-1989* (Chapel Hill, NC, 1997); and Jonathan Zatlin, *The Currency of Socialism: Money and Political Culture in East Germany* (New York, 2007). For Hungary, see Berend, *Hungarian Economic Reforms: 1953-1988* (Cambridge, UK, 1990); Roger Gough, *A Good Comrade: János Kádár, Communism, and Hungary* (London, 2006); and Attila Mong, *Kádár Hitele* (Budapest, HU, 2012).

survival."[50] In a causal chain that was less than clear, Kotkin argued that this dependence on Western capital combined with Gorbachev's repeal of the Brezhnev Doctrine to produce "the equivalent of political bank runs" in 1989, during which elites within Eastern European regimes began to sense that their time was running short and decided to give up power peacefully.[51] "The GDR was a Ponzi scheme that fell in a bank run," he wrote.[52] The fact that the argument was framed as a metaphor pointed to its central weakness – Kotkin still could not explain how the history of Western capital markets and Soviet oil actually, not metaphorically, caused the revolutions of 1989. This weakness left him open to severe scrutiny, with Timothy Garton Ash writing in the *New York Review of Books* that Kotkin's general explanation was "revisionism on stilts" and that his history of East Germany's 1989 was "little short of ludicrous."[53]

Thus, from the work of Gaddis, Maier, and Kotkin, the outline of a new history of the end of the Cold War has emerged, but the challenge that remains is clear. The end of the Cold War should be examined as an evolutionary process in which nation-states reacted to profound changes in the global economy that followed from the oil crisis of 1973-74. The most important of these changes occurred on oil and financial markets, and these markets in turn influenced why and when governments in both East and West had to inflict economic pain on their own populations. And yet to hit its mark and demonstrate that the end of the Cold War was a political consequence of the intertwined history of oil, finance, and austerity, this agenda will still have to

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[50] Kotkin, "The Kiss of Debt," in Ferguson et. al. eds., *The Shock of the Global*, pp. 80-93, quotes at 80 and 89.

[51] Kotkin, *Uncivil Society*, p. 34. Here he was relying on Steven Solnick's model for explaining the collapse of the Soviet Union, "stealing from the state." See Solnick, *Stealing from the State*.

[52] Ibid, p. 61.

[53] Garton Ash, "1989!," *New York Review of Books*, Nov. 5, 2009, http://www.nybooks.com/articles/2009/11/05/1989/, Accessed April 20, 2017.

meet the very high standards historians have set for explaining the discrete events of the end of the Cold War. What influence, *exactly*, did these long-term trends in the global economy have on, for instance, the signing of the Intermediate-Range Nuclear Forces (INF) Treaty, the launch of glasnost, the repeal of the Brezhnev Doctrine, the start of the Polish Roundtable, and the fall of the Berlin Wall? How *exactly* did economic change lead to political and ideological change? How, in short, can this research agenda *exactly* explain the processes and answer the questions that I have identified in this introduction as essential to any compelling history of the end of the Cold War?

It can do so on the basis of two foundations: the use of new and illuminating evidence from archives in both East and West, and the formulation of a new framework for connecting economic and political change in the late Cold War. The new archival evidence will be presented in the chapters that follow, but for now, it is the new framework that needs to be introduced. This framework begins from the conviction that the oil crisis of 1973-74 spurred a fundamental change in the global competition between capitalism and communism: it privatized the Cold War.

The Privatization of the Cold War

During the first twenty-five years of the Cold War, oil and financial markets played relatively small roles in the foreign and domestic policies of the Eastern and Western blocs. Until its collapse in 1971, the Bretton Woods system pegged Western currencies to each other at fixed values and severely restricted flows of capital across national borders in the Western world. The global financial markets that would come to play such a large role in the 1970s and 1980s did not exist in the 1940s, hardly existed by the end of the 1950s, and remained relatively small through the 1960s. The Eastern Bloc did not participate in the Bretton Woods system, but its member states maintained even firmer control over trade and finance than their Western counterparts. Eastern bloc currencies were not convertible into each other or Western currencies, which meant that they too were completely under governmental control. And other than the Soviet Union, which maintained a banking presence in the West to conduct international trade, the bloc as a whole remained isolated from the nascent development of global financial markets.

As for oil, it was cheap and plentiful in the capitalist world, and cheap and scarce in the communist world until the early 1970s. This simultaneous ubiquity in the West and scarcity in the East ironically made it less important in both blocs than it would become after 1973. In the West, oil's low price and uninterrupted flow allowed governments to build mass consumption industrial societies after the Second World War that showed little regard for oil's use or country of origin. Only after 1973 would Western societies awaken to the implications of their fervent consumption of a commodity whose price and production levels they did not control.[54] In the East, the Soviet government spent the 1950s searching its vast hinterland for oil deposits, and in the 1960s, it struck black gold in Western Siberia, where it found some of the largest oil fields in the world. Developing these fields took time, so it was only in the early 1970s, right before the oil crisis struck, that the Soviet Union and, by extension, the entire Eastern Bloc enjoyed "for the first time the luxury of cheap and efficient energy."[55] After the oil shock, this luxury would also fill the state coffers through oil exports to the world market, and energy would become the material basis of Soviet power. That was squarely a post-1973 development, however. For the

[54] This is not to deny, of course, that Western governments, particularly the United States, were keenly aware of oil significance and conducted geopolitics to secure oil's flow from the Middle East. See David Painter and Daniel Yergin, among others.
[55] Thane Gustafson, *Crisis Amid Plenty: The Politics of Soviet Energy Under Brezhnev and Gorbachev* (Princeton, NJ, 1989), p. 23.

first two and a half decades of the Cold War, neither oil nor finance played significant roles in both the East and West.

Instead of oil or finance, both Eastern and Western states based their power and legitimacy before 1970 on something else: economic growth. After World War II, the global economy grew for two and a half decades at an unprecedented and almost uninterrupted rate. People around the world, but particularly within the Eastern and Western blocs, experienced sustained increases in their standard of living on a scale never before seen in human history. In the capitalist world, this period would be remembered under a number of names that signal its uniqueness: the West Germans called it the *Wirtschaftswunder* (economic miracle), the French called it *les trente glorieuses* ("the glorious thirty" years), and historians now simply refer to it as "The Golden Age."[56] Not to be outdone, the Eastern Bloc matched and, for a while, even exceeded the growth of the capitalist West. Over the entire period 1951-73, per capita GDP grew at an annual rate of 3.7% in the industrial West as a whole, while it grew at a rate of 4.0% in Eastern Europe and 3.6% in the Soviet Union.[57] Of course, the two blocs were not economic equals. The West began the postwar period as a vastly richer territory, and remained vastly richer in the early 1970s. Moreover, mass consumption became a reality in the West while it remained only a far-off aspiration in the East.

Nevertheless, economic growth underwrote an important shared tenant in the politics in both blocs. Both capitalist and communist governments used this economic boom to expand the social contracts that underlay their domestic legitimacy. They partook in what I will call the

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[56] Hobsbawm, *The Age of Extremes*, Part 2. Barry Eichengreen, *The European Economy Since 1945: Coordinated Capitalism and Beyond* (Princeton, NJ, 2007), chapters 4 and 7.
[57] Table 18. "Selected Macroeconomic Indicators, 1951-88," *World Economic Outlook: A Survey by the Staff of the International Monetary Fund*, May 1990, (Washington, DC, 1990), p. 65.

Politics of Making Promises. Indeed, after the economic horrors of the Great Depression had given rise to fascism and world war, it was a fundamental premise of political life in both East and West after 1945 that government's first and most fundamental domestic responsibility was to improve the economic security and prosperity of all its people. The two systems fundamentally disagreed about what mix of economic security and prosperity was best – unable to match the West's prosperity, communist governments promised their citizens greater economic security – but both systems professed to provide both. Across the West, welfare states emerged to redistribute the economic gains of the market, and labor unions were empowered to allow the working class to share equitably in the benefits of growth. In the East, Soviet General Secretary Nikita Khrushchev famously used the Soviet Union's decade of stellar economic growth and scientific advancements in the 1950s to declare that the country would reach communism – the final stage of economic advancement and social organization in Marxism-Leninism – by 1980. Along the way, the government would provide its citizens with free housing, plentiful food, quality education and healthcare, longer vacations and shorter work hours.[58] These conveniences were the fodder of postwar political legitimacy in both East and West, and the two sides in the Cold War based their claim to the superiority of their own system on their ability to provide a bountiful and equitable distribution of modernity's "good life."

When Khrushchev and U.S. Vice President Richard Nixon met in Moscow in 1959 for their famous impromptu "Kitchen Debate," they were debating the merits of two different versions of government directed modernity, two different sets of promises. In front of a global TV audience, Nixon sang the praises of his system that could provide "any steel worker" with an affordable home complete with a dishwasher and color television. Khrushchev boasted that

[58] William Taubman, *Khrushchev: The Man and His Era* (New York, 2003), chapter 18.

under communism workers were "entitled to housing," and that in another seven years the Soviet Union would be "at the level of America, and after that we'll go farther." Confident in his system and its ability to provide material abundance, Khrushchev gleefully declared, "As we pass you by, we'll wave 'hi' to you, and then if you want, we'll stop and say, 'please come along behind us.'"[59] For its first twenty-five years, then, the Cold War was a competition between two systems of governmental promises underwritten by economic growth.

Then, around 1970, something unexpected happened. Contrary to the confident predictions of both ideologies, economic growth in *both* systems severely stagnated. Normally, scholars of the Cold War and communism only focus on the rigid economic stagnation of the Eastern Bloc during the 1970s and 1980s. But "The Great Slowdown," "Declining Growth, Rising Rigidities," and "The Descent of Growth" are titles or subtitles in the leading histories of capitalism, not communism, for sections about the period after 1970.[60] Only in the 1980s, after growth had recovered slightly and inflation had been significantly lessoned in capitalist countries, did Western confidence in the natural superiority of capitalism to communism return. Throughout the 1970s, the West's economic problems appeared equally intractable to any of those bedeviling the East.[61]

[59] "The Kitchen Debate – Transcript," 24 July 1959, CIA Online Reading Room, https://www.cia.gov/library/readingroom/docs/1959-07-24.pdf, Accessed April 28.
[60] "The Great Slowdown" from Phillip Armstrong, Andrew Glyn, John Harrison, *Capitalism Since 1945* (Oxford, UK, 1991), chapter 14; "Declining Growth, Rising Rigidities," from Eichengreen, *The European Economy Since 1945*, chapter 9; "The Descent of Growth," from "The Ascent and Descent of Growth," in Robert Gordon, *The Rise and Fall of American Growth* (Princeton, NJ, 2016); "The Fading Miracle" in Herbert Giersch, Karl-Heinz Paqué, and Holger Schmieding, *The Fading Miracle: Four Decades of Market Economy in Germany* (Cambridge, UK, 1992).
[61] From 1974-1982, per capita growth in the industrialized West averaged 1.4% per year, while it averaged 1.3% in Eastern Europe and 1.2% in the Soviet Union. From 1983-1988, Western per capita growth recovered to 2.5%, Eastern Europe achieved 2.3%, while the Soviet Union lagged

It was in this context of slower growth that the oil crisis of 1973-74 burst onto the scene and changed the Cold War forever. The fourfold increase in the price of the world's most important commodity accelerated the development of two vast pools of wealth, global capital markets and energy resources. After 1973, nation-states in both the Western and Eastern blocs became increasingly dependent on access to these pools of wealth to fund their societies. Guns and butter became dependent on finance and oil. This dependency was the defining feature of the privatized Cold War. As long as states had either access to global capital markets or oil wealth after the onset of the oil crisis, they could continue to fund their foreign and domestic policies. They could, in other words, continue to fight the Cold War abroad and implement the Politics of Making Promises at home.

If, however, states lost access to one or both of these sources of funding, they would have to implement domestic austerity programs to regain the favor of capital markets or outlast a downturn in world oil prices. Such austerity programs could force governments to alter both their domestic and foreign policies through cuts in commitments to domestic constituencies, international allies, or national defense. In the chapters that follow, we will observe instances of all three. Changes in global capital and energy markets, then, produced dramatic political changes both within and between nation-states after 1973. In place of the Politics of Making Promises that prevailed in the first two and half decades of the postwar period, the privatized Cold War forced nation-states to confront the Politics of Breaking Promises. Rather than championing further expansions of the social contract, governments on both sides of the Iron Curtain were forced to discipline their domestic social contracts or delay disciplining their social

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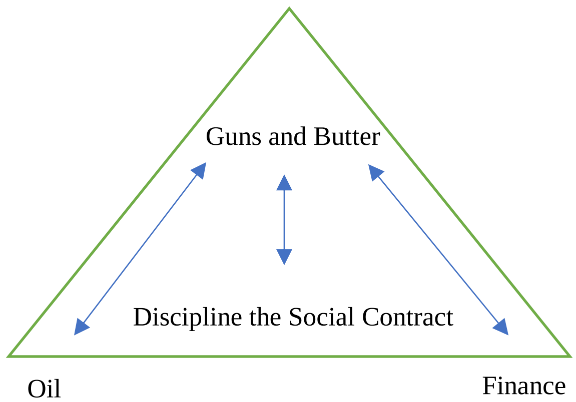
behind at 1%. Table 18. "Selected Macroeconomic Indicators, 1951-1988," *World Economic Outlook*, May 1990, p. 65.

contracts through infusions of oil wealth and debt. For its first two decades, the Cold War was a race between the communist and capitalist blocs to *make* promises to their people. But because oil and finance privatized the conflict after 1973, the Cold War over its last two decades became a competition between the blocs to *break* promises made to their people.

Nation-States in the Privatized Cold War



These are the dynamics that the figure above encapsulates. It is the framework that will guide the chapters that follow, and it draws attention to a number of important relationships that would define the end of the Cold War. First, at the heart of the privatized Cold War was a social question: how to revise the postwar social contracts that developed in both the East and the West after the Second World War. If the end of the Cold War is to be thought of as a product of states adapting to changes in the international system, then this social question was the challenge thrust upon them by the post-1973 global economy. States' ability to discipline their social contract would prove to be the key difference between those who survived and those who went extinct. Placing this social question at the center of the end of the Cold War means that ideology and domestic politics are essential components of this history. Revisions to the social contract needed to be justified in ideological terms to domestic constituencies. We will see in the following chapters that both states' governing ideologies and domestic political structures changed during the privatized Cold War in order to meet this challenge of revising the domestic social contract.

Therefore, on the fundamental question of the relationship between economic change and ideological and political change, the framework above puts forth a very particular viewpoint. In the privatized Cold War, the challenge of revising the domestic social contract drove states to adopt political and ideological "new thinking" in both East and West after 1973. Scholars normally identify "new thinking" as the particular idealistic movement that arose among the reformers around Gorbachev in the Soviet Union. But when one pulls back from the particular Soviet context, it is clear that many governments on both sides of the Iron Curtain adopted new thinking of various types during the 1970s and 1980s. These new forms of thinking emanated from diverse ideological traditions, but they shared one commonality – they were all approaches to disciplining the domestic social contract.

This is not to say that change in the global economy completely determined the *creation* of new thinking, but rather to argue that it drove the *adoption* of new thinking within governments and societies. Whether it was Thatcherism in Great Britain, monetarism and deregulation in the United States, perestroika and glasnost in the Soviet Union, or roundtable democratization in Poland and Hungary, these forms of new thinking were adopted by the governments in power because they appeared to provide the ideological and political means required to achieve the end of disciplining the social contract. In 1987, Gorbachev told the

Soviet Politburo that Thatcher was also "carrying out a perestroika" in the United Kingdom.[62] If Gorbachev himself saw parallels between perestroika and Thatcherism, then perhaps historians should too. The thread that united these two ideologically opposed movements in the 1980s is that they were both efforts to ideologically and politically justify structural adaptations to the changing global economy. Oil and finance thrust this challenge of breaking promises onto nation-states after 1973, and domestic political orders and ideologies adjusted to meet the challenge.

Though this framework centers our attention on a core domestic concern, it also makes clear that changes in the international system were of vital importance as well. Indeed, through oil and financial markets, developments at the international level were what forced states to address the challenge of revising their social contract. Although these changes occurred at the international level that did not mean that they were products of inter-state relations. Most changes in oil and financial markets were outside the control of any particular nation-state. This was the period when the nebulous, but all-important, opinion of "the market" began to decide the fate of nations.

Nation-states could not fully control oil or financial markets, but they could wield power in the privatized Cold War by altering other states' access to oil or finance. Statecraft in this new international system consisted of granting or denying other states' access to oil and financial resources, and late Cold War diplomacy reflected this reality. In the 1970s, the Soviet Union and its Western adversaries fought a quiet battle for control of Eastern Europe through oil and capital markets – the Soviets by granting its bloc allies growing and subsidized deliveries of oil; the

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[62] A. S. Chernyaev, Georgy Shakhnazarov, and Vadim Medvedev, eds., *V Politburo TsK KPSS* (Moscow, 2006), p. 155-156.

West by granting Eastern Bloc states growing and subsidized access to global capital markets. In the 1980s, the process reversed. The Soviet influence over the bloc waned as the growth and subsidy of its oil deliveries tapered off, and the West's influence increased as it sought to attach conditions to the Eastern Bloc's access to credit. Therefore, statecraft mattered in the privatized Cold War, but the power of diplomacy was always limited by the fact that nation-states, even very powerful ones like the United States and the Soviet Union, could never completely control other states' access to finance and oil. The opinion of "the market" always existed alongside Cold War statecraft, and together they comprised the two key international determinants of any state's access to oil and finance.

It will not surprise the reader to note that this framework closely maps onto the four areas of change I identified at the beginning of this introduction as essential to explaining the end of the Cold War. The privatized Cold War produced changes within and between states, as well as changes in power and identity. This close alignment means that the framework I have outlined can potentially explain the collapse of communism as a system of governance, and in so doing, explain the end of the Cold War as a geopolitical conflict.

I also stated at the beginning of this introduction that the end of the Cold War comprised four processes – the end of the nuclear arms race, the end of the global ideological competition, the collapse of state socialist regimes, and the reunification of Germany. The history of each of these processes will be taken up in the second half of the dissertation, chapters five through eight.[63] The first four chapters will instead be devoted to explaining the emergence of the privatized Cold War after the oil crisis of 1973-74, and the shift from the Politics of Making Promises to the Politics of Breaking Promises that accompanied it. Chapter 1 compares the

[63] In the future book, German reunification would be chapter 9.

reaction of both the East and West to the oil crisis in the middle of the 1970s, and details how the states of Eastern Europe became dependent on subsidized Soviet oil and Western credit markets. Chapter 2 examines how governments in both the East and West tried to avoid, and then were forced to confront, the challenge of implementing austerity in the late 1970s. It brings new attention to two key turning points in the late Cold War: the stagnation in Soviet oil production beginning in 1977, and Paul Volcker's dramatic increase in US dollar interest rates beginning in 1979. The intertwined histories of oil, finance, and austerity clearly emerge in chapter 3, where I will analyze the history of the Polish Crisis of 1980-1981. The Polish Crisis was the Eastern Bloc's turning point from the Politics of Making Promises to the Politics of Breaking Promises, and also the moment at which the Soviet leadership realized that the economic costs of empire had become too much to bear. Both of these developments will be the focus of the chapter. Just as the Soviet leadership was discovering the limits of its material power in the early 1980s, the United States under Ronald Reagan was discovering, as I detail in Chapter 4, that the material limits on its power were virtually limitless. Through what I am calling the Reagan Financial Buildup, the United States began to borrow capital from its allies in Western Europe and Japan to pay for its own guns and butter. By tapping global capital markets at a level unprecedented in history and unmatchable by the Soviet Union, the Reagan administration fundamentally altered the relative power of the two superpowers and decisively influenced the Soviet decision to seek arms control in the late 1980s.

The second half of the dissertation will consider the period normally thought of as the end of the Cold War, 1985-1990. Chapter 5 will take up this history from the Soviet side, and cover the decline of the world oil price in 1985-86, Gorbachev's launch of perestroika and glasnost, his repeal of the Brezhnev Doctrine in Eastern Europe, and his effort to seek arms control with the United States. In this chapter, we will begin to see how the economic challenge of breaking promises led to ideological and political change in the Eastern Bloc, as Gorbachev attempted to legitimize his economic reform through revisions to communist ideology and the introduction of electoral democracy. Chapters 6 and 7 will examine how similar processes unfolded in Poland and Hungary in the late 1980s, where the governments attempted to use roundtable democratization to legitimize economic austerity and reform. Importantly, these chapters will demonstrate that the impetus for the roundtables, and thus the cause of the revolutions of 1989, was neither pressure from Gorbachev nor Eastern European civil society, but rather pressure to implement austerity emanating from the global economy. These developments in Poland and Hungary spilled over into East Germany, where the government was dealing with its own foreign debt problem and feared the prospect of having to implement its own domestic austerity program. Chapter 8 will detail how the East German government tried to avoid the challenge of this austerity by leveraging the opening of the Berlin Wall in exchange for new loans from the West. This attempt failed when, on the night of November 9th, 1989, the Wall was accidently opened, and East Germans freely and defiantly walked into West Berlin for the first time in almost thirty years. Within a year, the Cold War ended on October 3, 1990, when the four occupying powers of postwar Germany – the United States, the Soviet Union, Great Britain, and France – revoked their rights to control over German territory, and a newly united, democratic, and capitalist Germany emerged on fully Western terms.[64]

Each of these chapters will make new empirical contributions to important specific problems in the current historiography on the end of the Cold War and the collapse of

[64] The subject of a future book chapter.

communism.[65] But beyond specific empirical contributions, this dissertation aims to provide precisely the new interpretive framework for understanding the end of the Cold War that scholars ranging from Gaddis to Maier to Garton Ash have called for. To do that, it will finally have to answer the three questions identified at the outset that lie at the heart of the end of the Cold War. Why did the holders of imperial and authoritarian power in the Eastern Bloc willingly give it up? Why did they do so at the end of the 1980s? And why did electoral democracies and market economies emerge from the ashes of state socialism?

My answers to these questions rest in the Politics of Breaking Promises. In the global economy that prevailed after the oil crisis, the only practical purpose the Soviet empire in Eastern Europe served was to insulate socialist states from the pressure of breaking promises. This insulation, which came in the form of subsidized oil and other raw material deliveries, was extremely costly. By the early 1980s, the Soviet leadership decided that protecting its allies from

[65] Chapters 1 and 2 present the first archivally-based history of how the Eastern Bloc reacted the oil crisis of 1973, and demonstrate that the Soviet Union was already looking to shed the burden of its empire in the 1970s. Chapters 4 and 5 put forth evidence and argue that the Reagan military buildup *was* decisive in changing Soviet behavior and pushing Gorbachev to end the arms race, but importantly, this buildup was only possible because of unprecedented and completely unexpected inflows of foreign capital into the United States. Historiography on the end of the Cold War has long debated the question of when, why, and how the Brezhnev Doctrine was repealed, and chapter 5 presents new documentation from East German archives that clearly demonstrate that in October 1986 Gorbachev told his allies that they were now responsible for their own affairs, and that he did so because the economic burden of the Soviet empire had become too much too bear. Based on new documentation from the archives of the IMF and underutilized Polish and Hungarian sources, chapters 6 and 7 present evidence that the Polish and Hungarian governments embraced Roundtable negotiations not out of pressure for reform emanating from *perestroika* in the Soviet Union, but rather because sought political legitimacy in order to solve their foreign debt problems. On the important question of why and how the Berlin Wall was opened in November 1989, chapter 8 of this dissertation demonstrates with new archival evidence that the East German government tried to ransom the opening of the Wall in exchange for Western credits in the hope of solving the country's sovereign debt problem. Similarly, chapter 8 presents evidence that the Hungarian government took down the "Iron Curtain" fence on its border with Austria because of the pressures of economic austerity, rather than out of a desire to meet standards of Western human rights.

the pressures of the global economy was in fact too costly, and they committed themselves to lowering these costs, even if that meant risking the loss of the empire itself. When Gorbachev informed his allies of the repeal of the Brezhnev Doctrine in October 1986, he was not self-consciously liquidating the Soviet empire, but rather breaking the promise the Soviet Union had made to its allies since the oil crisis to protect them from the disciplining demands of the global economy. When the empire crumbled in 1989, Soviet leaders peacefully accepted the result because they no longer believed that protecting Eastern Europe from the challenge of breaking promises was in the Soviet Union's national interest.

The loss of Soviet imperial protection from the global economy, however, did not automatically lead the holders of authoritarian power in the Eastern Bloc to peacefully give up their power within communist states. They did not lose 'heart' or suffer from a political 'bank run.' Instead, authoritarians throughout the bloc gave up their power in order to gain the political legitimacy they believed was necessary to implement the Politics of Breaking Promises. Beginning with Gorbachev's launch of perestroika and glasnost, extending through the roundtable discussions in Poland and Hungary, and culminating in the fall of the Berlin Wall and the peaceful reunification of Germany, authoritarian leaders proactively tried to legitimize their power so that they would in turn be able to discipline the domestic social contract. When it became clear that these attempts to legitimize their power would in fact result in their loss of power, communist leaders chose not to violently prevent their loss of power because they understood that the challenge of breaking promises would still remain. Under the Politics of Breaking Promises, there were no spoils for the powerful and victorious, only costs. Communist leaders chose to let their successors bear the burden of the costs that came with breaking promises.

These stunning events in the Soviet empire and within communist states happened when they did because the global history of oil and capital markets made the challenge of breaking promises unavoidable within the Eastern Bloc by the late 1980s. Access to Soviet oil and Western capital markets allowed the bloc to delay the task of disciplining the social contract throughout the 1970s. But the advantage of Soviet oil deliveries to Eastern Europe and Western capital markets' confidence in the region peaked in 1980, and never fully recovered. By 1986 and 1987, Poland and Hungary faced severe international pressure to break domestic promises, which led their governments to the roundtable process and set in motion the events of 1989. Thus, the timing of the end of the Cold War was a product not only of individual agency and historical contingency, but also of structural developments in the international system dating back to the oil crisis.

Lastly, electoral democracy and market economies emerged in the East after the collapse of communism for the same reason that they survived in the West during the last two decades of the Cold War – they were the best political and economic systems for breaking promises. Democratic capitalist states were not immune from the challenges that befell the communist world in the late Cold War. They too had to rewrite their social contracts in the 1970s and 1980s. But unlike the state socialist regimes of the Eastern Bloc, the democracies of the West were able to do so because they were viewed as legitimate by their own citizens. The major difference between the Politics of Making Promises and the Politics of Breaking Promises is that the latter favored governments with political legitimacy. Eastern Bloc governments had lacked political legitimacy since their founding, but only when faced with the Politics of Breaking Promises did this lack of legitimacy become fatal. State socialism survived the 1950s, 1960s, and 1970s, but failed to survive the 1980s precisely because a particular history of oil and finance caused the switch from the Politics of Making Promises to the Politics of Breaking Promises in both East and West after 1973. From then on, the fate of both blocs rested on their respective ability to renegotiate their domestic social contracts. Democracy granted the industrial nations of the West the legitimacy to meet this challenge. Authoritarianism granted the communist regimes of the East no such legitimacy.

This suggests a peculiar, and perhaps troubling, kind of Western triumph in the Cold War, but it is the only kind of triumphalism that the end of the Cold War can teach us. We should have no problem stating that the West won the Cold War, but we should recognize clearly why it did. The triumphalism of broken promises is a theme to which I will return in the conclusion. But first, we must begin with the crisis that forever changed the Cold War. In the fall of 1973, the price of oil suddenly quadrupled, and the world was never again the same.

Chapter 1

Years of Reckoning and Illusion:

The Challenge of the Oil Crisis in East and West

> "While the world economy is based partly on a socialist and partly on a capitalist social system, there are not two world markets, there are no 'capitalist and socialist' machines and products, but only good or bad machines, modern or obsolete products."
>
> - János Fekete, Hungarian central banker[66]

On December 10th, 1976, East German Prime Minister Willi Stoph was leaving Moscow disappointed and empty handed. He had come to the Soviet capital seeking an increase in Soviet oil deliveries to the German Democratic Republic (GDR), but his Soviet counterpart Alexei Kosygin had roundly rejected his request. "We don't have the resources for it," Kosygin had said during their meeting in the Kremlin. "We have an acute energy shortage in our country…. You must get your mind out of the clouds." "My mind's not in the clouds," Stoph had shot back. "But you want us to increase our deliveries," Kosygin had responded. "We cannot meet that level of demand. No one in the world can do that."[67]

[66] János Fekete, *Back to Realities: Reflections of a Hungarian Banker* (Budapest, HU, 1982), p. 12.
[67] "Niederschrift über die Verhandlungen zwischen dem Vorsitzenden des Ministerrates der DDR, Genossen Willi Stoph und dem Vorsitzenden des Ministerrates der UdSSR, Genossen A.N. Kossygin, am 10.12.1976," December 12, 1976, DE/1/58569, BArch Berlin.

Now, as the two men drove through the streets of the Soviet capital on the way to the airport for Stoph's departure, Kosygin tried to lighten the mood by reminding his comrade of the overriding advantages of the socialist system compared to the chaos that currently prevailed in the capitalist world. "We understand that the situation in the GDR is not easy," the Soviet Premier said, speaking for the entire Soviet leadership, but "compared with the predicament in capitalist states, all socialist states – the USSR as well as the GDR – [are] in an incomparably better situation." To him, the advantages were clear. The socialist countries were "in a position to plan" their economies "until 1980, 1985, and beyond" as well as "agree on the course of our development." In contrast, Kosygin said, "capitalist states couldn't even plan for the next three months." Perhaps shaken from his disappointment by Kosygin's comparison, Stoph piled on the criticism of their ideological foes. "All of the planning efforts of capitalist states have only led them into crisis," he said. Kosygin agreed and concluded, "Our situation is a thousand times better."[68]

In the mid-1970s, one did not need to be a communist ideologue to share this view. Indeed, many in the West believed that the oil crisis of 1973-1974 had exposed fundamental flaws in both capitalism and democracy. The combination of widespread unemployment and high inflation throughout the West confounded both the professional economists who studied market economies and the democratically elected leaders who governed them. The reigning economic doctrine of Keynesianism offered few answers in this world of "stagflation," and those that it did put forth – increased government spending and accommodating monetary policy –

[68] This reconstruction of the conversation comes from two documents that recorded the same events. Willi Stoph, "Information über die Beratung mit Genossen Kossygin am 10.12.1976 in Moskau," and "Niederschrift über die Verhandlungen zwischen dem Vorsitzenden des Ministerrates der DDR, Genossen Willi Stoph und dem Vorsitzenden des Ministerrates der UdSSR, Genossen A.N. Kossygin, am 10.12.1976," both in DE/1/58569, BArch Berlin.

appeared to only make the problems worse. Because democracy subjected Western governments to the demands of all their citizens, it was widely believed that Western welfare states were doomed to chronic high inflation because politicians needed to promise their citizens too much of the good life in order to get elected. In foreign policy, a new buzzword – interdependence - dominated discussions of the West's place in the world and appeared to portend an end to Western societies' control over their own fates. What could the developed West do in the face of dependence on oil from the Middle East? To many on both sides of the Iron Curtain, the answer appeared to be nothing at all. Could democratic leaders, who were beholden to the interests of their constituents, solve the riddle of stagflation if it meant inflicting pain on those they governed? Smart money said no.

The Soviet Bloc was thought to be different. Socialist states appeared to Western observers to be largely immune to the crises afflicting the capitalist world. As the Kosygin-Stoph exchange shows, socialist leaders maintained a similar confidence in the superiority of their own system. The Soviet Union was one of the world's largest producers of energy resources, so the fourfold increase in the price of oil at the end of 1973 and early 1974 first arrived as a financial windfall rather than a structural economic challenge for the leadership in Moscow. The socialist states of Eastern Europe had few oil resources themselves, but under the generous patronage of the Soviet Union, they received large and growing deliveries of Soviet energy during the 1970s at highly subsidized prices. Because almost all trade and prices were fixed under Five Year Plans within the bloc, socialist states appeared exempt from the violent gyrations of inflation and commodity price shocks that crippled the Western world after 1973. And if democracies' penchant for promising their citizens too much was the cause of Western inflation, then the socialist states' authoritarian structure appeared to make them helpfully unresponsive to the demands of their populations. Taken together, these traits were enough to keep Kosygin and Stoph brimming with confidence as they drove through the Soviet capital that day in 1976.

And yet this chapter begins by recounting their exchange because beneath the professions of confidence, the discussion also pointed to the problems upon which state socialism itself would founder. Stoph had made the initial request for more Soviet oil for a very particular purpose: to lower the GDR's ballooning sovereign debt to Western banks and governments. With more oil, the GDR would be able to produce more petrochemicals and export them to the West for hard currency. This, in turn, would lower the need to take out Western loans to pay for imports and service old debts. In the first half of the 1970s, Western banks had been eager to loan money to the socialist bloc for the very reasons that socialism appeared ascendant to all manner of Western observers in the 1970s: it had energy, authoritarianism, and no inflation. But by 1976, the first inklings of doubt had begun to bubble up in the minds of Western bankers: would socialist states really be able to pay them back? Seen in this light, it becomes clear that Stoph's pilgrimage to Moscow in search of oil was, in fact, an indirect effort to put the minds of Western bankers at ease and keep the flow of Western capital running smoothly.

The GDR's predicament was far from unique; all states in the Council of Mutual Economic Assistance (Comecon) shared the East German dependence on both Western capital and Soviet oil to varying degrees.[69] Thus, Kosygin's rejection of Stoph's request points to the second problem lurking in the background of their discussion: after a ten-year period of dramatic growth, Soviet energy resources began to plateau in the mid-1970s and were projected to decline

[69] Except for Romania, which imported its oil from the world market. This freed the country from dependence on Soviet oil, but dramatically increased its dependence on Western capital.

after 1980. The Eastern Bloc's apparent imperviousness to the travails of the global economy rested on these two foundations: easy access to Western capital and an ever-increasing supply of Soviet energy resources. If either or both of these faltered, as they would around 1980, the entire bloc would be forced to reckon with the social, economic, and political problems that beset the West after 1973.

Thus, this chapter tracks the response of both the industrial West and the socialist East to the oil crisis to make one overriding point clear. Although the crisis at first appeared to validate the fundamental differences between democratic capitalism and state socialism, in time it demonstrated that both blocs were subject to the pressures of the same world market. It was a market that neither side could fully or even partially control,[70] so how the states within each system reacted to the whims of the global economy became the key determinant of their success and survival. The dramatic expansion of global capital markets after the crisis presented both sides with a means of softening the blow of adjustment to the new market conditions. But the fundamental challenge that the crisis posed to both the democratic welfare states of the West and the late socialist systems of the East could not be permanently avoided. The crisis challenged governments on both sides of the ideological divide to domestically distribute the economic losses caused by the oil price shock, transition their societies to more profitable and energy efficient systems of production and consumption, and maintain access to the global capital markets that rapidly expanded after the oil shock. All of these pressures threatened the

[70] The theme of loss of control is explored in Harold James, *International Monetary Cooperation Since Bretton Woods* (Washington, DC, 1996), where the author termed the international monetary system that emerged after Bretton Woods a "non-system," and Daniel Sargent *A Superpower Transformed* (Oxford, 2015). Of course, the socialist bloc never believed it controlled the capitalist "imperialist" world economy, but it did operate under the illusion that it could insulate itself from that system.

legitimacy of both the welfare states in the West and the late socialist regimes of the East. At first faintly felt and then stridently resisted, the crisis began for both blocs the transition from the Politics of Making Promises to the Politics of Breaking Promises.

A Visible Crisis in Welfare State Capitalism

On October 6th, 1973, the Egyptian armed forces crossed the Suez Canal into the Israeli-occupied Sinai Peninsula, and Syrian forces pushed from their homeland to confront Israeli forces occupying the Golan Heights. Over the next three weeks, the Arab coalition and the Israeli Defense Forces fought pitched battles in what would come to be known as the Yom Kippur War. In the early days of the fighting, the Soviet Union resupplied its Arab allies, and on October 14th, the United States responded with its own decision to resupply Israel. For the Arab Gulf states that supported the Egyptian and Syrian campaign, this American decision demanded a response equal to the perceived injustice of supporting Israel. Thus, they unsheathed 'the oil weapon' and unilaterally announced a 70% increase in the price of their oil to $5.11 a barrel. The next day, they committed themselves to a rolling embargo against supporters of Israel, chief among them the United States, cutting oil production 5% a month. After US President Richard Nixon announced a new $2.2 billion aid package to Israel on October 19th, King Feisal of Saudi Arabia upped the ante considerably by imposing a complete embargo on oil supplies to the United States.

By the end of October, the guns had fallen silent, but the effects of the price increase were only beginning to ripple outward. In December, ministers from the Organization of Petroleum Exporting Countries (OPEC) met in Tehran to discuss where to peg the oil price going forward. At the urging of their host, Shah Mohammad Reza Pahlavi, the group settled on an even higher price target of $11.65, one that would have been unfathomable only months before.[71] As recently as 1970, OPEC had only been able to fetch $1.80 per barrel on the world market. With the breakdown of the Bretton Woods system in 1971 and the resulting devaluation of the US dollar (in which oil was priced), some of the oil price could be accounted for by producers' desire to recapture the value they had lost with the dollar's decline. But the fourfold increase from $2.90 in mid-1973 to $11.65 at the end of the year represented more than that. Economically, it reflected the fact that the development of affluent industrial societies in the West had increased oil demand six fold since 1950 and had pushed the United States beyond energy autonomy to dependence on foreign oil in the late 1960s.[72] Politically, the price increases represented a precipitous culmination of decades of struggle on the part of developing nations to increase the value of the commodities that formed the basis of their national wealth. When they collectively called for a "New International Economic Order" at the United Nations in May 1974, they did so with the winds of long-sought wealth at their backs.

The boon for the developing world delivered a bust to the developed world on a scale unknown in the postwar years. The Western world was first and foremost a world of industries, and through the early 1970s, industrial production had relied on ever increasing amounts of cheap energy resources to fuel economic growth. Between 1949 and 1970 US oil consumption increased from 5.8 million to 16.4 million barrels per day. Western Europe's grew over the same period from 970,000 to 14.1 million barrels per day, and Japan's skyrocketed from a few thousand to 4.4 million barrels per day.[73] By the eve of the oil crisis, Western countries were

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[71] For a detailed narrative of these events, see Daniel Yergin, *The Prize: The Epic Quest for Oil, Money, and Power* (New York, 1991), chapter 29.
[72] Sargent, *A Superpower Transformed*, p. 132, 135.
[73] Ibid, p. 132.

also lands tormented by inflation. The rising price level had a diverse set of causes including US President Lyndon Johnson's attempt to fund his Great Society programs and the war in Vietnam without a tax increase, an explosion of real wage increases across the West from 1968-1972, and the 1971 American decision to suspend the convertibility of the dollar into gold, which freed the United States from the nominal constraint of limiting its money supply to amounts that could be converted into gold by the US Treasury at $35 an ounce. In combination, these forces had pushed consumer price inflation in OECD (Organization for Economic Cooperation and Development) countries to an annual rate of 8.2% in 1973.[74]

With prices already galloping ahead at a steady pace, the fourfold increase in the price of the commodity that formed the basis of industrial society was bound to have dramatic economic effects. In short order, the West experienced its worst economic downturn since the Great Depression in 1974-1975. After growing at a rate of 5.7% in 1973, real growth in the industrialized West dropped to 0.7% in 1974 and contracted by 0.3% in 1975.[75] From mid-1974 to mid-1975, international trade fell at an annual rate of 13% and industrial production in developed countries declined by 10%.[76] This decline was quickly reflected in job losses, as unemployment across the OECD reached 5.5% in 1974, and peaked at 8.9% in the United States in May 1975.[77] Under the economic conditions that had prevailed since 1945, a downturn of such scale would have nipped the problem of inflation in the bud. But the skyrocketing oil price

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[74] OECD (2017), Inflation (CPI) (indicator). doi: 10.1787/eee82e6e-en (Accessed on 19 March 2017).

[75] Harold James, *International Monetary Cooperation*, p. 264.

[76] Armstrong, Glyn, and Harrison, *Capitalism Since 1945*, p. 225.

[77] Charles Maier, "Inflation and Stagnation as Politics and History," in *The Politics of Inflation and Economic Stagnation* (Washington, DC, 1985), p. 17.

made this contraction different, and consumer price inflation increased across the West to 14.1% in 1974 and 11.8% in 1975.[78]

And so, in defiance of postwar economic theory and experience, “stagflation” was born. In the realm of public policy, the years since 1945 in the West had unfolded in the long shadow of the British economist John Maynard Keynes and the body of economic theory that bore his name. During their heyday in the 1960s, Keynesian economists who populated Western governments had declared victory over the business cycle and professed the ability to prevent economic downturns through changes in monetary and fiscal policy. “Recessions are now considered fundamentally preventable, like airplane crashes and unlike hurricanes,” Arthur Okun, Lyndon Johnson’s chief economist, declared in 1970.[79] On the European continent and in Japan, two decades of almost uninterrupted economic growth from 1950-1970 lent the credibility of lived experience to such claims. Even in the United States, where recessions had been a recurrent, if also mild, part of postwar life, economists found reason in the 1960s to think that economic performance was ultimately subject to government control. The Phillips Curve, named for the New Zealand economist, A.W. Phillips, who had first theorized its existence in 1958, purported to show that inflation and unemployment were inversely related – the more one went up, the more the other would go down. With this knowledge in hand, economists argued in the 1960s that governments could control the level of both inflation and unemployment through fiscal and monetary “fine tuning.” If inflation was running too hot, this thinking held, governments could simply cut spending or raise interest rates to return the price level to a desirable rate of growth. Unemployment would temporarily increase while inflation receded,

[78] OECD (2017), Inflation (CPI) (indicator). doi: 10.1787/eee82e6e-en (Accessed on 19 March 2017).
[79] Quoted in Robert Samuelson, *The Great Inflation and Its Aftermath* (New York, 2008), p. 55.

and the economy would return to equilibrium. If instead unemployment was the overriding problem, as indeed it was in the 1950s and 1960s, then governments could increase spending and lower interest rates in order to increase demand in the economy and cause firms to hire more workers. Using this line of thinking, postwar governments had based their policy and built their legitimacy on the promise of optimizing the social effects of the economy. From this, the central economic goal of the Western welfare state emerged: full employment. As Charles Maier has written of the postwar years, "a full employment 'standard'" emerged after 1945 as the measuring stick by which all Western governments were judged. Under this standard, it was now the responsibility of government to ensure that everyone who wanted a job had one. This commitment was a dramatic departure from the responsibilities of democratic capitalist governments in the prewar years, when under the gold standard, the nations of the West prioritized their international solvency over the interests of their domestic working class. The horrid experience of the Great Depression, Europe's descent into Fascism, and the emergence of a socialist bloc that purported to govern in the interest of the working class, all forced democratic capitalist governments after the war to adopt the interests of the working class as their own. The result of this fusion of interests between the working class and its governments was full employment. As Maier writes, "Accepting the primacy of full employment meant that a major priority of the working class had become that of society in general."[80]

Stagflation, quite plainly, called into question the entire promise of Keynesian governance, and with it, the legitimacy of Western welfare states too. If the basic task of postwar government was to *do* something to protect the interests of the working class (and, by

[80] Charles Maier, "Fictitious Bonds…of Wealth and Law': On the Theory and Practice of Interest Representation," in Maier, *In Search of Stability* (Cambridge, 1987), p. 251.

extension, society in general), it was not clear after 1973 what that should be. Inflation appeared to signal that governments and the unions they supported had already done too much. As a financial phenomenon, inflation was straightforward to understand - the price level increased when there was more money than goods in an economy. But as a social phenomenon, inflation was a signal of unresolved conflicts within a society over how wealth should be distributed. Workers believed they should get a greater share, so they demanded wage increases. Capital, unwilling to see its profits decline, responded by increasing prices, and the process continued without resolution until there was more money than goods. More than simply a monetary phenomenon, inflation appeared in societies where competing social groups had been promised more than the market could deliver.[81] In Western societies, the culprit of the accumulated promises was widely believed to be the postwar welfare state and its foundational promise of full employment. Inflation was caused by "the worldwide commitment to full employment and maximum production," the American magazine *Business Week* wrote in October 1974. This view was not confined to the spokesmen of the business community. Even those sympathetic to the interests of labor and the welfare state, such as the Keynesian economist Paul Samuelson, agreed that the 1974-1975 crisis signaled that governments were doing too much to protect workers from market realities. Inflation "is deep in the nature of the welfare state," he concluded, because "even when there is slack in the system, unemployment doesn't exert the

[81] This point was the general thrust of historical considerations of inflation that appeared in the 1980s. See the essays in Charles Maier, ed., *The Politics of Inflation and Economic Stagnation* (Washington, DC, 1985), especially Albert O. Hirschman, "Reflections on the Latin American Experience," pp. 53-77. See also Jonathan Kirschner, "The Political Economy of Low Inflation," *Journal of Economic Surveys*, Vol. 15, No. 1 (2001), pp. 41-70, in which the author argues, "[I]nflation is always and everywhere a political phenomenon. All levels of inflation, high and low, are the outcomes of political conflicts."

downward pressure on prices the way it did under 'cruel capitalism.'" The problem, he wrote, was that "I don't think anyone wants to turn the clock back."[82]

This is precisely what made defeating inflation so difficult. It implied that someone would have to lose. The oil crisis compounded the challenge by bringing about the situation that the Phillips Curve had proclaimed impossible – high unemployment and inflation at the same time. Governments could fight one or the other, but not both at once. The IMF's 1975 Annual Report couched the problem in dry language. "Unfortunately… recent experience cannot readily be translated into precise guidelines for current policy, inasmuch as the present situation is so different from that in previous postwar periods." Simultaneous high unemployment and inflation made "it very difficult to judge the degrees of monetary or fiscal expansion that might prove sufficient to restore adequate levels of resource utilization at a satisfactory pace without touching off new difficulties regarding inflation."[83] The stability of Western societies and the legitimacy of their governments depended on the restoration of economic growth; the fight against inflation required that this restoration not add more claims on societies resources to those already going unfulfilled.

In Europe, this predicament threatened to destroy the fragile order that had emerged since 1945. "The postwar era is over," the historian Fritz Stern declared in a May 1974 article. "For some twenty-five years...a steadily expanding economy protected Europe from major political upheavals." In the upheavals of 1968, students and radicals may have rebelled against the conformity of bourgeois life, but the core constituents of postwar politics – the workers – had been appeased with ever increasing promises of prosperity. "The workers of Europe found

[82] *Business Week* and Samuelson quoted in Jefferson Cowie, *Stayin' Alive: The 1970s and the Last Days of the Working Class* (New York, 2010), p. 223.
[83] Quoted in James, *International Monetary Cooperation*, p. 265-266.

embourgeoisement a novel and, on the whole, exhilarating experience…. [E]ach year, in every European country, more workers were able to afford cars, take vacations, dream of country bungalows, hope for a better life for their children." That world was now gone. With Europe headed toward "'zero growth' – at best," Stern believed democracies on the continent would be robbed of the premise of prosperity that had underpinned them since the Second World War. The prospects were dim. "[T]he unthinkable has suddenly become thinkable. Is there anyone who has the temerity to assume that the range of freedom in Europe will be as great in five years as it is now?....[O]ur hope that the worst tyranny that Europe ever saw would also be the last will have to be defended to remain true."[84]

The essence of this defense was to keep the promise of the postwar order alive, even as its economic foundation crumbled all around it. Across the West, governments and the unions they supported ensured that the living standards of the working class were protected as the oil crisis took hold in 1974. In the United States, workers' pay increases for the year outpaced inflation.[85] In West Germany, the first public employees strike in the country's history in May brought workers across the board a 3.4% real wage increase for the year.[86] In Great Britain, a tense national election in February yielded a weak Labour government which immediately granted the nation's industrial workers a 29% nominal wage increase.[87] In Italy, where all salaries were indexed to inflation through a system called the *scala mobile,* workers even received a 10% increase in real wages in 1975.[88] In Japan, where inflation ran at an astounding

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[84] Fritz Stern, "The End of the Postwar Era," *Commentary*, Vol. 57, No. 4, April 1974, pp. 27.
[85] Cowie, *Stayin' Alive*, p. 72.
[86] Appendix 10, "Wages and Productivity per Person," in Andrei Markovits, *The Politics of West German Trade Unions*, (Cambridge, UK, 1986), p. 459.
[87] Kevin Hickson, *The IMF Crisis of 1976 and British Politics* (London, 2005), p. 53.
[88] James, *International Monetary Cooperation*, p. 283.

24% in 1974, workers covered the increase and more with a 32% increase in wages.[89] Across the West, the first reaction in every political system was to protect the nation's workers from the changing global market.

Since the habits of postwar politics were not easily jettisoned, new sources to fund them had to be found. The oil crisis transferred roughly 2% of the world's wealth to the oil producing nations, and if life in the West was to go on as it had before, a way needed to be found to bring these funds back into Western economies.[90] "Looking out to 1980 and beyond," the US Treasury noted in August 1974, "the World's capital requirements will be massive by historical standards."[91] To be successful, the United States would need to claim a lion's share of this capital, even if this meant relying on foreigners to provide it. At a 1974 US Treasury Secretary seminar, the participants deemed it "questionable" whether the United States would "have the capital required for the economic expansion which will be required in the foreseeable future." Adapting to the energy crisis would require "a great influx of capital, much of which may have to come from oversees." They noted that "since a very large share of the world's savings will, in the near future, be in the hands of the oil producing nations" it might be "necessary" to encourage these nations to invest in the United States "if we are to obtain the share of world savings which our capital requirements demand."[92] If these were the concerns of the government

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[89] T.J. Pempel, "Japanese Foreign Economic Policy: The Domestic Bases for International Behavior," in Peter Katzenstein, ed., *Between Power and Plenty* (Madison, 1978), p. 184.
[90] Richard Mattione, *OPEC's Investments and the International Financial System* (Washington, DC, 1985), p. 23.
[91] William Withrell for Assistant Secretary Parsky, "World Capital Markets Study," August 14, 1974, Folder "1974," Box 1, Office of Assistant Secretary for International Affairs, Chronological Files of the Office of Financial Resources and Energy Finance, 1974-1977 (OASIA), National Archives and Records Administration (NARA), College Park, Maryland.
[92] "Report of Seminar on Economic Interdependence and the Nation's Future," March 23, 1974, George Schultz Treasury Papers, NARA.

with the world's largest economy and deepest capital markets, it is easy to imagine how much more pressing these concerns were for the many other countries of the world, including in the Eastern Bloc, who did not receive a financial windfall from the oil price shock.

The Euromarkets – the forerunners of today's unregulated global capital markets - presented on possible avenue to distribute world savings from oil producers back to oil consuming nations. Founded in London in 1955 using Europeans surplus US dollars, the Euromarkets were comprised of all currency held outside its country of origin and thus subject to little regulation. Because the US dollar was the most important and widely used currency in international trade, Eurodollars represented the overwhelming majority of liquidity in the Euromarkets, though West German Deutsch Marks, Swiss Francs, and British Pounds played a role as well. Throughout the 1950s and 1960s, the United States heavily regulated the interest rates that banks could apply to their deposits within the United States, so increasing numbers of companies, banks, and central banks began to keep their US dollar holdings abroad and receive a higher rate of return in the Euromarkets. Neither the U.S. nor British government was eager to regulate this activity, so the Euromarkets continued to grow. By 1970 the markets were valued at $110 billion, and by the time the oil crisis struck, they represented one option for managing the world's rapidly growing financial interdependence.

But they were far from the only one. Many financial observers and policymakers believed that governments or the International Monetary Fund would have to manage the recycling process rather than leave such an important element of the global economy to the volatility of the marketplace. In the first ten months of 1974, OPEC nations deposited $16.5 billion of their $45 billion surplus in the Euromarkets compared with just $10.5 billion in the

United States.[93] This was a strong start for the unregulated markets, but most doubted that it could last long. On June 26, 1974, West Germany's largest private bank, Herstatt, collapsed under the pressure of speculative foreign exchange losses. Many within the financial community itself believed the crash would be just the first of many dominoes to fall if the recycling process remained the responsibility of banks and the Euromarkets. David Rockefeller, the Chairman of Chase Manhattan Bank and one of the leading voices in international finance, worried in the summer of 1974 that banks were "loaned up" and would soon be unable to meet industrial countries' demands for credit without exposing themselves to Herstatt's fate. Banks were using short term deposits from OPEC countries that could be withdrawn after thirty days to make loans to oil importing countries with maturities ranging from seven to ten years. That was, as The *Wall Street Journal* noted days after the Herstatt collapse, "borrowing short and lending long, the bankers' classic formula for trouble." Given what appeared to be an untenable situation, the Journal concluded that governments and the IMF would have to take over the primary task of petrodollar recycling. "The only other choice is an ominous one," it noted, "drastic reductions of imports, currency devaluations and sharp economic slowdowns at the cost of rising unemployment."[94]

Once more, events defied expectations. By late 1974, it became clear that oil producers had no interest in using finance to destabilize the countries that purchased their oil, and they moved to secure their deposits with Western banks on a longer-term basis. Banks, in turn, found fewer reasons to worry about lending countries more money than ever before. By the summer of 1975, a US Treasury official could report that "the financing problems due to the OPEC financial

93 Department of State to OECD Capitals, "OECD Committee on Financial Markets Meeting, November 21-22, 1974," Folder "1974," Box 1, OASIA, NARA.
94 Charles Stabler, "Jitters on the Euromarkets," *Wall Street Journal*, June 28, 1974, p. 14.

accumulations now are generally recognized by most banks as manageable."[95] If the private banking system could manage the recycling process, then there was little role for the IMF or governments to play. From the start of 1975 onward, government efforts to control the recycling process waned, and the vast majority of sovereign borrowing stayed on the Euromarkets.

This was, for the history of both capitalist welfare states and late socialist regimes, a fateful development. With the world's surplus capital now at its disposal, the international financial community became an arbiter of politics around the world. Neither bankers nor most politicians were eager to see the role of finance in these terms, but it was true nonetheless. Any nation-state, in either East or West, that relied on the borrowed capital of the Euromarkets to fund the products of its domestic politics was now subject to the capricious confidence of capitalists. As long as markets remained convinced that borrowed capital would be repaid on time and with interest, politics within states could proceed normally. Politicians could continue to promise their people prosperity, and the legitimacy of the government could survive unquestioned. But should market confidence ever falter, the domestic politics of borrowing states would be thrown into immediate disarray. In both East and West, the temptation to use borrowed capital to support domestic living standards proved too strong to resist. This meant there was now a direct connection between the promises governments made to their citizens and the capital markets they used to fund them.

As the importance of global capital markets rose after 1975, the importance of central banks increased in equal measure. If governments could not control the capital markets to which they were now subject, central banks still could control how much liquidity pulsed through these

[95] "Remarks by William Witherell, Director of the Office of Financial Resources, U.S. Department of the Treasury," June 17, 1975, Folder "June 1975," Box 1, OASIA, NARA, p. 12.

markets on a daily basis. Lower interest rates would lead to more liquidity, more loans, and more government promises kept. They would also lead to more inflation. Higher interest rates would bring the exact opposite chain of events. Thus, in a world of countries that depended on borrowed capital to finance politics, monetary policy was inherently political.[96] This made the reaction of the most important central banks in the world to the oil crisis as important as the response of governments. At the US Federal Reserve, the most important central bank in the world because of its control over the liquidity of the US currency now circulating the globe as petrodollars, the bank implemented a brief period of high interest rates in 1974 to counter the price shock, only to return to an accommodating policy after the failure of Franklin National Bank in October 1974 to prevent a wider crisis of confidence in the American banking system. This left interest rates at or below the level of inflation, which in turn made the real cost of borrowing US dollars around the world virtually zero. With minor variations, the real cost of dollars remained close to zero until the late 1970s.[97] Needless to say, this encouraged the global sovereign lending process a great deal. Other central banks tried harder to restrict the growth of money and reduce inflation in their societies. In West Germany, the Bundesbank adopted annual targets for monetary growth in December 1974 in the hope of lowering expectations of future inflation throughout the Federal Republic. If workers and corporations knew that the money supply would grow at 8% (the bank's first growth target), then it was hoped that growth in wages and prices would be stunted. Although the bank consistently overshot its targets until the late 1970s, the strategy was generally effective and West German inflation stayed far below the

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[96] This had always been true about monetary policy, but the political nature of central bank policy dramatically increased as the amount of government borrowing increased after 1973-74.
[97] Jeffrey Frieden, *Global Capitalism: Its Fall and Rise in the Twentieth Century* (New York, 2006), p. 368-369.

OECD average throughout the 1970s.[98] In Tokyo, the Bank of Japan also adopted a form of monetary targeting in 1975 aimed at influencing the wage bargaining process and inflation responded, dropping from an average of 10.8% from 1970-1975 to 6.4% in 1975-1980. Both the West German and Japanese moves to control inflation with stricter monetary policy were important in solving their own countries' inflationary pressures. But as long as the real engine of global liquidity, the U.S. Federal Reserve, failed to attack inflation with all its might, governments would continue to have little trouble financing their domestic priorities. Until the Federal Reserve adjusted, political systems throughout the world would not be forced to adjust either.

This made any governmental attempt to adjust to the post-oil crisis reality a political choice, and an extremely unpopular one at that. Three days after assuming the presidency in August 1974, US President Gerald Ford told the nation in a nationally televised address, "inflation is our domestic public enemy No. 1," and proceeded to launch a campaign to WIN (Whip Inflation Now), under which he encouraged Americans to grow their own food, balance their budgets, and use credit sparingly. Doing little to halt inflation, the only real effect of the WIN campaign was to contribute to the record losses of the Republican Party in the November 1974 midterm elections. Chastened by electoral defeat and dealing with massive Democratic majorities in both houses of Congress, Ford signed a series of simulative tax cuts in 1975 and left the challenge of government-imposed austerity to another day.[99] Throughout the rest of the

[98] From 1975-1978, the Bundesbank targeted an 8% growth in the money supply, and the supply actually grew by 10.1%, 9.2%, 9.0%, and 11.4% in the years 1975-1978. See Norbert Kloten, Karl-Heinz Ketterer, and Rainer Vollmer, "West Germany's Stabilization Performance," in Maier, ed., *The Politics of Inflation and Economic Stagnation*, p. 394.
[99] Judith Stein, *Pivotal Decade: How the United States Traded Factories for Finance in the Seventies* (New Haven, CT, 2010), pp. 112-115.

West, governmental attempts to prioritize fighting inflation over restoring full employment were ground to pieces by the forces of political opposition. Only in West Germany did Chancellor Helmut Schmidt, a social democrat who enjoyed strong ties with the West German trade unions, succeed in passing a contentious austerity package in 1975. He did so by leaning on his stature as a representative of the workers who was merely delivering the economic bad news that the new market conditions demanded. As he told the nation the year after the austerity measures passed, "Nothing will ever be like it was before 1974."[100]

Most Western politicians and the constituents they served did not want to believe Schmidt's fatalistic conclusion. Even those who did found their message unpopular in democracies that favored those who promised a return to the glory of the pre-oil crisis years. Perhaps no other work captured the prevailing mood across the West like the British economist Fred Hirsch's 1976 *The Social Limits to Growth*. "Economic liberalism," Hirsch wrote, is "a victim of its own propaganda: offered to all, it has evoked demands and pressures that cannot be contained." The promise of affluence had been extended to everyone in Western societies because of the "principle of universal participation" and "the demands of political legitimation." Although "the spread of bourgeois objectives downward through the social scale strengthens the political legitimacy of liberal market capitalism," Hirsch wrote, "the same process proves ultimately disruptive to economic performance." To restore the economic performance of bygone years, Hirsch argued that "a major adjustment needs to be made to the legitimate scope for individual economic striving." The fundamental economic problem of "advanced societies," he wrote, "is a structural need to pull back the bounds of economic self-advancement." The prospects of this occurring were dim because the "central fact of the modern situation is the need

[100] Markovits, *The Politics of West German Trade Unions*, p. 126-132, quote at p. 126.

to justify." That, Hirsch wrote, was "its moral triumph and its unsolved technical problem." The fact that resolution to the West's economic problems needed to be "ethically defensible" imposed "drastic limits on the set of feasible solutions." This meant that the biggest challenge to industrial societies was formulating policies to solve the crisis, but rather gaining "the public acceptance necessary to make them work."[101]

Public acceptance was indeed the challenge of the hour, and few Western states appeared capable of fostering it. If social consensus would forever evade Western democracies, perhaps political systems that discarded it all together would fare better in the post-1974 world. If nothing would ever be the same after the oil crisis, perhaps the future at last belonged to the community of socialist states.

An Invisible Crisis in State Socialism

Quite understandably, the socialist leaders of the Eastern Bloc wanted to avoid the problems vexing their democratic capitalist counterparts. At first glance, they appeared well positioned to do so. Over the course of the decade, however, it would become clear that they could no more escape the instability of the world market than the nations of the West. Until the mid-1970s, prices within Comecon were fixed as part of the five year planning process for the duration of the plan period. Thus, in 1970, the USSR had set the price for its oil within Comecon for the entire period 1971-1975 at 14 rubles per ton, roughly $2.43 per barrel.[102] At that time, oil prices on the world market hovered around $2 per barrel, so Comecon states paid a slight price

[101] Fred Hirsch, *The Social Limits to Growth* (Cambridge, MA, 1976), pp. 11, 170, 190.
[102] Calculated based on oil and currency values in "Preise für den Import von Erdöl und Erdgas aus der UdSSR seit 1972 Gegenüberstellung dieser Preise zu den kapitalistischen Weltmarktpreisen und Ausweis des Vorteils für die DDR," undated but 1985, DE/1/58747, BArch Berlin.

premium for Soviet oil. It was a premium they were happy to pay because trade with the Soviet Union was not conducted in “hard currency" - currencies that were freely convertible such as the US dollar, British pound, or West German Deutsch Mark. Although Soviet oil was priced in rubles for accounting purposes, Comecon trade was conducted on a barter basis within the five-year plans. Before the oil crisis, planners would use the five year planning process to determine that Soviet oil was worth a certain amount of East German television sets, Czechoslovak engineering equipment, or Polish ships, and trade for the entire period would proceed at that price. For Eastern Bloc countries, which generally imported raw materials and exported finished products, this arrangement had two overriding advantages compared to the trade they conducted on Western markets: their products had a guaranteed buyer, and the could be sold without regard for their quality. Soviet officials could (and did) protest about the quality of East European goods sent their way, but without radically altering the structure of Comecon, there was little they could do to stop the flow of inferior goods. These advantages for Eastern Europe notwithstanding, trade within Comecon before the oil crisis was not fundamentally different from trade on the world market. The barter system did not emphasize quality, but the economic value ascribed to goods (as seen in the rough parity of Comecon and world oil prices) was basically in line with world market values.

The commodity price explosion of the early 1970s fundamentally altered this dynamic. Within a matter of months from late 1973 to early 1974, the world market value of the Soviet Union's energy resources quadrupled, and with it, the country's dominion over the rest of the bloc became an enormous economic liability.[103] As long as world energy prices remained above ten

[103] Scholars generally believe that Eastern Europe had only been an economic "asset" under the reparations regime of the postwar period. In the 1960s, it is generally estimated that the Soviet Union lost slightly from its trade with Eastern Europe, but only in the 1970s did the opportunity

dollars a barrel, any deliveries of Soviet oil to Eastern Europe at two and a half dollars a barrel would represent a breathtaking loss on the sale of the country's most valuable asset. However, if Comecon prices were adjusted to reflect the new world market prices, Eastern Bloc countries would have to dramatically increase their exports to the Soviet Union to pay the new prices. This increase in exports would have to come at the expense of domestic consumption, and thus it had the potential to disrupt the unwritten social contracts of late socialism and produce another 1953, 1956, 1968, or 1970. This was a prospect that all Eastern Bloc leaders hoped to avoid, so they used all the tools at their disposal to insulate their domestic social contracts from changes in the world market and Comecon. After the oil crisis, a new tension defined relations among the "fraternal allies" - the economic interests of the Soviet Union now stood in stark opposition to the geopolitical, ideological, and social priorities of the bloc as a whole.

This tension first appeared in 1974 after the Soviet leadership proposed a new Comecon pricing system that would dramatically increase the price of Soviet energy resources to move them more in line with the new world market prices. The Soviet Politburo debated the issue on numerous occasions that year, and Soviet General Secretary Leonid Brezhnev "personally attache[d] great importance to this question," Gosplan chairman Nikolai Baibakov told his East German counterpart Gerhard Schürer in December of that year. The Soviet leader believed "that no socialist country, nor the Soviet Union, should have a setback in national economic development due to price regulation." For the leadership, the issue of oil prices was "fundamentally a political question, not just a purely economic problem," Baibakov said. Soviet

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cost of its trade with Eastern Europe dramatically increase. That is, before 1973, all commodities were relatively undervalued on world markets, so the slight losses in the Soviet-Eastern European economic relationship were not unique for policymakers in Moscow. After the 1973 commodity price explosion, the low price of Soviet raw materials within Comecon stood in stark contrast to world market prices.

leaders knew that a transition to current world market prices “could lead to the emergence of chaos in the economies of the socialist countries, as is currently the case in capitalist countries.” At the same time, however, they believed the socialist countries could not “completely separate themselves from the development on the world market” because the price changes were “an objective [and] irreversible process.” This meant that the socialist bloc could not “escape the prevailing price increase on the world market.”[104]

Escape was precisely what Eastern European leaders believed the bloc should do. For them, the oil crisis was the clearest sign yet that capitalism was prone to crisis and doomed to failure. Official East German policy maintained that the oil price shock was “influenced to a large degree by speculative and inflationary factors,” which arose “out of the intensification of the general crisis of the capitalist system, especially from the chronic energy, currency, and financial crisis.”[105] Similarly, the Hungarian Socialist Workers’ Party concluded that “manipulations of international capitalist monopolies” had produced the commodity price shock. Hungarian party documents declared in 1975, “The general crisis of capitalism deepens, ... it is demonstrated by phenomena such as the slowdown and decline in industrial production in a number of capitalist countries, accelerating inflation, economic imbalance, and frequent disruption.”[106]

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[104] Gerhard Schürer, “Information über ein Gespräch zwischen Genossen Schürer und Genossen Baibakow am 9.12.1974,” December 9, 1974, DE/1/58586, BArch Berlin.
[105] “Standpunkt der DDR zur Gestaltung der RGW-Preise 1976-1980,” May 30, 1974, DE/1/58577, BArch Berlin.
[106] Mong, p. 150. [1975 tavaszára, a párt XI. kongresszusának idejére
ez a növekedési vitáéi isdőlt, azzal, hogy az ütem nem csökkenthető lényeges
mértékben, a módosítottterv végül az 5,5-6 százalékos tartományt lőtte be. A kongresszus
dokumentumaaz olajárrobbanást elsősorban
„a nemzetközi tőkés monopóliumok mesterkedéseinek"tulajdonította, amelytől „nem
függetleníthette magát a magyar népgazdaság sem", deaz egészet a kapitalizmus bomlásaként
értelmezte. „A kapitalista rendszer általános

Faced with capitalism's evident failures, Eastern European leaders thought it foolish to willing import the effects of capitalism's crisis through changes to Comecon prices. As GDR policymakers told their Soviet comrades, the bloc "should under no circumstances" incorporate price increases into the Comecon price system that are based "on speculative… factors of the imperialist system." Such a move would only "transmit the effects of capitalist inflation into our economic relations." Therefore, bloc leaders would have to eliminate "the competitive, speculative, and inflationary factors in the imperialist system from the world market price" before setting Comecon prices. Failure to do so would have drastic social consequences on bloc countries. "In addition to the economic effects," they said, "we must also recognize that political problems could arise if price increases for raw materials trigger a general price increase within our community of states."[107]

Soviet leaders understood the explosive social potential of price changes, but they remained firmly convinced that the price increases were something to be celebrated, not admonished. Far from signaling the power of monopolies and speculators in the capitalist world, the commodity price shocks represented a resounding victory for the global forces arrayed against Western imperialism. "Something fundamental has happened in the world," Nikolai Patolichev, the Soviet Minister of Foreign Trade, told his East German colleagues. "Developing countries have achieved their economic independence in recent years. 1973 was the conclusion of this struggle. This is not an imperialist process but an anti-imperialist development." The socialist community had "supported developing countries in their political struggle, and now

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válsága mélyül, [...] ezt olyan jelenségek is mutatják, mint az ipari termelés megtor-panása vagy visszaesése számos tőkés országban, a felgyorsuló infláció, a gazdaságiegyensúly mind gyakoribb megbomlása."]

[107] "Standpunkt der DDR zur Gestaltung der RGW-Preise 1976-1980," May 30, 1974, DE/1/58577, BArch Berlin.

they have triumphed," Patolichev said. This meant that "by their very nature, the new commodity prices are the result of the anti-imperialist struggle."[108]

In both the East European and Soviet positions on the oil crisis, ideology and material self-interest seamlessly aligned. East European leaders, who had a strong economic interest in maintaining low energy prices, unsurprisingly found ideological justification for their position in the long-standing Marxist-Leninist assumption that capitalism served the capitalist class and inevitably tended toward crisis. The Soviet leadership, which had an overwhelming material interest in extracting a greater price from their allies for their most valuable asset, drew on an ideological tenet with an almost equally long pedigree: Marxism-Leninism's historic alliance with forces of anti-imperialism and decolonization. These differences in ideological interpretation reflected differences in national self-interest and domestic politics that the oil crisis had exposed. As the Soviet Foreign Trade Minister Patolichev rhetorically presented it to GDR officials, "How are we to explain to our people that we are selling our oil 30 rubles below the world market price?" The East German side, and by extension, all Eastern European countries, needed to "understand," Patolichev said, "what it would cost the Soviet side to sell the raw materials so cheaply." The Soviets could not go on providing such a subsidy because they could no longer "explain it to the Soviet people." This made it "absurd to reject" the Soviet Union's "right (*Berechtigung*)" to revise the Comecon price structure.[109] Conversely, as Honecker wrote

[108] Underlining in the original. Horst Sölle, "Niederschrift über eine Zusammenkunft des Ministers für Außenhandel der DDR, Genossen Sölle, mit dem Minister für Außenhandel der UdSSR, Genossen Patolitschew, anläßlich der Übergabe des Aid-mémoires zur Bildung der Vertragspreise im RGW 1976-1980 und 1975," October 3, 1974, BArch Berlin, DE/1/58588
[109] Horst Sölle, "Niederschrift über eine Zusammenkunft des Ministers für Außenhandel der DDR, Genossen Sölle, mit dem Minister für Außenhandel der UdSSR, Genossen Patolitschew, anläßlich der Übergabe des Aid-mémoires zur Bildung der Vertragspreise im RGW 1976-1980 und 1975," October 3, 1974, DE/1/58588, BArch Berlin.

in a 1974 letter to Brezhnev criticizing the proposed price increases, the East German leadership felt it could not allow “a reduction of the population's standard of living" because the state's "class enemies” in the West led “a daily ideological diversion against the people of the GDR.” To counter this threat, Honecker wrote, the East German leadership thought it “necessary to solve a series of social questions (increases in pensions, the minimum wage, support for young families, aid for children, [and] acceleration in the construction of housing, hospitals, and schools, etc.).”[110] The same governing strategy defined the regimes János Kádár in Hungary, Edward Gierek in Poland, Gustáv Husák Czechoslovakia, Todor Zhivkov in Bulgaria, and Nicolae Ceaușescu in Romania. Higher Soviet energy prices would mean fewer houses in Leipzig, lower wages in Gdánsk, emptier shelves in Sofia, and more political instability everywhere.

Ultimately, it was the Soviet Union that had the oil, so it was the Kremlin that set the policy. At first, according to Gosplan chairman Baibakov, the Soviet Politburo decided that energy prices within Comecon for 1975 should be set based on an average of the world market price in 1973 and 1974. Because these two years contained the dramatic price increases, this would have served Soviet economic interests handsomely. But after hearing the loud protestations of their Eastern Bloc allies, particularly “Czechoslovakia and Bulgaria,” the Politburo decided that the two year price average would be "too difficult for the socialist countries because only the years with the high world market prices would be covered." Instead, they chose to base the 1975 price on an average of 1972, 1973, and 1974 in order to include "one year each with low, medium, and high price[s]." After 1975, in what would become known as

[110] Letter from Erich Honecker to Leonid Brezhnev, December 9, 1974, DE/1/58586, BArch Berlin.

the Bucharest Formula for the city in which it was agreed upon, the Comecon price system would adjust based on a rolling average of the previous five years of world market prices.

It was a decision worth billions of rubles, and by extension, billions of dollars. As Baibakov explained, if Comecon moved immediately to world market prices, the socialist countries would have to export an extra sixteen billion rubles worth of goods to the Soviet Union during the 1976 to 1980 Five Year Plan. Under the system of flexible prices, the sixteen billion ruble burden on Eastern Europe would fall to seven or eight billion rubles. "In other words," Baibakov made clear, "the Soviet Union [will] receive 7-8 billion rubles less from the CMEA countries than if [trade] were based on current world market prices."[111] Patolichev described the new sliding price system as "an optimal compromise, which splits the necessary strains between the USSR and the other CMEA countries." Optimal did not mean easy, however. Everyone involved in the negotiations throughout the bloc knew that the consequences of their decisions would be vast and long lasting. As Patolichev told Erich Honecker in the midst of a particularly testy exchange, "The current change in Comecon prices is the most difficult task of my life…. The system of sliding prices is not only a question for the USSR, but also politically and economically important for the entire socialist community."[112]

That which appeared difficult to Soviet officials appeared life-threatening to Eastern European officials. Even under the sliding price system, it was now clear that the price of their energy would dramatically increase in the years ahead. Upon hearing of Moscow's move to change the pricing system, Erich Honecker called an emergency meeting of the East German

[111] Gerhard Schürer, "Information über ein Gespräch zwischen Genossen Schürer und Genossen Baibakow am 9.12.1974," December 9, 1974, DE/1/58586, BArch Berlin.
[112] Even though he is not listed in the document title, Patolichev quoted in, "Niederschrift über die Beratung zwischen Genossen Erich Honecker und Genossen Baibakow am 21.12.1974," December 21, 1974, DE/1/58586, BArch Berlin.

leadership to formulate a response. There were domestic and international dimensions to the Soviet decision that needed to be discussed. Internationally, the General Secretary observed that the oil crisis had fundamentally, and perhaps permanently, changed Eastern Europe's economic value to the Soviet Union. "Until now," he said, "we have paid more for a ton of oil from the USSR than the FRG [Federal Republic of Germany]. That may have changed as a result of the price increases in the West." For the foreseeable future, Eastern Europe would now be an economic burden on Moscow. Domestically, the sliding price system presented the prospect of social and political disruption. The first estimate of the economic losses for the GDR under the new price system projected an additional cost of 7-8 billion Marks in 1975 and 8-9 billion Marks per year during the period 1976-1980. To put the scale of these costs in perspective, Horst Sölle warned that the new annual costs for Soviet oil were "more than the annual increase in national income." Günter Mittag, Honecker's deputy and chief economic official in the GDR, understood immediately what this would mean for the country: "an absolute fall in living standards in the GDR." He was furious. "These measures would practically invalidate Comecon's system of fixed prices," he said. "Planning without fixed prices is not possible." If prices were not fixed, then insulating the GDR from world market volatility would be impossible and the inflation pervading the capitalist world would creep into the Eastern Bloc. For Honecker, preventing this from happening was a top priority. "We have no intention of letting inflation penetrate the socialist camp," he told the group. Budget subsidies were the only way to turn flexible and rising import prices into stable and cheap domestic prices, so the fight against world inflation would come at the expense of the state budget.[113] Honecker gave the new marching orders to his

[113] Klopfer, "Persönliche Niederschrift über eine Beratung beim 1. Sekretär des Zentralkomitees der SED am 9.8.1974," August 9th, 1974, DE/1/58586, BArch Berlin.

State Planning Commissioner, Gerhard Schürer, on January 31, 1975. “The main task,” he said, was to achieve economic growth “by means of intensification” - the socialist term for increases in productivity – and to ensure that “social security is placed at the center of the development of working and living conditions.” Social security meant “above all, stability of prices…. implementation of the housing program, preservation and expansion of health care capacities, and safeguarding of the school program.”[114] Progress in the land of real existing socialism would go on, Honecker had decided, no matter the consequences.

So too would it in Hungary. In 1972, the Hungarian Politburo had decided on “the need to further improve the position of the working class” and “to increase real wages.” A capitalist crisis like the oil price shock was not going to stand in the way of this goal. János Kádár told the country in his speech to 11th Party Congress in 1975, “Despite the external difficulties it is possible for our national economy to develop in the coming years at approximately the same rate and for living standards to continue to rise as they have in the past.”[115] The party program adopted at the 1975 congress insisted, as Attila Mong notes, “in the style of the 1950s,” that the final stage of communism would arrive in Hungary in the next fifteen to twenty years. “In order to create conditions for the transition from a developed socialist society to the establishment of communism, the following production and development targets are to be achieved: a 2-2.5 fold increase in per capita national income, a 2.5-3 fold increase in industrial production, 1.5-2 fold increase in agriculture, and a 2.5-3 fold increase in construction.”[116] The inevitable arrival of

[114] Gerhard Schürer, “Vermerk,” January 31, 1975, DE/1/58746, BArch Berlin.
[115] Quoted in Mong, p. 151. [Kádár a kongresszuson mondott beszédében elismerte ugyan, hogy valószínűleg tartós változásról van szó a világpiacon, de hangsúlyozta, hogy *„a külső nehézségek ellenére elérhetőhogy népgazdaságunk a következő években is az előző éveket megközelítő ütemben fejlődjék és az életszínvonal tovább emelkedjék"*]
[116] Quoted in Ibid, p. 150-151 [A programnyilatkozat ezért a következő 15-20 évre a korábbi növekedési ütem fennmaradásával számolt. A dokumentum az 1950-es évek stílusában - azt

communism clearly would not be delayed or deferred. To minimally account for the oil crisis, ministers in the National Planning Office tried to suggest the annual growth rate in national income for the 1976-1980 Five Year Plan be modestly reduced to 5-5.5% from the 6.3% it had been from 1971-1975. "We received a vigorous response" from the party leadership, István Hetényi, an official in the planning office recalled. "The Chairman of the National Planning Office toured the various party organizations, and then came back and composed new [planning] materials that did not decrease the pace [of growth]. The "'give more' attitude" of the early 1970s, Hetényi recalled, "exploded into the oil crisis."[117]

The bloc regimes' decisions to leave the social contract untouched in the face of the oil crisis was born of searing historical memories. Gerhard Schürer, the head of the East German State Planning Commission, wrote of the East German leadership, "Since the sugar price increase of June 17th, 1953, the fear of price increases on basic goods sat so deep in the bones of policymakers that no one achieved a change."[118] In Poland, dangerous history was much closer at hand – Gierek owed his entire ascension to the pinnacle of the country to the repeal of the

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bizonygatta, hogy a helyzet kiegyensúlyozott, a magyar társadalom nekiláthat a kommunizmusba való megérkezés utolsó fázisához. „A fejlett szocialista társadalom megteremtése és a kommunizmus építésére való átmenet feltételeinek létrehozása érdekében hazánkban az eljövendő 15-20 év alatt a következő termelési-fejlesztési célokat kell elérni: az egy főre jutó nemzeti jövedelmet a jelenleginek 2-2,5-szeresére, az ipar termelését 2,5-3-szorosára, a mezőgazdaságét 1,5-2-szeresére, az építőiparét 2,5-3-szorosára kell emelni."]

[117] Mong, p. 150. [1966-1970 között átlagosan 6,8, majd 1971-1975 között 6,3 százalékos volt a nemzeti jövedelem évi átlagos bővülése.91 Az Országos Tervhivatal szakértői finoman felvetették, hogy a kitűzött ütemet az 5-5,5 százalékos tartományba kellene mérsékelni.92 „Nagyon erőteljes visszautasításban részesültünk. Ne felejtsük el, hogy ez volt az az időszak, amikor az 1972-es MSZMP KB-határozat után felmerült, hogy tovább kell javítani a munkásosztály helyzetén, növelni kell a reálbéreket, tehát éppen egy ilyen »többet adni« hangulatba robbant bele az olajválság. Az OT elnöke végigjárta a különböző pártszervezeteket, majd visszajött, hogy készítsünk egy másik anyagot, abban pedig ne csökkentsük a tempót" - idézte vissza az eseményeket Hetényi, aki szerint „a remény győzött a tapasztalat felett".]

[118] Gerhard Schürer, *Gewagt und Verloren*, p. 75.

1970 price increases and the start of his "New Development Program" that promised workers a better life. In Hungary, Kádár had secured the political acquiescence of the population after the national trauma of 1956 with a single promise: ever increasing living standards. Gustav Husak was detested throughout Czechoslovakia, but after 1968 he had driven a similar bargain. Higher living standards were the price of social peace.

But if history and politics provided the impetus for late socialism, they are not what made it possible. For that, the particular configuration of the global capitalist economy that emerged after the oil crisis was required. In a supreme irony, it was only the development of global finance capitalism that allowed late socialism to exist. Without the explosive growth of global capital markets after 1970, and particularly 1974, the governing model of late socialism would have been impossible. Had there been no transnational pools of capital in the 1970s, or had they been more highly regulated and thus less easily accessed, the entire timeline of socialism's denouement would almost certainly have looked completely different. Rather than speaking of the rise of Solidarity in a Polish Crisis of 1980 and 1981, we might instead be writing about a Polish, Hungarian, or East German Crisis of 1974 or 1975. Günter Mittag, the East German party leader for economic policy, admitted as much in his memoirs. Since in the 1970s, he wrote, "it was regarded as an indisputable axiom that the standard of living should increase, loans were taken out to bridge supply shortages." Had these loans not been available, the Unity of Social and Economic Policy – the East German version of late socialism - would have quickly become untenable. Abandoning this policy, Mittag wrote, would have "been a funeral for the GDR in the 1970s." Upending the social contract would have produced "social conflicts with political consequences, which would probably have affected more than just the former GDR." In the 1970s, "a possible political destabilization in the GDR through a restriction of social policy was connected with an incalculable political risk. In this respect, the guarantee of economic and social stability was a basic premise of all political action."[119] In the same way, a basic, yet unexamined, premise of our political histories of the last period of the Cold War is the intimate relationship between the globalizing financial capitalism of the 1970s and the fragile stability of late socialism. It was a relationship that quietly underwrote everything from the daily lives of Eastern Europeans, who unknowingly depended on it to put food on their tables and goods in their stores, to the high politics of the Cold War, where it was the prerequisite for détente on the European continent. Its power was really only apparent once it was gone, as it would be in 1980, at which point the broken connection between finance capitalism and late socialism would produce a crisis in Poland that would disrupt both the daily lives of Eastern Europeans and the high politics of the Cold War.

A closer look at the situation of the GDR at the moment the oil crisis struck will illustrate this interdependence.[120] Just as the oil crisis was beginning to unfold in November 1973, members of the East German Ministry of Finance produced a projection of the GDR's debt out to 1980 if the country maintained its trajectory under the rapidly rising world prices. The results were frightening. The GDR's debt to the West at the end of 1974 was projected to be 8.7 billion

[119] Günter Mittag, *Um Jeden Preis* (Berlin, DE, 1991), p. 61-63.

[120] Here, as throughout the chapter, I will examine East Germany in depth, because the documents are available and I can conduct research in German. As with Soviet oil prices, differences between East Germany, Poland, and Hungary in their interaction with Western capital markets were differences of degree, rather than kind. So, although a complete history will await further documentation in domestic archives, it can be assumed that the dilemmas present in the history that follows were also present in Poland, Hungary, Bulgaria, and Czechoslovakia. Romania was slightly different because it did not import any Soviet oil, but this only exposed it more heavily to the world market changes and dependence on Western credit markets. Yugoslavia stood apart from the rest of the socialist states of Eastern Europe because Western governments viewed it with favor, so it received highly subsidized credits to a greater degree than any other country.

VM [Valutamarks], roughly $3.5 billion.[121] Even under the optimistic assumptions that East German exports to the West would rise 15% annually while imports would rise only 5% annually from 1975-1980, the projection anticipated the hard currency debt growing from 12.1 billion VM in 1975 to 25.5 billion VM, or roughly $10 billion, in 1980. The officials believed such a level of debt would simply not be possible to attain. They estimated that over the entire period of 1974-1980, 18 billion VM of planned borrowing on global capital markets was simply "not financeable." "All calculations show," they wrote, that the nation's economic trajectory "is not viable" because "of the development of the debt and the impossible financing [requirements]." The projections, the officials wrote, showed that "viable solutions for the balance of payments up to 1980 require a change of exports and/or imports on a scale of about 2 billion marks in 1974."[122] Two billion marks worth of goods would have to be removed from the domestic economy and sent abroad (or, conversely, prevented from being imported in the first place) to ensure the long-term solvency of the country, and similar amounts would have to be removed each year from 1975-1980 as well. This was, in numerical form, a call for a revision of the domestic social contract and an end to the Unity of Social and Economic Policy.[123]

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[121] Valutamarks were the East German accounting unit meant to signal the value of a West German Deutsch Mark without, for political and ideological reasons, using the designation Deutsch Mark. At this time, a Valutamark was valued at a rate of 2.5 VM to 1 US Dollar, so this total represented about $3.5 billion.

[122] Günter Ehrensperger and another author whose signature is illegible, "Probleme und Konsequenzen aus der Arbeit am Volkswirtschaftsplan 1974 auf dem Gebiet der Zahlungsbilanz gegenüber dem nichtsozialistischen Wirtschaftsgebiet bis 1980," November 6, 1973, DY/30/25761, BArch Berlin.

[123] Sixteen years later, Ehrensperger would rise to address the East German leadership on the morning of November 10, 1989, the day after the surprise opening of the Berlin Wall. With the entire leadership stunned at the collapse of communist order and authority unfolding all around them, there was a desperate search for answers as to how they found themselves in such a dire position. Ehrensperger drew their attention back to the early 1970s. "In 1973 there was a huge worldwide price explosion," and "the purchase of oil and other raw materials became much more expensive for the GDR." In November of that year, he recounted to the group, the Finance

In its first months, the oil crisis only seemed to make the prospects for substantial Eastern Bloc borrowing worse. As discussed above, many Western observers did not think the Euromarkets could sustainably manage the process of petrodollar recycling for any period longer than a couple of months. David Rockefeller, chairman of Chase Manhattan Bank, worriedly noted in the summer of 1974 that "both the capital of the banks and the increasing lending risks are becoming serious constraints." Banks, in short, did have enough money to meet the world's credit needs, and they were beginning to hesitate in lending out the money they did have. This dynamic, Rockefeller said, could "sharpen the scarcity of funds in the market."[124] This analysis was immediately and urgently echoed within the East German leadership. In March 1974, there were "fundamental differences of opinion" among the economic leadership on the question of whether "the necessary sources of credit for financing the planned imports of 1975-1980" could be found. It remained an open question because East German bankers had recently been forced to "meet existing debt payments by taking out new loans." This was "already a tense goal because the existing sources of credit [were] largely exhausted." Foreign banks were "increasingly questioning the liquidity of the GDR." As a result, there were "already increasing

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Ministry put together a "calculation of the effects" of the oil crisis that showed that if the country "drew no conclusions and went on living [as it had been], we would have 20 billion VM in debt by 1980." Ehrensperger told the assembled leaders that he submitted the projection to leader of the Finance and Planning Division at the time, Werner Krolikowski, who in turn took the report to Honecker for the General Secretary's review. The reaction was swift and firm. After meeting with Honecker, Krolikowski summoned Ehrensperger to his office that night and told him that "effective immediately" he "did not have to work on such calculations and planning" any longer. "I did not get the material back," Ehrensperger recalled, "and I was to arrange that all relavant documents [to the calculations] were destroyed." With the shock of the fall of the Wall still fresh in everyone's mind, he concluded, "If you want to know in a sentence why we are in this position today, then you must say completely objectively (*ganz sachlich*) that year after year we have lived beyond our means and deluded ourselves since at least 1973." See "Diskussionreden E. Krenz, G. Ehrensperger, Gerhard Schürer auf 9. Und 10. ZK-Tagung," November 8-10, 1989, DE/1/58736, BArch Berlin.

[124] Quoted in James, *International Monetary Cooperation*, p. 320.

difficulties" in financing "the growing payment obligations by promptly taking out new loans." The first months of higher commodity prices had made the availability of credit worse, not better. "Leading capitalist industrial states, France, Great Britain, and Italy for example, have significant problems in funding their balance of payments…This results in a high level of credit requirements for these countries, which restricts the possibilities of mobilizing credit sources for the banks of the GDR."[125] Markets, it seemed, might force a change in East German domestic policy whether the leadership wanted one or not.

Throughout the tumultuous summer of 1974 in the West, the debate over the sustainability of the bloc's access to global capital markets continued. As the Soviet Union worked to change Comecon prices in September, a newly formed group of top economic officials in the GDR, "The Balance of Payments Working Group," discussed a Marxist-Leninist analysis of the Euromarkets designated "Top Secret." In the first section titled, "The Nature of the Eurocurrency Market and Its Risks," the author (who remained unnamed) detailed how the markets had begun in the late 1950s when surpluses of US dollars ended up in Europe due to the "unrestricted political and economic predominance of US imperialism on the world capitalist market." Then, in the late 1960s, "objectively acting laws of the capitalist mode of production" such as the "uneven economic development of capitalist industrial states" and "the excessive expenditure of US imperialism on financing its aggressive global strategy" led to a breakup of the Bretton Woods system in 1971. The report reminded the working group that the party had recently decided that "the general crisis of capitalism has reached a new stage," and declared that

[125] Grünheid, "Information für Genossen Schürer über die Planberatung mit dem Minister für Außenhandel, Genossen Sölle, zum Stand der Ausarbeitung der Staatlichen Aufgaben für 1975 und zur Konzeption für den Zeitraum 1976 bis 1980," March 28, 1974, DE/1/58580, BArch Berlin.

this conclusion was “fully applicable to the development of the Eurocurrency market.” Global confidence in the US dollar was falling “constantly,” the report noted, and the floating exchange rate system had led to “more and more speculative transactions” on the capitalist financial and foreign exchange markets, which made activities on these markets “ever more risky.” The upshot was clear: “with its inherent risks, the Eurocurrency market does not provide a long-term basis for financing balance of payments deficits.”[126] Exactly how officials in other socialist states analyzed their prospects on the Euromarkets at this moment awaits further archival research. Because Western banks tended to evaluate all socialist states as a single group, it is likely that Polish and Hungarian officials shared the East German doubts. But whether analysis in other bloc capitals echoed that coming out of East Berlin, all bloc states nevertheless confronted the same precarious situation. As 1975 approached with all Eastern European leaders determined not to let increases in Soviet energy prices lead to a fall in domestic living standards, bankers throughout the bloc had no choice but to test how much money Western capital markets would let them borrow.

To universal surprise, it turned out to be a great deal. Once it became clear that private banks could manage petrodollar recycling on a permanent basis, economic plans across the world that had been deemed “not financeable” in 1973 became eminently so by 1975. The rapid expansion of the Euromarkets that began in 1974 pushed the horizon for living on credit to a level that would have been deemed dangerous and impractical just one year earlier. OPEC nations accumulated a $60 billion current account surplus in 1974. Of this $60 billion, $21

[126] No author, “Die Auswirkungen der krisenhaften Situation auf dem Eurogeldmarkt auf die Lösung der Finanzierungsaufgaben der Außenhandelsbank im Rahmen der Zahlungsbilanz 1975 und für die weiteren Jahre,” attachment to “Tagesordnung für die Sitzung der Arbeitsgruppe Zahlungsbilanz am 27. September 1974, 8.30 Uhr, Zimmer 441,” September 27, 1974, DY 3023/963, BArch Berlin.

billion was deposited with Eurocurrency banks, and the total assets of the five largest US banks grew at an unprecedented annual rate of 40% in 1974.[127] The US Federal Reserve's attempt to ease the recession in the United States through accommodating monetary policy kept interest rates low and liquidity high. Western banks were, in short, flush with cash and eager to find places to put it. The time was ripe for a marriage of convenience, and in 1975, the Eastern Bloc as a whole borrowed more money than they ever had before. Publicized Eurocurrency loans to the bloc – the type that East German officials had feared would suddenly become scarce - more than doubled from 1974 to 1975, rising from $1 billion to $2.4 billion. Quite literally, the surplus capital generated by a global crisis in capitalism was now funding state socialism's defense against the global capitalist system.[128]

Indeed, by the opening of 1976, the growth of socialist borrowing was so notable that *Euromoney* magazine, the publication of record for the Euromarkets in the 1970s, put the Eastern Bloc on the cover of its January issue (Figure 1). "It is customary to begin the new year with a backward look," the lead article noted, "and if we focus on the Euromarkets, the number and nature of Comecon borrowings in 1975 are striking."[129]

[127] William Witherell, "Policy Issues in International Finance," June 17, 1975, Folder "June 1975," Box 1, Office of Assistant Secretary for International Affairs, Chronological Files of the Office of Financial Resources and Energy Finance, 1974-1977, National Archives and Records Administration (NARA), College Park, MD.
[128] Publicized loans were only one type of loan that the Eastern Bloc received. A much greater, but also untraceable, percentage of the debt was built up through short-term deposits that Western banks placed in Eastern Bloc central and foreign trade banks. These short-term deposits also dramatically increased in 1974-75, though by precisely how much is unclear. Short-term deposits and the level of publicized credits are discussed in "How the East Bloc Tapped the Euromarkets," *Euromoney*, January 1977, p. 24.
[129] Charles Schmidt, "Comecon's Borrowing Requirements in 1976," *Euromoney*, January 1976, p. 12.

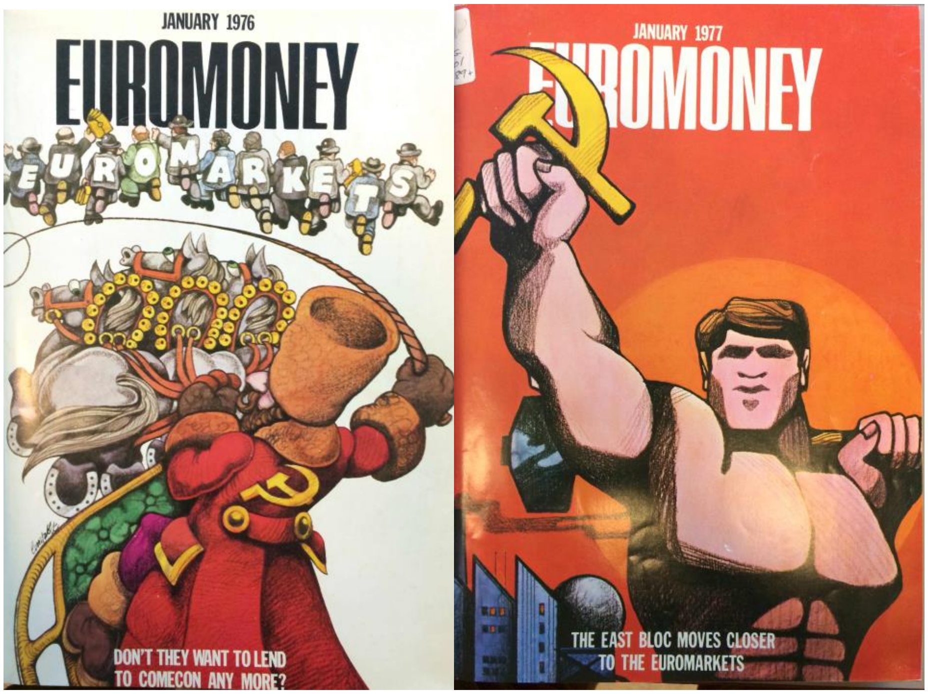

Figure 1: The January 1976 and January 1977 covers of *Euromoney* magazine, the periodical of record for the international bankers in the 1970s, demonstrates the importance the Western financial community placed on its lending to socialist states.

There was so much Comecon borrowing in 1975 that by early 1976, Western financial and political leaders were beginning to question the bloc's creditworthiness. The January 1976 *Euromoney* article noted it was "inevitable" that "the magic" would eventually "go out of lending to Comecon countries. Western commercial banks are beginning to conduct business with the Socialist [*sic*] world on the same terms that they extend to the rest of the international community."[130] In May, a widely discussed article in *Business Week* quoted Zbigniew Brzezinski, a leading voice in the Trilaterist movement and soon to become Jimmy Carter's National Security Advisor, on the political dimensions of the increase in the Eastern Bloc's debt. "We are dealing with both an opportunity and a threat," Brzezinski told the magazine in a

[130] Ibid, p. 14.

quintessential expression of the logic of interdependence. “Indebtedness often increases the leverage of the debtor and decreases the leverage of the creditor,” he said. “If a Comecon country defaulted, it could create considerable problems” for banks in Western European countries, who had lent out the most money.[131] This threat of interdependence was the concern of US Secretary of State Henry Kissinger, who warned a gathering OECD officials in June 1976 of “possible efforts” by socialist states “to misuse economic relations for political purposes inimical” to the West.[132] Amidst more pressing East-West problems like the war in Angola and nuclear arms control, these vague concerns only momentarily rose above the general din of Cold War concerns.

Nevertheless, the flurry of commentary in the West caught the ear of officials in the East who were now highly sensitive to changes in global market sentiment. “The capitalist national and international banks,” East German officials wrote in early 1976, “have recently expressed doubts about the creditworthiness of the socialist countries. That was not always so. A few years ago, outstanding credits to socialist countries were among the safest credits of any capitalist bank. Insolvency from a borrower in a socialist country was as unthinkable, for example, as an insolvency from the American automaker General Motors.”[133] A translated copy of the *Business Week* article citing Brzezinski made the rounds through the East German leadership. Horst Kaminsky, the President of the East German State Bank, attached an explanatory cover note stating that the article “points to the imperialist side’s particular intentions and objectives in granting credit to socialist countries.” But if the dangers of a Comecon default had become

[131] “The Debt That Overhangs East-West Dealings,” *Business Week*, May 3, 1976, pp. 118-119.
[132] Bernard Nossiter, “U.S. Urges Wariness in East Trade,” *The Washington Post*, June 22, 1976
[133] “Information über Aspekte und Beziehungen SW/NSW Nr. 8,” February 2, 1976, DN/11/6431, BArch Berlin.

thinkable for both sides by the spring of 1976, that did not stop the banks from lending. As the *Business Week* article summarized, “Comecon will continue to rely heavily on Western financial resources,” and for now “Western banks and governments are still lending.”[134] By the start of 1977, the bloc was once more the star of the Euromarkets and reappeared on the cover of *Euromoney*. “Any concern over the rapid increase in the level of indebtedness of the CMEA countries has not restricted the volume of lending. On the contrary, 1976 was a vintage year,” journalists for the magazine wrote. Banks seemed to agree they had lent Comecon too much, but they couldn’t help themselves from lending more. Eurocurrency credits had increased 33% in 1976 to $3.2 billion, and there was no end in sight.[135]

So, why did the banks continue to lend? Money and erroneous assumptions pushed their enthusiasm beyond rationality. “On any normal criteria” one London banker told *Euromoney*, the Eastern Bloc was “certainly overborrowed.” But banks were not holding the bloc to high standards of creditworthiness “because they’re so flush with funds,” another said.[136] A confident ideology compounded the enticements of easy liquidity. Citibank CEO Walter Wriston, the leading proponent of the global movement toward sovereign lending in the 1970s, had notoriously proclaimed, “Countries don’t go bankrupt.”[137] Above and beyond “normal” capitalist countries, bankers believed socialist countries had three other advantages. First, they had a pristine record of timely payment and had never defaulted on their debts. Second, bankers

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[134] “The Debt That Overhangs East-West Dealings,” *Business Week,* May 3, 1976, pp. 118-119.
[135] Richard Ensor and Francis Ghiles, “CMEA Debts May Be $45 Billion, but the Loans Have Kept Flowing,” *Euromoney*, January 1977, p. 23.
[136] Ibid, p. 23.
[137] There are many versions of Wriston’s phrase, usually quoted by his critics and followed by a derisive comment about his foolhardiness, but this version comes from the IMF website. http://www.imf.org/external/np/exr/center/mm/eng/mm_dt_01.htm. Accessed on 12 December 2013.

assumed that socialist states' authoritarian structure meant they had the "ability to control domestic consumption and investment," which would put them "in a better position" to exercise "restraint."[138] Unlike capitalist democracies that promised their citizens too much, socialist authoritarianism was assumed to be adept at implementing austerity. Should that fail, however, bankers saw a strategic reserve behind the Eastern Bloc unparalleled throughout the rest of the global economy – the Soviet Union. Over the course of the decade, they came to believe in what was termed "the umbrella theory," whereby they anticipated that the USSR would "come to the rescue" of its allies if they ran into financial trouble. A U.S. Congressional analysis from the period noted that the umbrella theory had "no known legal premise…as there is no signed agreement, bilateral or multilateral, within the context of Comecon, that would make it incumbent upon the USSR to be the lender of last resort" for Eastern Europe. But, "It is presumed to be in the political interest of the USSR to provide that function…possibly in exchange for non-membership in the IMF."[139] Under the Soviet umbrella, Eastern Europe seemed safe from financial harm.

On top of favorable ideological and financial structures, a group of very talented communist central bankers represented their countries on Western financial markets with aplomb. To read the Western press coverage of these men is to sense the potent mix of intrigue and respect with which Western bankers look upon their communist counterparts at this time. Standing at the head of this group, and on par with any financial official in the West, was János Fekete, the Deputy Vice President of the Hungarian National Bank. Fekete had earned his venerable reputation in Western financial circles for accurately predicting a devaluation of the

[138] Charles F. Schmidt, "Comecon's Borrowing Requirements in 1976," *Euromoney*, January 1976, p. 12.
[139] Eichler, "Country Risk Analysis," in *Eastern European Economic Assessment*, p. 767.

US dollar in 1971 and the global recession of 1974-75. By the time he was profiled in *Euromoney* in 1977, the magazine treated his opinions with what verged on oracle-like reverence. There was an entire separate article on the topic of "What Fekete Says About the West," presumably to help the magazine's readers glean insight into the future of capitalism from this astute "Marxist economist." Described as "bespectacled and ebullient," Fekete told *Euromoney* and thus the banking community, that the Eastern Bloc was vastly under borrowed, not overly indebted. "If you take the economic potential of these countries, their debts are ridiculously low," he said. Playing on the Western notion of an umbrella theory, he seamlessly shifted questions about Eastern Europe's problems to a discussion of the Soviet Union's material strength. "In a year, [the Soviet Union] is producing 480 million tons of petrol, it is producing about 300 billion cubic metres of gas, and 700 million tons of coal. It is an enormously strong economy."[140] With such strength in Soviet natural resources, it was implied that the debt of the rest of the bloc hardly mattered. For the time being, Western banks couldn't help but agree.

If Fekete projected self-confidence, Poland's Jan Wołoszyn, the First Deputy President of Bank Handlowy, the Polish foreign trade bank, projected stately elegance. The same 1977 *Euromoney* issue described him as a "distinguished, elder statesman of Polish banking who would look equally at home in the boardroom of any bank in the West."[141] In October 1980, the magazine ran a profile of Wołoszyn as the Solidarity protests grew in Poland. "If Poland's political leaders have a credibility problem with their own citizens," the article reassured, "Wołoszyn…has none with the banks of the West." Contrary to their views of his country's

140 Padraic Fallon, "Hungary's Marxist Economist and Central Banker, János Fekete," *Euromoney*, January 1977, pp. 14-17.
141 Description of Wołoszyn in Padraic Fallon, "Roman Malesa. Bank Handlowy's President and Negotiator," *Euromoney,* January 1977, p. 31.

economic system, bankers had nothing to fear with "Mr. Poland": Wołoszyn was "credible, knowledgeable, and…impressive," had never joined the Polish Communist party, and had thought more than once about leaving banking for more leisurely bourgeois pursuits, gardening foremost among them. "This is a people business," bankers reported to *Euromoney,* and Wołoszyn was "the one who, through his own charisma, standing, and personality, persuades many banks to lend to Poland."[142]

In East Germany, two men, Werner Polze and Horst Kaminsky, ran the country's public financing efforts on the Euromarkets. Polze and Kaminsky went about their business in the West without the fanfare of Fekete or Wołoszyn. After the Cold War, their actions receded further into the background in Germany after the revelation that a man named Alexander Schalck-Golodkowski – known simply as Schalck - had been running an organization within the East German government called *Kommerzielle Koordinierung*. KoKo, as it was called, was charged with creating hard currency for the East German state using any means available. From the late 1960s to the collapse of the state in 1989-1990, this mission led KoKo into all manner of activities including currency and commodity speculation, hotel management, highway construction, consumer goods stores, garbage disposal services for West Berlin, and weapons sales to developing countries. Schalck became one of the most important people within the East German leadership because he became the state's chief negotiator with West Germany on almost all financial matters. After the launch of Willy Brandt's *Ostpolitik* in the late 1960s and the signing of the Basic Treaty normalizing relations between the two German states in 1972, the West German government began to use its financial resources as a tool of its détente policy. East

[142] Nocholas Cumming-Bruce, "Jan Wołoszyn's Struggle for Poland," *Euromoney*, October 1980, pp. 60-62.

Germany was granted access to a "Swing" credit with West German banks, under which it could borrow Deutsch Marks without interest up to a negotiated limit, which ranged from DM500 million to DM800 million in the 1970s and 1980s. Bonn also made an annual transportation payment to the GDR that was ostensibly for the maintenance of the roads running between the Federal Republic and West Berlin, but in fact was free for the East Germans to use as they pleased. Most spectacularly of all, the Federal Republic began buying East Germans' freedom, transferring increasing sums of money to the East German government in exchange for the release of dissidents (and eventually, many others) to the West. Schalck played a role in all of these negotiations while still organizing KoKo's varied commercial activities, so his influence within the East German hierarchy steadily grew over the last two decades of the Cold War. Once the Berlin Wall fell, the public revelations of Koko's dubious activities led many in the newly reunited Germany to label Schalck "public enemy #1."[143]

The East German situation was a particularly vibrant example of how the politics of détente further eased the reigns of capital constraints beyond their already lax hold. Gierek's regime in Poland proved particularly adept at using Western governments' interest in better relations with the Eastern Bloc to unlock Western state coffers. Each US President in the 1970s – Nixon, Ford, and Carter – visited Poland under the banner of détente, and each time they landed in Warsaw, they brought with them increases in US government loan guarantees as a sign

[143] One example of Schalck's divisiveness in the reunited Germany can be found on YouTube. Schalck appeared on the German talk show *Talk im Turm* along with many of his critics for a heated discussion of his role and KoKo's role in the GDR. https://www.youtube.com/watch?v=obf403ii19Y. Accessed March 29. The best historical monograph on Schalck and KoKo is Mattias Judt, *Koko: Mythos und Realität: Das Imperium Schalck-Goldkowski* (Berlin, 2015). A stimulating and comprehensive overview of West German *Ostpolitik* and its attendant financial transfers remains Timothy Garton Ash, *In Europe's Name: Germany and the Divided Continent* (New York, 1993).

of goodwill and a means of boosting US exports.[144] In 1975, on the sidelines of the meetings to sign the Helsinki Accords, Gierek and West German Chancellor Helmut Schmidt signed an agreement granting Warsaw a "jumbo credit" of 500 million DM in exchange for the Polish government's willingness to let its German minority emigrate to the Federal Republic.[145] Ceausescu's Romania parlayed its reputation for independence from Moscow into membership in the International Monetary Fund in 1972, which in turn helped the country gain broader and cheaper access to Euromarket credit. The Kádár regime generally refrained from using détente to gain politically motivated credits from Western governments, but it nevertheless used its reputation in the West as the most liberal and reform-minded country in the bloc to great financial effect.

Even if the question of access to Western credit markets turned out to be surprisingly easy to solve, the question of how to use the borrowed capital proved infinitely vexing. Every foreign borrowing strategy in the Eastern Bloc was at least officially premised on a single idea: using the hard currency to import Western technology, modernize domestic production, and develop industries capable of producing exports to the world market that would earn enough hard currency to pay off the loans. "My principle is that if a country takes a credit and invests it well, producing goods that are necessary to the market, goods that can be sold at the right price, then that credit is a well covered credit," Fekete, the Hungarian central banker, summarized in

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[144] See Documents 130-175 in James Miller, Douglas Selvage, and Laurie Van Hook, eds., *Foreign Relations of the United States, 1969-1976, Volume XXIX, Eastern Europe and Eastern Mediterranean, 1969-1972* (Washington, DC, 2007) and Documents 44-57 in Edward C. Keefer and Peter Kraemer, eds., *Foreign Relations of the United States, 1969-1976, Volume E-15, Part 1, Documents on Eastern Europe, 1973-1976* (Washington, DC, 2008).
[145] See Michael Kieninger, Mchthild Lindemann, Daniela Taschler, eds., *Akten zur Auswärtigen Politik der Bundesrepublik Deutschland 1975* (Munich, DE, 2006).

1977.[146] In Poland, Gierek's New Development Strategy had augmented the country's traditional export strengths in copper and coal with new hard currency investments in heavy industry, chemicals, aircraft, construction equipment, and auto parts on the assumption that these industries would produce exportable goods by the end of the decade. In East Germany, planners had funded a massive expansion of the petrochemicals industry in the late 1960s and early 1970s to take advantage of growing Soviet energy supplies to produce more exports of refined petroleum products to the West. In each case, some of the imported capital made it all the way to improving the quality of Eastern European factories and production processes, but much of the rest of it merely presented rampant opportunity to expand domestic corruption and patronage networks. More importantly, the decision to base long-term development on future exports to the world market broke an important barrier between Comecon and the rest of the world economy. Eastern Bloc countries would have to compete with the developing countries of Latin America and East Asia to sell their goods in the developed West. This competition subjected Eastern Bloc goods to direct competition with capitalist goods and pitted socialist methods of production against the capitalist methods the bloc had long eschewed. As Fekete said in the quote serves as this chapter's epigraph, in the 1970s there was a socialist world and a capitalist world, but there was only one world market. Implicit in the Eastern Bloc's choice to borrow on global capital markets was also the choice to compete on global trade markets.

It was a competition that the bloc would lose time and again in the 1970s. Despite constant exhortations from the very top of each state's governing structure about the importance of increasing exports and eventually producing hard currency trade surpluses, the Eastern

[146] Fallon, "Hungary's Marxist Economist and Central Banker, János Fekete," *Euromoney,* January 1977, p. 17.

European members of Comecon (excluding the Soviet Union) ran, by one authoritative estimate, a cumulative hard currency trade deficit from 1970-1977 of roughly $26 billion dollars.[147] Eastern Bloc officials liked to blame their inability to increase exports on the slow growth and high inflation of Western economies as well as discriminatory Western trade policies that prevented their goods from reaching Western consumers. But the reality was that they simply were not producing goods that Westerners wanted to buy. If, as Fekete claimed, there were no "'capitalist and socialist' machines and products, but only good or bad machines, modern or obsolete products," then the Eastern Bloc most assuredly was producing flawed obsolescence by the late 1970s. And if the trade surpluses required the pay back the debt could not be created through increases in exports, then they would need to be created through decreases in imports. The challenge of austerity lurked just around the corner.

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[147] Dollar figure converted from SDRs at rate of 1 SDR / 1.21 U.S. Dollar. Based on author's calculations of sums of Eastern European trade deficits calculated in current SDRs in Table 8 and 9 of Jan Vanous, "Soviet and Eastern European Trade in the 1970's: A Quantitative Assessment," in *Eastern European Economic Assessment: Part 2, Regional Assessments* (Washington, DC, 1981), p. 696. SDR exchange rate based on James, *International Monetary Cooperation*, p. 279.,

Chapter 2

Oil, Interest Rates, and the Search for Politics to Support Austerity

By the summer of 1976, the rapid rise in Eastern debts and Western doubts led Edward Gierek to alter his plans for Poland. Although the socialist bloc as a whole remained credible in the eyes of Western bankers, Poland was setting a torrid pace for debt accumulation that appeared unsustainable. From 1971 to 1975, the nation's debt to the West had exploded from $764 million to $7.4 billion, and it showed no sign of slowing down unless the country's economy underwent dramatic changes to lower imports and increase exports.[148] To that end, on June 24th the Polish government announced a plan to increase food prices across the country by an average of 60%. Real wages in Poland had grown at an annual rate of 6.8% from 1971 to 1975, and the price increases were meant to bring the consumer market back into balance with the increased buying power of the population. The increases would contribute mightily to solving the debt problem by lowering domestic demand. All of this was to the better, but two glaring problems stood in the way: the increases would make Polish citizens poorer and undercut late socialism's foundational promise to always increase living standards. Recognizing that the proposal would be unpopular, the government committed to holding "public consultations" to discuss the plan with the population. The fact that the consultations were scheduled to take place

[148] Figures given in Joan Parpart Zoeter, "Eastern Europe: The Hard Currency Debt," in *Eastern European Economic Assessment: Part 2, Regional Assessments* (Washington, DC, 1981), pp. 716-731, figures at p. 720.

in the course of a single day signaled the propagandistic intent that underlay them, but Polish workers nevertheless took the invitation to express their opinion of the decision seriously. On June 25th, strikes and street demonstrations broke out in industrial centers, and countless smaller work disruptions rippled through the rest of the country. Workers from the Ursus tractor factory near Warsaw marched to the transcontinental railway line nearby and halted the Paris-Moscow express, while workers in Radom took more direct action and set fire to the local party headquarters. Shaken and unwilling to risk a full reprise of the events of 1970, the authorities claimed by nightfall to have held production consultations with the working class and rescinded the price increases indefinitely.[149]

In what context should these events be placed? Normally, the events of June 1976 are placed at the midpoint of Polish, late socialist, or Eastern Bloc narratives about the rise of Solidarity that begin with the food price strikes of 1970 and end with the formation of the union in the summer of 1980. In this light, the attempted price increases signal the ineptitude and injustice of the Gierek regime as well as the broader economic stagnation and political illegitimacy in the bloc. Workers were not going to let such an illegitimate ruling class solve the nation's financial problems on their backs, so the strength and cohesion of their resistance grew. With the founding of the Workers' Defense Committee (KOR), an organization of Polish intellectuals committed to supporting the workers' opposition in the aftermath of the unrest, the attempted price increases marked an important moment in the construction of a unified Polish opposition that would unleash the full power of its resistance under the banner of *Solidarność* in August 1980. As Timothy Garton Ash, one of the first Western chroniclers of Solidarity, wrote

[149] Andrzej Paczkowski, *The Spring Will Be Ours*, Jane Cave trans. (University Park, PA, 1998), p. 357-358. Timothy Garton Ash, *The Polish Revolution* (London, 1991), p. 19.

of the attempted price increase and the founding of KOR, “it was the first bridge thrown over the fatal gulf between workers and intellectuals….Without this bridge Solidarity would have developed, if at all, very differently.”[150]

But there is another way to describe the events of that June. Removed from their particular Polish context, they were emblematic of phenomena occurring across the industrial world as nations adapted to the oil crisis. First, they exemplified the power of financial markets to force changes in domestic policies. Second, they reflected governments’ torturous attempts to legitimize changes in domestic policy that would harm the interests of the population. And finally, they spoke to the potential power of the working class to thwart governmental plans for domestic austerity. Described in this way, the Polish attempt to increase prices represents just one of many instances of the basic riddle at work in both Eastern and Western politics in the late 1970s: how could governments extract economic sacrifice from their peoples? It was a challenge that few governments mastered and most tried to avoid until they had no choice. In the 1970s, the power of the working class was, if anything, stronger in the West than in the East, and most governments on both sides of the Iron Curtain waited as long as financial markets would allow before asking their citizens to sacrifice. Because Western currencies were internationally convertible and Eastern currencies were not, crises in the West appeared under a different name than in the East: currency crises bedeviled Western societies, while debt crises came to haunt Eastern ones. But Western currency crises and Eastern debt crises were different manifestations of the same thing: international capital's loss of confidence in the viability of a nation's economy. As such, they required the same response, which can broadly be defined as austerity – government policies that intentionally lower the living standards of the domestic population in

[150] Garton Ash, *The Polish Revolution,* p. 20.

order to restore financial markets' confidence in the national economy. Calling this austerity economic "adjustment," as financial officials did in the 1970s and 1980s, disguised the policy's fraught social and political consequences. In both East and West, economic "adjustment" was nothing short of a direct challenge the legitimacy and governing ideology of any government that tried to implement it. In Poland, the power of austerity to challenge the legitimacy and ideology of the regime only became fully apparent when another attempt to raise prices in 1980 spawned the most direct challenge to communist authority since 1968, Solidarity. But as the first attempt at austerity was withdrawn in 1976 before it could spark a political crisis, the power of economic adjustment to transform political orders was already on display in many Western societies.

This chapter chronicles these fraught moments of economic crisis that rolled across the Western and Eastern world over the course of the late 1970s. Governments of the Eastern Bloc continued to rely on their access to cheap Soviet raw materials and Western credit markets to avoid the disruptive adjustments that austerity brought to Western societies beginning in 1976. But as this chapter will show, both of these economic lifelines ran out in the late 1970s, and economic adjustment became unavoidable. The Soviet announcement in 1977 that it would no longer be able to increase energy deliveries to the rest of the bloc after 1980 weakened one of the crutches that Eastern European governments used to defer the effects of the oil crisis since 1973. It left them overwhelmingly reliant on the continued flow of Western capital, and particularly US dollars, from the Euromarkets to defer the encroaching demands of the world market. Because the US dollar was controlled by the US Federal Reserve, Western capital would continue to flow easily only as long as US monetary policy remained loose, as it had been throughout the 1970s to help the United States defer its own adjustment to the new world market conditions. America's reckoning with economic adjustment, which came in the form of runs on the US dollar in 1978 and 1979, forced the US government to implement domestic austerity at the decade's end to restore international capital's confidence. The US, like the Eastern Europeans, had been deferring adjustment as long as possible. But by the late 1970s, its time too had run out. As this chapter will show, US Federal Reserve Chairman Paul Volcker's resolution of the 1979 dollar crisis through the imposition of domestic austerity brought an end not only to the United States' years of deferring the effects of the oil crisis, but also to the days of easy money on the Euromarkets. The centrality of the US dollar to the entire world economy meant that when the United States finally decided to face *its* reckoning with austerity, the rest of the world, including the communist states of the Eastern Bloc, had no choice but to reckon with austerity too.

The Dominos Begin to Fall

Her Majesty's Government in London was the first to fall into austerity's grip. Like its counterpart in Warsaw, the British government had borrowed heavily on international credit markets after the oil crisis to defer adjustment. As was recounted briefly in the previous chapter, the British Labour Party had returned to power in the months following the onset of the oil crisis on the promise that British workers would receive large pay increases. Through 1974 and 1975, the government of Harold Wilson had relied on the inflow of petrodollars into London and heavy borrowing from the IMF to keep funding this promise to his constituents. But by March 1976, international capital holders began to doubt the long term viability of the British economy, and they started moving their wealth out of the British Pound. This precipitated a run on the currency (the pound lost a significant amount of value relative to other currencies), and the Bank of England was drawn into supporting the pound on international currency markets. Soon, its resources were exhausted and the government was forced to approach the other

Western central banks for a loan. They granted the British a $5.3 billion loan, but the US Treasury and the German Bundesbank attached the condition that the Wilson government reach a "high-conditionality stand-by agreement" with the IMF.   This would involve the Fund dictating changes in domestic policy that would bring about an improvement in its balance of payments (thus reassuring international capital holders), but also domestic austerity (thus infuriating the British working class). A package of measures was agreed to in July, but it failed to stem the flow of capital out of the country.

By November, the Labour government, now under the leadership of James Callaghan, was back at the IMF with a request for further assistance. The terms of the deal that emerged were stiff: 3.5 billion pounds in government spending cuts over the next two years, a reduction in the state borrowing requirement, limits on domestic credit creation, and the adoption of an "incomes policy" under which British workers' wage increases would barely match inflation. Callaghan lobbied the US and West German governments to get the IMF to ease its terms. But both President Ford and Chancellor Schmidt demanded that Callaghan accept the IMF's demands. Out of international lifelines, Callaghan had no choice but to move ahead with the IMF plan, which was adopted in December 1976.[151]

The country's arrival at the precipice of insolvency led to further diagnoses of democracy's ultimate propensity to promise more than it could deliver. "The greatest sacred cow of all – unfettered representative democracy – will have to be questioned," the British financial writer Samuel Brittan concluded in 1977 book *The Economic Consequences of Democracy*. "The basic trouble is *the lack of a budget constraint among voters*," he wrote. "Is it possible," he went on to doubtingly ask, "to create or evolve a consensus, so far missing, on a

[151] James, *International Monetary Cooperation*, pp. 279-282.

legitimate social order which would appeal to people's sense of justice and persuade them to moderate their pursuit of private interest, both in the ballot box and in their other collective activities?"[152] The prospects for the emergence of such a system appeared bleak.

At the highest levels of the British government, however, the resolution of the crisis began to fundamentally alter the Labour Party's views on the role of government. IMF austerity made budget constraints the order of the day and led to a rejection of Keynesianism in the economist's home country. A fierce divide emerged between those, led by Callaghan, who believed the country's only choice was to discard Keynesianism in favor of austerity in order to maintain the favor of international capital and those, led by Callaghan's rival Tony Benn, who demanded that the government solve the crisis by taking further control of the economy. Benn circulated what he termed the "Alternate Economic Strategy" among the Labour leadership as it considered the IMF's proposal. The plan called for solving the crisis by imposing strict controls on imports and exports, nationalizing banks and insurance companies, increases taxes on the wealthy, and withdrawing Britain from the European Common Market. These inclinations had to be resisted, Callaghan believed, if the country was to restore economic growth, lower inflation, and maintain its standing as a home for international capital. As he famously declared in a speech to the Labour Party conference on September 24, 1976, "We used to think that you could just spend your way out of a recession...I tell you in all candor, that that option no longer exists and that in so far as it ever did exist, it only worked...by injecting bigger doses of inflation into the economy, followed by higher levels of unemployment." Callaghan's position ultimately

[152] Original Italics. Samul Brittan, *The Economic Consequences of Democracy* (London, UK, 1977), p. xi, 255, and 267. For an authoritative discussion that places Brittan's work within a broader context of widespread beliefs in the 1970s that democracy led to economic excess, see Charles Maier, "'Malaise': The Crisis of Capitalism in the 1970s," in Ferguson, et. al. eds., *The Shock of the Global: The 1970s in Perspective* (Cambridge, MA, 2011), pp. XX.

carried the day, and his speech inaugurated a period of profound change for the British Left. Coming as they did from the political standard bearer of the British working class, Callaghan's words stood as a profound rejection of the Keynesian economics that had dominated the British politics since the Second World War. History has remembered them as such, and the crisis now stands as the beginning of the end for the British Left as the defender of the working class in British politics.[153]

As global financial markets battered the postwar social contract in Great Britain, they also mounted a sustained assault on Italy. Since the oil crisis, Italian unions had brought their workers significant gains in real wages under the automatic wage indexation mechanism known as the *scala mobile* and protected their members from the threat of labor "redundancy" as firms moved to become more efficient through layoffs. By 1976, Italian workers were, in short, expensive and difficult to fire, and the ruling coalition led by the Christian Democrats (known by its Italian initials, DC) was at a loss for how to slow labor's momentum. To cover the yawning gap between national production and consumption, the government had borrowed heavily on the Euromarkets and from the IMF in 1974 and 1975, but financial lifelines had run out by the start of 1976. Negotiations with both the IMF and the European Community early in the year produced demands that the government slow the growth of real wages, domestic monetary creation, and government spending. Lacking enough credibility with Italian labor to get them to agree to voluntary wage restraints and facing a tough election in June against the Italian

[153] Quote and narrative from James, *International Monetary Cooperation*, pp. 279-282, quote at p. 282. The conclusion regarding the fate of the British Left is shared by Kevin Hickson, *The IMF Crisis of 1976 and British Politics* (London, 2005). In *Governing the World: The History of an Idea* (New York, 2012), Mark Mazower goes even further, calling the 1976 crisis "much more than a defeat for the British left, the unions, and the working class. It was the first step in the capitalist restoration of the West." See p. 346.

Communist Party (PCI), the Christian Democrats balked at international capital's demands. In the context of the Cold War, the threat of a PCI victory in the elections appeared to signal that the Italian Left was dangerously ascendant. But in the crucible of financial crisis, it became clear that, like its British counterpart, it too would accommodate international pressures for austerity. After narrowly winning the June election, the Christian Democratic leader, Giulio Andreotti, formed a government of "national solidarity" that relied on the PCI to make the internationally demanded austerity policy "socially acceptable."[154] The Communist Party leader, Emilio Berlinguer, embraced what he described as the "ideology of austerity" in the hope of leading the nation out of its financial crisis. After the passage of deflationary measures in the fall of 1976 that were estimated to reduce domestic demand by 3% of GDP, the leading Italian industry and labor groups signed a "social compact" in January 1977 that began to restrict the use of the *scala mobile* and marginally boost labor mobility within firms. It remained difficult to outright fire workers and most wages remained indexed to inflation, but the social compact nonetheless marked a turning point in Italian politics. From then on, labor was on the defensive. With the support of the CPI and over the objections of many Italian unions, the government reached an agreement in April with the IMF on cutbacks in public spending and domestic consumption.[155]

As in Britain, the deleterious legacy of the financial crisis took both material and ideological forms. After rising by an average annual rate of 10.8% from 1970 to 1975, real wages in Italy grew at a rate of 2.6% from 1976-1979.[156] The tenuous working relationship

[154] The CPI did not formally join the government, but the ruling coalition relied on the CPI's abstention from voting to pass legislation.
[155] Previous paragraph based on Robert Flanagan, David Soskice, and Lloyd Ulman, *Unionism, Economic Stabilization, and Incomes Policies* (Washington, DC, 1983), pp. 546-556. Also James, *International Monetary Cooperation*, pp. 283-285.
[156] Calculated from Table 9-4 on p. 528 in Flanagan et. al., *Unionism, Economic Stabilization, and Income Policies*.

between the CPI and the Christian Democrats proved only marginally effective in fixing the nation's economic problems. But their attempt to forge a "historic compromise" between the two parties spurred high-profile human tragedy, ideological rebellion from the Far Right and Left, and national instability. On March 16, 1978, Aldo Moro, a former prime minister and president of the Christian Democrats at the time, was kidnapped by the Red Brigades, an Italian Marxist-Leninist paramilitary group that had sought throughout the 1970s to turn Italy into a "revolutionary" state through armed struggle. The Red Brigades were stridently opposed to any accommodation with capitalism, and the kidnapping of Moro was meant to torpedo the compromise between the Christian Democrats and the CPI. After almost two months of negotiations over Moro's release, the brigade leaders concluded their demand for a prisoner exchange would not be met, and they murdered Moro, leaving his body in the trunk of a car parked (legend had it) half way between the headquarters of the DC and CPI. The killing destroyed the basis for the historic compromise, and the communists returned to the opposition in the spring of 1979, never to enter the government again. With wages stagnant and unemployment rising, domestic terrorism became a destabilizing part of daily Italian life at the turn of the decade, as both the far Left and the far Right of Italian politics rebelled against the political compromises mandated by austerity's arrival. As Tony Judt wrote of this period in Italian history, "That democracy and the rule of law in Italy survived these years is a matter of no small note."[157]

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[157] Tony Judt, *Postwar: A History of Europe since 1945* (New York, 2005), pp. 473-477, quote at 476.

The disruptive legacy of austerity in Western democracies reinforced socialist regimes' reluctance to implement restrictive policies. For Erich Honecker and Janos Kadar, it also pointed the way to how their regimes could lay claim to superiority over their Western rivals. Austerity, they believed, was for capitalists whose system was evidently failing. Socialist countries, by contrast, had to appear as lands of economic serenity. "Many people admire the GDR," Honecker told a meeting of East German officials addressing the country's economic problems in November 1976 as the crises in London and Rome were unfolding. "Under capitalism there is the path of deflation or inflation. We don't use either one. We go the way of methodical, proportional development of the economy to ever higher levels." Any economic reform must be sure not to "break the backs of the workers," he told his comrades.[158] In a Hungarian Politburo meeting that same month, financial officials warned that country's "debt burst" of 1974-1976 might not be sustainable without revisions to the national plan. Kádar, however, remained committed to the necessity of raising workers' standard of living. In early 1977, he said, "We cannot responsibly say that there is a need to constantly raise living standards, but it does mean that there must be a systematic increase in living standards with the construction of socialism. This in turn is reflected in the improvement in living standards in our plans for this year." After a pause in the increase in real wages in 1976, Kádar committed the country to a 3.5-4% increase in 1977. The debt, in turn, increased apace.[159]

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[158] No author, "Niederschrift über eine Beratung zum Entwurf des Fünfjahrplanes 1976 -1980 unter Leitung des Generalsekretärs des ZK der SED, Genossen Erich Honecker, am 5.11.1076," November 5, 1976, DE/1/58633, BArch Berlin.

[159] [Novemberben a Politikai Bizottság ülésén kaptak figyelmeztetést a vezetők arról, hogy - mint Németh Károly gazdaságpolitikai titkár fogalmazott - „ az eladósodás lökésszerű" módon következett be 1974-76-ban, és nem biztos, hogy az ütem fejreállás nélkül fenntartható. Németh - mint a politikai vezetők számára készített statisztikákban, kimutatásokban általában - a bruttó helyett a sokkal ked-vezőbb képet mutató nettó adósságállományról beszél, ami figyelembe veszi Ma-gyarország dollárköveteléseit. (Míg a devizatartozások „kemények" voltak, tehát tőkés

After the price increase debacle of 1976, Gierek undertook what he termed an "economic maneuver," which would supposedly lower the nation's debt to the West without lowering domestic standards of living. It would achieve such an improbable feat by cutting back investment instead. Polish rates of investment were extremely high, so there was some room for restriction, but unless the remaining investment was used more effectively, the new policy would only worsen the long-term debt picture by lowering future economic growth. Polish officials were well aware of this, but like their counterparts in both East and West, they chose the policy that guaranteed present social stability, no matter the long term consequences.[160] In March 1977, financial officials within the Polish Central Committee warned, "The level of Poland's indebtedness to capitalist countries at the turn of 1976/1977 should be seen as the maximum. Its further growth threatens to negatively impact Poland's socio-economic development throughout the current five year plan."[161] But the political mandates of the moment prevailed over the economic concerns of future years. As long as the nation could borrow money and import subsidized Soviet resources, political expediency would be the order of the day.

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devizában álltak fenn, addig a követelések - a keleti blokk többi országával vagy a fejlődő államokkal szemben - nagyon is puhák.)], p. 157-158. [Az év áprilisában a szocialista brigádok vezetőinek értekezletén Kádár ezért be is jelentette, hogy az előző évi megingás után 3,5-4 százalékkal emelkedik majd a reáljövedelem. *„Nem állíthatjuk felelősen, hogy a dolgozók életszínvonalának állandóan emelkedni kell, de azt igen, hogy a szocializmus építésének együtt kell járnia a dolgozók életszínvonalának rendszeres emelkedésével. Ezt viszont álljuk, s ez tükröződik az életszínvonal javítását tükröző idei terveinkbe* - érvelt Kádár, vagyis ha egy évben nem emelkedik számottevően az életszínvonal, akkor a következő évben már mindenképpen javulnia kell, bármilyen is a gazdaság teljesítménye.] Mong, *Kádár Hitele*, p. 160.

160 Włodzimierz Brus, "Aims, Methods, and Political Determinants of the Economic Policy of Poland, 1970-1980," in Nove, Hohmann, and Seidenstecher, eds., *The East European Economies in the 1970s* (London, 1982), pp. 108-139.

161 "Wpływ Bilansu Płatniczego y Krajami Kapitalistycznymi na Społeczno-Gospodarczy Rozwoj Polski w Latach 1977-1980," March 11, 1977, PZPR-KC XI A-510, Archiviwum Akt Nowych, Warsaw. I would like to thank Lukas Dovern for sharing this document with me.

By the spring of 1977, the gap in East Germany between the political priorities of the party and the economic capacities of the state had grown so large that the chairman of the State Planning Commission Gerhard Schürer and the party's economic leader Günter Mittag wrote a secret letter to Honecker pleading for an adjustment. "For the first time we are experiencing acute payment difficulties," they wrote in March 1977. They anticipated that in 1978 the country would have "to come up with [VM] 11 billion just to pay back the principle and interest on the debt. The hard currency income from our exports amounts to [VM] 9.3 billion and is already insufficient to finance new imports." The recurrent fear since the first moments of the oil crisis that credit would suddenly become unavailable was once again at the forefront of their minds. To ward off the threat of looming insolvency, the two men urged the General Secretary to undertake an immediate export offensive and restriction of imports.[162]

Honecker took their warning as a personal affront. Referring to his cherished Unity of Social and Economic Policy, the General Secretary scolded his two deputies in a face to face meeting. "We cannot change the entire policy overnight. What is suggested means deep cuts in the policy….The material gives the impression that the policy followed after Ulbricht [his predecessor, who was removed in 1970] was wrong, that Ulbricht didn't increase the debt and it was only Honecker. What policy should we have followed instead? The policy of price increases would not have solved any of the problems."[163] Social and price stability were the hallmark advantages of socialism over capitalism, and Honecker was not about to give them up. In describing the Schürer/Mittag proposal later that year, he would tell the Central Committee that the two men had "submitted a plan which would not allow for the continuation of the social

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[162] Quoted in Hans-Hermann Hertle, *Der Fall der Mauer* (Opladen/Wiesbaden, DE, 1999), p. 37.
[163] Ibid, p. 38.

policy program. But the path of restriction is not possible. Under capitalist conditions we would have great complications."[164] Chastened by the browbeating, the two men beat a hasty and sycophantic retreat. "It was not our intention to give you such an impression," Mittag replied. "If there are formulations that do this, we will be sure to change them." Schürer laid it on thick. "How could I and how could we in the State Planning Commission, who are so thankful to you, Erich,…formulate personal attacks on you and the policy that has been adopted? We are ready to correct [the] formulations…"[165] Correct them they did, and the challenge of asking the nation to sacrifice was delayed another day. The nation's bankers returned to the Euromarkets to continue financing real existing socialism on credit. They could only hope that the days of easy money would not soon run out.

Lucky for them, 1976 was a "vintage year" for the socialist states on the Euromarkets, as *Euromoney* termed it, and all indications were that 1977 would be the same.[166] So long as Western capital and Soviet oil keep flowing freely, the day of reckoning could continue to be deferred. After the Polish attempt to raise prices was abandoned, leaders in Warsaw, Budapest, and East Berlin decided to defer the challenge of economic adjustment as long as possible. Some of their counterparts in the West, such as those in London and Rome, had no such luxury. For the moment, real existing socialism had defied the laws of economic gravity dragging the rest of the industrialized world down. But in 1977, cracks in the foundation of Soviet oil production signaled that the reckoning would not be long in coming.

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[164] No author, "Notizen zu einer Beratung des Generalsekretärs mit den 1.Sekretären der Bezirkleitung der SED im Anschluß an die 6. Tagung des Zentralkomitees am 24.6.1977," July 1, 1977, DE/1/58618, BArch Berlin.
[165] Quoted in Hertle, *Der Fall der Mauer*, p. 38.
[166] Richard Ensor and Francis Ghiles, "CMEA Debts may be $45 Billion, But The Loans Have Kept Flowing," *Euromoney*, January 1977, p. 23.

When the Wells Ran Dry

"The Soviet oil industry is in trouble." So began a bombshell March 1977 report from the Central Intelligence Agency titled "The Impending Soviet Oil Crisis." The CIA kept close tabs on the industry that formed the economic base of Soviet power, and they now projected that Soviet oil production would "soon peak, possibly as early as next year and certainly no later than the early 1980s…Maximum [production] levels are not likely to be maintained for long, however, and the decline, when it comes will be sharp." The giant Samotlor oil field in Western Siberia, which had accounted for most of the growth in Soviet oil production since the late 1960s, was projected to reach peak production by 1978 and maintain that level for only four years. The country had large amounts of coal and natural gas that could compensate for the drop off in oil but, the agency noted, these were "east of the Urals" so "distance, climate, and terrain will make exploitation and transport difficult and expensive." The Soviet government had long prioritized maximizing current oil production over investing in exploration, so the CIA believed it would soon find it difficult to replace declining output from existing wells with production from new fields. Any new fields they did discover would take at least a decade to bring on line because they were located in geographically challenging areas like East Siberia and the Arctic. Taken together, the picture was bleak and the repercussions "profound." With plateauing oil production, the Soviet Union would "find it extremely difficult to continue to simultaneously meet its own requirements and those of Eastern Europe while exporting to non-Communist countries on the present scale." These were "important considerations" for the leadership in Moscow, the agency wrote, because it currently supplied three quarters of Eastern Europe's oil, and "it undoubtedly wishes to retain the political and economic leverage that goes with being their principle supplier." At the same time, however, oil exports to non-Communist countries were "the USSR's largest single source of hard currency."[167] Thus, as the Soviet Union's era of exceptional oil growth came to end, fundamental political choices awaited the Brezhnev regime.

The CIA's timing was impeccable. At the very moment the report was published, the Soviet government was itself grappling with the knowledge that its oil production might soon begin to decline. As early as 1973, Soviet oil specialists had been warning the political leadership that the West Siberian oil boom was temporary and would not provide a basis for growth after 1980. Brezhnev had rebuffed the warning signs even as his Prime Minister Alexei Kosygin began to call for greater oil and gas conservation in the mid-1970s. As quoted earlier, Kosygin referred to an "acute energy shortage" in the USSR in his December 1976 discussions with East German Prime Minister Willi Stoph. By the end of 1977, the signs of impending crisis forced action, and Brezhnev decided on emergency changes to the Five Year Plan to redirect investment to the oil industry to ensure that the output targets through 1980 were met. This bought the country some time and prevented the CIA's prediction of plateau and decline from coming to fruition, but it did so at significant costs to the efficiency of the oil industry and the productivity of the rest of the economy, which lost out on precious investment resources. Even with the emergency investment plan, the challenge of energy stagnation after 1980 remained unsolved. A fierce debate broke out within the Soviet leadership around how to rectify it, but all sides agreed on one thing: the future would not be like the past; the time of energy abundance

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[167] Central Intelligence Agency, Intelligence Memorandum, *The Impending Soviet Oil Crisis*, March 1977, CIA Online Reading Room, https://www.cia.gov/library/readingroom/docs/DOC_0000498607.pdf, Accessed March 22, 2017. This analysis was echoed in Central Intelligence Agency, Directorate of Intelligence, "Soviet Economic Problems and Prospects," July 1977, Box 1, End of Cold War Collection, National Security Archive, Washington, DC.

had come to an end.[168] As a Soviet official told his East German counterpart in early 1978, "The question of raw materials is very difficult…As of today…one cannot expect an increase in oil resources. There are also comrades in our country who cannot believe it. We had grown accustomed to having an increase of around 100 million tons of oil in each Five Year Plan and not 0% growth, as it will be for the Five Year Plan from 1981-1985."[169]

As the CIA anticipated, the crisis had immediate effects on Moscow's relations with its satellites. At a meeting of Comecon ministers in June 1977, Premier Kosygin told a room full of officials hoping for increases in Soviet energy supplies after 1980, "the real rate of growth of the oil production after 1980" would be "considerably lower" than in the 1970s. The problems in the Soviet oil energy industry were numerous. "Our expenses for exploration, exploitation…and the transport of oil and gas are increasing rapidly," he said. "The specific expenses for the increase in the production of oil are increasing three to four times." Under such conditions, Kosygin told the group that the only answer for the bloc was to increase its energy efficiency. He framed the challenge as global in nature, one equally shared by East and West. "The fuel and energy problem is one of the sharpest problems of economic development in the world. All countries are looking for their solution by increasing the effectiveness of energy consumption through substantial savings of energy resources." As examples, Kosygin cited the United States, which, he said, aimed to reduce the annual growth rate of its energy consumption from the 3.5% it had been over the last twenty-five years to 2% or less in the 1980s. Western Europe was aiming for similar targets, he said. To adapt to the new environment, the Soviet Union had made

[168] Thane Gustafson, *Crisis Amid Plenty: The Politics of Soviet Energy under Brezhnev and Gorbachev* (Princeton, NJ, 1989), particularly pp. 27-29.
[169] Abteilung UdSSR, "Arbeitsniederschrift über das Gespräch zwischen Genossen Grünheld und Genossen Worow am 12.2.1978 in Berlin," February 12, 1978, DE/1/58564, BArch Berlin.

increasing its energy efficiency a priority as well. "We intend to achieve a turnaround in saving fuel and energy by making use of the achievements of scientific and technological progress." Although the Soviet Union could not match Western countries' gains in efficiency, Kosygin said the country still planned "to reduce the annual growth rate of fuel and energy consumption to about 4.1%," down from 4.7% annual growth in the 1970s.

The same could not be said, Kosygin believed, for the rest of the bloc. Satellite governments had put forth woefully inadequate plans to increase their energy efficiency. Given the wastefulness of the Soviet economy, this had more than a tinge of the pot calling the kettle black. Nevertheless, Kosygin had come to the meeting to scold his allies into action. In preparation for the gathering, each nation had submitted projections of their energy needs out to 1990 to the leadership in Moscow. The resulting picture of the bloc's energy situation over the next decade was sorry indeed. "It is clear from these materials," Kosygin said, "that most countries are planning to *increase* the rate of growth in energy consumption over the period up to 1990 [my emphasis]." While they collectively planned to increase their energy demand by 47% through 1990, the Eastern European nations only planned to increase their energy production by 23%. To the Soviet leader, it was clear that they planned to make up the difference "mainly by an increase in petroleum and gas supplies from the USSR." This, Kosygin firmly told them, was not possible. The numbers simply did not add up. When considered together, the Eastern Europeans were counting on a 74% increase in Soviet oil deliveries, a 130% increase in Soviet natural gas, and a 135% increase in Soviet electricity from 1980-1990. "We have made thorough calculations," Kosygin told his audience, and those calculations made clear that "energy supplies from the Soviet Union at such levels are not possible."

Not only was dramatic growth not possible, but even keeping deliveries constant at the level set for 1980 (the last year of the current five year plan) over the course of the 1980s would be a challenge. “We will make every effort to maintain the volume of annual Soviet supplies of…fuels to the CMEA countries in the years 1981-85 at the 1980 levels,” Kosygin told the group. But Soviet energy could no longer be the bloc's economic elixir. “The CMEA countries’ fuel supply problem cannot be solved only through an increase in supplies from the Soviet Union.” Instead, Kosygin said, each country would have to look inward, to their own economies, and figure out how to use resources more efficiently. “All countries must take additional measures to save and rationalize energy resources.” “We must say," he concluded, "that so far this work is insufficiently accomplished in all Comecon countries, including the Soviet Union.”[170]

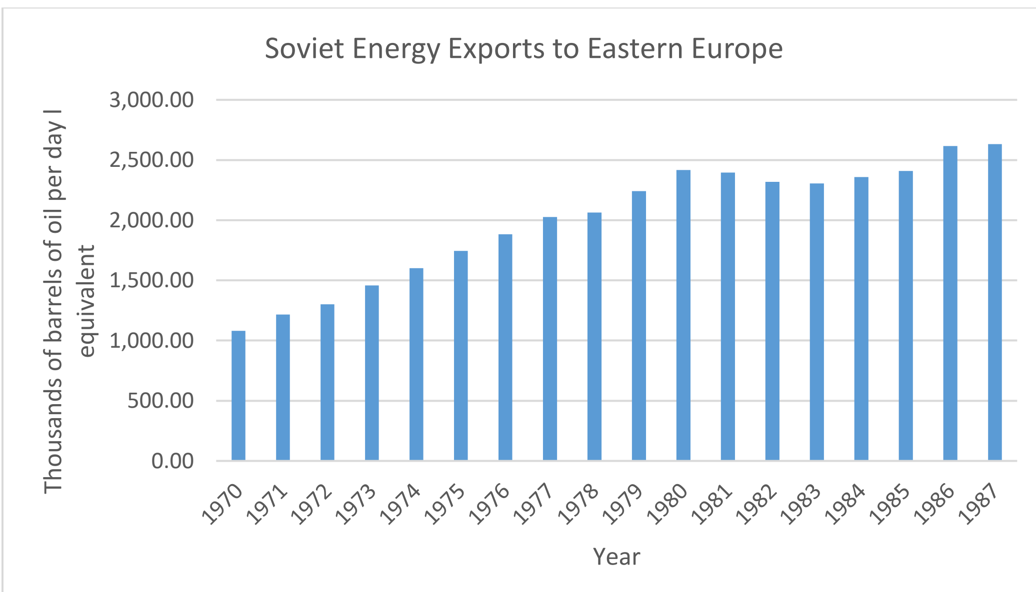

Figure 1: Soviet energy exports to the so-called “CMEA Six”: East Germany, Hungary, Poland, Czechoslovakia, Bulgaria, and Romania. Source: PlanEcon, Inc., *East European Energy Databank*, cited in Table 8.2 in Gustafson, *Crisis Amid Plenty*, p. 275.

[170] “Rede des Leiters der Delegation der UdSSR auf der XXXI. Tagung des RGW, Genossen A.N. Kossygin,” June 15, 1977, DE/1/55847, BArch Berlin.

The news that Soviet energy deliveries were likely to peak in 1980 sent shock waves through the bloc. For states whose economic growth depended on ever increasing inputs of energy rather than the more efficient use of energy, Kosygin's message was nothing short of alarming. A full record of the reaction in all bloc capitals will have to await further archival research, but the GDR's reaction to the news is likely indicative of the broader group.

Throughout the 1970s, East German policymakers had closely linked the fate of their nation to the supply of Soviet raw materials. The changes in Comecon prices announced in 1974 had altered the price of these raw materials, but they had left their year-over-year growth rate untouched. Even at higher prices, it was clear to the leadership that the continued growth of Soviet resource deliveries was essential to their survival. "<u>It was and is an invaluable advantage for our national economy</u>," the State Planning Commission wrote in 1975, "<u>that we import the majority of our raw materials from the socialist economic area, especially from the USSR</u>, at long term contract rates that are below the capitalist world market price."[171] A year and half later, as planners began to work on the 1980-1985 plan period, they returned to the fundamental importance of increasing Soviet deliveries. "The questions of covering [our] demand for raw materials and energy," planners wrote at the end of 1976, occupied "a central place" in the Soviet-East German relationship. The GDR was undertaking "great efforts" to develop "<u>its own energy and raw material base</u>," but nevertheless would "continue to depend on growing imports for many energy sources and raw materials." Even under the country's plan to make "the most efficient use of fuels and energy," the planning commission stressed that "<u>we need further</u>

[171] Staatliche Plankommission, "Information zu einigen Problemen der Außenhandelsbeziehungen der DDR," May 21, 1975, DE/1/58558, BArch Berlin.

increases in oil and natural gas supplies from the USSR." To that end, the policymakers asked that annual oil deliveries be raised from their 1980 level of 19 million tons to a level of 22 million tons by 1985 and 25 million tons by 1990. Similarly, they requested that the annual natural gas deliveries be raised from the 1980 level of 6.5 billion cubic meters to 9 billion cubic meters in 1985 and 11 billion cubic meters in 1990.[172]

Kosygin's announcement in the summer of 1977 clearly threw a significant wrench in these plans. Without the increases in energy after 1980, the GDR would have two options: either it could figure out a way to use energy resources more efficiently, or it could make up for the lost Soviet deliveries by taking out more debt from the West to purchase the raw materials on the world market. With regard to the first option, East German officials who studied the problem knew that despite the leadership's commitment to undertaking "great efforts" to save energy, there was a fundamental problem at the heart of the economy that would prevent any substantial gain in efficiency from occurring: energy was too cheap. The Western gains in energy efficiency that Kosygin praised in his 1977 speech occurred primarily because the price of energy had skyrocketed after 1973. Naturally enough, in market economies higher energy prices encouraged companies and countries to use less of it and develop energy efficient innovations across the economy. But the same was not occurring under socialism. East German officials raised industrial prices on a number of occasions after 1975, but they remained too low to spur efficiency.[173] By the late 1970s, officials concluded that "current energy prices in the GDR are

[172] No author, "Zur langfristigen ökonomischen Zusammenarbeit zwischen der DDR und der UdSSR und Arbeit an den Zielprogrammen," November 30 and December 1, 1976, DE/1/58569, BArch Berlin.
[173] Manfred Melzer, "The GDR – Economic Policy Caught Between Pressure for Efficiency and Lack of Ideas," in Alec Nove, Hans-Hermann Hohmann, and Gertraud Seidenstecher, eds., *The East European Economies in the 1970s* (London, UK, 1982), pp. 64-67.

too low and are an inadequate stimulant to energy savings. The share of energy costs in the total costs of industry is on average only 6.4%." The current planning system did not take into consideration that "in many cases, it is cheaper to save energy than it is to obtain or produce it." This led them to conclude that "the current stimuli in our planning system are no longer sufficient to meet the significant need for a more effective energy economy" and recommend that domestic energy prices be increased by 50-70%.   Perhaps out of fear that looking to the West for solutions might have a treasonous ring, the officials could only suggest that the leadership examine "the experience of other socialist states" with energy saving measures to examine their "applicability in the GDR."[174] Even with higher energy prices (which were raised in 1980) the basic structure of the planned economy, which prioritized gross output over quality and efficiency, led firms to hoard input materials, rather than try to save them.

At a loss over how to increase energy efficiency, officials quickly recognized that the only other option would be to make up for the shortfall in Soviet deliveries with imports from the West. This would, in turn, worsen their already serious sovereign debt problem. Indeed, presumably to both increase their leverage over the Soviets in negotiations and to gain a sense of the problem for themselves, East German officials began to quantify the connection between a decline in Soviet energy and raw materials and increasing hard currency imports from the West. First, they tallied the gains they had already received in the 1970s from the Soviet Union's patronage. In 1977, planners concluded (and underlined for emphasis), "If the GDR had been forced to buy the amount of oil it received from the Soviet Union from 1974-1976 on the world

[174] Staatliche Plankomission Abt. Energiewirtschaft, "Problemmaterial zur energetischen Sicherung der Entwicklung der Volkswirtschaft 1981-1985 unter Berucksichtigung vom Prämissen aus den Verhandlungen mit der UdSSR über Rohstoff- und Energieträgerliefermögichkeiten," undated, but likely from 1978 or 1979, DE/1/58657, BArch Berlin.

market, it would have been forced to pay about 4.5 billion VM more than it paid the Soviet Union." Even that figure, the planners recognized, understated the benefit because rather than paying for the oil with hard currency, East Germany had been allowed to pay for the Soviet oil "with goods from the GDR, which as experience shows, would have been difficult to sell on the capitalist market." Similarly, from 1971-1975, 6.1 million tons of Soviet grain had been delivered to the GDR. The planners emphasized that "if the GDR had bought this amount of grain on the capitalist world market, it would have had to raise 1.6 billion VM [to buy it]."[175] In countless other areas like natural gas and steel, the planners well understood that Soviet price patronage had directly lowered the country's debt to the West. As high as the debt was, it was clear that it would only have been higher without Soviet raw materials.

This was a point East German officials tried to make over and over to their Soviet counterparts in the late 1970s. After numerous conversations in 1977 in which the Soviet side emphasized that there could be no increase in deliveries after 1980, East German officials opened 1978 by stressing that Soviet shortfalls would only drive them further into the arms of the West. After being told yet again in a February 1978 meeting that increases were not possible, a member of the State Planning Commission told his Soviet counterpart that he could "not imagine the extent of the possible consequence" of such a decision. "If in the case of oil, steel, and other raw materials, the supplies of the USSR cannot be increased…we would have to buy the raw materials in the West."[176]

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[175] No author, "Zur Frage der Aufwendungen der DDR in freikonvertierbaren Währung im Zeitraum 1971/76," July 10, 1977, DE/1/58554, BArch Berlin.
[176] Abteilung UdSSR, "Arbeitsniederschrift über das Gespräch zwischen Genossen Grünheld und Genossen Worow am 12.2.1978 in Berlin," February 12, 1978, DE/1/58564, BArch Berlin.

This back and forth continued between the two sides at various levels of government until October 1978, when Kosygin informed his East German colleagues that rather than level off their deliveries after 1980, the Soviet Union would in fact have to cut them back. The East Germans were furious. They immediately told him that such a decision would either "call into question" the economic development of the GDR or force the country to carry out "a politically and economically unacceptable increase in hard currency imports." In response, Kosygin told them that Soviet deliveries had given the GDR the luxury of being "largely independent from raw material imports from capitalist countries." Because the development of raw materials in the Soviet Union had become "increasingly difficult and expensive," that luxury was now winding down.[177]

Back in East Berlin, planners quickly calculated that the Soviet decision to cut back deliveries would lead to 10.7 billion VM more in imports (and debt) from the West.[178] Schuerer, the State Planning Commissioner, returned to Moscow to plead his nation's case once more. In a meeting with Gosplan chairman Nikolai Baibakov, he told his counterpart that the reductions were "unacceptable." Baibakov made clear that he understood the "difficulties that had been created for the GDR" due to the raw materials decision, but he asked for "understanding from the GDR side about the complicated situation in the USSR." Already under the current Five Year Plan, he said, "there are enormous problems in securing the supply of raw materials and fuels." To make matters worse, the USSR was "compelled to further strengthen its

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[177] Karl Grünheid, "Information über Gespräche mit Vertretern des Gosplan der UdSSR auf Expertenebene zu den Fragen der Rohstofflieferungen im Zeitraum1981 bis 1985," October 29, 1978, DE/1/58665, BArch Berlin.
[178] No author, "Überschlagsrechnung zur Auswirkung der bisherigen Mitteilungen über Rohstofflieferungen der UdSSR 1981/85 gegenüber der volkswirtschaftlichen Konzeption," October 30, 1978, DE1/58665, BArch Berlin.

efforts to ensure its military security because of the activities of the United States."[179] Because of these widespread struggles, the plan to cutback deliveries could not be changed. Schuerer returned to East Berlin alarmed and empty handed.

The time had come to take their case to the highest court. In late 1978, Honecker made a direct appeal to Brezhnev to hold energy and raw materials at their 1980 level during the next Five Year Plan. By the time East German Premier Willi Stoph returned to Moscow in December to meet with his old friend and comrade Kosygin, Honecker's appeal had worked. Kosygin announced that the 1980 levels would be maintained because "Comrade Brezhnev has decided to find possibilities to help the GDR in this matter." The announcement removed a contentious issue from the agenda, but left a simmering tension between the two sides that boiled over in the remainder of the meeting. Socialist solidarity could no longer mask the widely divergent economic interests of the allies. Kosygin began by demanding that unlike the 1970s, when the USSR had granted the GDR long-term loans to help compensate for the rise in Soviet energy prices, loans would not be made available in the 1980s and trade between the two states would have to be fully balanced. Current projections showed the GDR running a substantial trade deficit with the USSR in the 1980s, and Kosygin warned that the Soviet Union would not be stepping in to cover this shortfall with credits. "I must tell you openly that we cannot grant larger loans," Kosygin said. "We have large additional expenses for defense. Agriculture also requires increased expenditures."[180] After Stoph pushed his luck by asking for more oil, Kosygin launched into an extended tirade about how easy the GDR had it in the grand scheme of the

[179] Gerhard Schürer, "Information über die Beratung mit Genossen Baibakow am 29.10.1978," October 29, 1978, DE/1/58665, BArch Berlin.
[180] "Information über die Beratung mit Genossen Kossygin im Moskau am 8. Dezember 1978," December 8, 1978, DE/1/58666, BArch Berlin.

global economy. “I would like to...say that the entire economy of the GDR is in a rather privileged position," the Soviet Premier said. "You will not think about that sometimes, but I would like to remind you of it." Posing what he termed "a foundational question (*Basisfrage*) for the entire economy," Kosygin asked, "Where can you find, Comrade Stoph, such a situation in the world, where oil and also natural gas come by pipelines practically to your front door? There is no need for transportation, no oil tankers, no double or triple pumping into tankers, no handling in ports." Pushing the thought further, he said, "The economy of the country is in paradise. The GDR [is] in a much better and more privileged position than the economy of Italy, France, or the Federal Republic. This also applies to natural gas....France pays enormous costs. But for you it comes to your front door.” “What do you mean Italy, France, and the Federal Republic?," Stoph angrily shot back. "We’re not them at all. We are the GDR!” Kosygin responded, “I understand that you are not Italy or France. But very often you hear – ‘We have different conditions.’” On the question of energy, this was not so. "I would only like to say," Kosygin concluded, "that one of the fundamental questions…is that of [energy] savings." Its "effect on economic efficiency is very large, and in this respect, you have a favorable situation, a very favorable situation.”[181] With that, the two parted ways.

As Stoph left Moscow, the worst case scenario had been averted. The Soviet leadership had committed to maintaining deliveries at the 1980 level for the 1981-1985 period. But there were few reasons for optimism. The basic dilemma remained the same – either the GDR could achieve radical advances in energy efficiency or it would have to increase its Western imports

[181] No author, “Stenograpfische Niederschrift der Beratung des Vorsitzenden des Minterrates der DDR Genossen Willi Stoph, mit dem Vorsitzenden des Ministerrates der UdSSR Genossen Alexei Kossygin, am Freitag, dem 8. Dezember 1978, in Moskau,” December 8, 1978, DE/1/58666, BArch Berlin.

and debt. In 1979, the State Planning Commission tried to formulate a realistic estimate of how the burden of stagnating Soviet supplies would be split between these two elements. The results were a lopsided reflection of the problems with the planned economy. Frozen at their 1980 levels, Soviet oil deliveries to the GDR from 1981-1985 would be 19.5 million tons below what the GDR had planned for. Of these 19.5 million tons, planners believed that only 3.8 million could be saved through increased efficiency. That meant that 15.7 million tons of oil, worth about 8 billion VM, would have to be imported from the West for hard currency.[182]

But just as Soviet stagnation was increasing the GDR's demand for Western loans, warning signs were appearing in the West that financial markets' confidence in the socialist bloc was wearing thin. While officials from the State Planning Commission were busy shuttling back and forth to Moscow to try and secure more Soviet oil, officials from the East German Foreign Trade Bank were making the rounds in the nerve centers of global capitalism to secure more Western loans. In May 1978, the president of the bank, Werner Polze, made a two week trip around North America to drum up support for a new round of finance credits. He wined and dined with the leading titans of global finance, Chase Manhattan Chairman David Rockefeller and Citibank CEO Walter Wriston, as well as representatives from eighteen other banks scattered across North America, including Bankers Trust, Union Bank of Los Angeles, Continental Illinois Bank, Bank of Montreal, and Canadian Imperial Bank of Commerce (CIBC). Upon his return, Polze filed an ominous report. Many bankers had told him that "although the socialist countries have always repaid their loans on time, there is now no absolute confidence in the future

[182] Staatliche Plankomission Abt. Energiewirtschaft, "Problemmaterial zur energetischen Sicherung der Entwicklung der Volkswirtschaft 1981-1985 unter Berucksichtigung vom Prämissen aus den Verhandlungen mit der UdSSR über Rohstoff- und Energieträgerliefermögichkeiten," undated, but likely from 1978 or 1979, DE/1/58657, BArch Berlin.

repayment capacity of the socialist countries." Eastern Bloc states had always published very few national financial statistics in order to obscure their economic situation, but even without firm numbers, Western bankers could see that the situation was starting to become untenable. "The question was continuously raised," Polze reported, of how the GDR planned to "balance its trade and payments accounts" in the face of "considerably higher import prices, poor export opportunities to capitalist markets…and the stable domestic price level, which leads to constantly increasing domestic demand." The same questions could be (and surely were) equally asked of all socialist countries.[183]

In the eyes of Western banks, the most pressing problem was Poland. Since the aborted 1976 price hikes, the debt had continued to rise at a torrid pace. Polish officials, led by Wołoszyn, had returned to the Euromarkets over and over again in 1977 and 1978 for the same reason East Germany had: to take out new loans to pay off old debts. By the fall of 1978, this search for Western capital led them to announce that they would seek to organize a $500 million loan on the Euromarkets, an unprecedented and shocking amount for a socialist country. The First Deputy Finance Minister Marian Krzak told *The Financial Times* in a front page article that the loan was for "general economic purposes," a readily transparent admission that it would be used to pay off old debt, and that Poland planned to "be an active client on the credit market" in the years to come. He was not worried, though, because "some of the world's foremost banks would like to be among the leaders" in organizing the capital for the loan.[184] Despite the public

[183] Werner Polze, "Bericht über eine Dienstreise nach den USA und Kanada in der Zeit von 8. bis 19.5.1978," May 23, 1978, DN/10/447, BArch Berlin.
[184] The front page article is Christopher Bobinski and Anthony Robinson, "Poland Seeking Long-term $500m Euro-loan" *The Financial Times*, Thursday, November 30, 1978; pg. 1. Quotes from Christopher Bobinksi, "Poland to Open Its Books for $500m Loan," *The Financial Times*, Thursday, November 30, 1978; pg. 2

efforts to minimize the growing financial difficulties, the truth was plain enough in private. Just as Poland was getting set to announce its new loan, Polze returned to the West, this time to London, to once more test the waters for East German credit. In meetings with National Westminster Bank, Lloyds, Barclays, Royal Bank of Scotland, and the Bank of England, "the question of socialist countries' debt again played a clear role in the negotiations," he reported. "Almost all banks emphasized that Poland's frequent appearance in the market had led to a certain distrust of granting further credit to the Poles." In the shadow of Warsaw's spiraling financial needs, the banks "warned [against] a country or a bank entering the market for finance loans too often."[185]

Thus, with Soviet raw material deliveries about to level off and Western financial confidence hanging by a thread, the task confronting all Eastern Bloc countries at the dawn of 1979 was daunting. Perhaps best summed up by the East German State Planning Commission that summer, "the basic problem" for their economies was that "despite the fraught task of increasing performance under extremely limited commodity supplies" and despite efforts to raise exports and lower imports from the world market, "a significant unresolved financial deficit of 10.3 billion VM remains."[186] The "unresolved financial deficits" in Hungary and Poland were no doubt of different magnitudes, but the basic problem was the same. Try as they might to cut their dependence on Western capital, policymakers in East Berlin, Budapest, and Warsaw, remained more dependent than ever on the financial markets of the West to finance their regimes. Moscow could no longer be relied on to shield the bloc from the world economy. In

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[185] Werner Polze, "Bericht über eine Dienstreise des Präsidenten der Deutschen Außenhandelsbank nach Großbritannien in der Zeit vom 25.10. – 2.11.1978," November 3rd, 1978, DN/10/447, BArch Berlin.
[186] No author, but State Planning Commission, "Information und Vorschläge zur Ausarbeitung des Planansates 1980," June 7, 1979, DE/1/58657, BArch Berlin.

their own ways, each regime surely received the same basic message from their imperial patron. The times were changing, as Brezhnev demonstratively told Honecker in the fall of 1979. Pounding his fist on the table during a meeting with the entire East German Politburo in East Berlin, the Soviet General Secretary declared, "Those who say that you can only consume what you produce are correct." In a thinly veiled warning, he continued, "None of us wants to live at the expense of others or declare ourselves bankrupt."[187]

What could tip the scales and turn this array of warning signs into a full-blown crisis? Only the United States Federal Reserve. As Fed Chairman Paul Volcker would one day say of the US dollar, "Our money is the world's money."[188] So long as the Fed, the engine of global monetary creation, kept real interest rates low and US dollars flowing easily around the world, late socialism would be able to retain its veneer of tranquility amid the choppy waters of the world market. A shining example of this fact came in the spring of 1979, when despite their profound misgivings about the Polish economy, Western bankers pooled their capital together and granted the Polish request for the $500 million loan anyway.[189] But if events ever conspired to force the Fed to change its policy and restrict the easy flow of capital around the world, then the bloc would be exposed to the crisis that it had fought to avoid since 1973. It was a frightening prospect.

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[187] "Stenographische Niederschrift der Zusammenkunft des Generalsekretärs des ZK der SED und Vorsitzenden des Staatsrates der DDR, Genossen Erich Honecker, sowie der weiteren Mitglieder und Kandidaten des Politbüros des ZK der SED mit dem Generalsekretär des ZK der KPdSU und Vorsitzenden des Präsidiums des Obersten Sowjets der UdSSR, Genossen Leonid Iljitsch Breschnew, sowie den anderen Mitgliedern der sowjetischen Partei- und Regierungsdelegation am 4.10.1979 im Amtsitz des Staatsrates der DDR," October 4, 1979, DY 30/2378, BArch/Berlin, p. 91. Brezhnev pounding his fist during this meeting comes from Hermann-Hertle, *Der Fall der Mauer*, p. 42.

[188] Quoted in William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York, 1987), p. 58.

[189] "The Polish Problem," *Euromoney*, April 1979, p. 5.

But as late as 1979, it also remained an unlikely one. A significant increase in the Federal Reserve's interest rates would surely bring austerity to the United States, and just like the communist states of Eastern Europe, the American government had shown little inclination and no ability to impose austerity on its own people in the 1970s. By the end of the decade, even officials within the US government had come to question whether their democracy would ever be able to solve their own riddle of austerity. Inflation, the telltale sign of too many promises chasing too few goods, was running at 13% in 1979 and showing no sign of slowing down. "Can a democracy discipline itself?" Alfred Kahn, a prominent American economist and advisor to US President Jimmy Carter, weightily asked in 1979.[190] The answer would have implications on both sides of the Iron Curtain.

Dollars in Doubt

In the fall of the previous year, the future of the US dollar had hung in the balance. After menacing Great Britain and Italy with currency crises in 1976, international capital holders had turned their attention to United States and forced the dollar to depreciate 40% against the Japanese Yen and 13% against the Deutsch Mark from September 1977 to October 1978. As with the more acute currency crises in London and Rome, capital holders' departure from the dollar in search of financial security in other currencies and precious metals signaled their doubts about the long-term viability of the US economy. After declining to 4.86% at the end of 1976, the consumer price index had risen back to 9.02% by 1978, which lead capital holders to worry that the future value of their US dollar holdings would be frittered away by inflation.[191] Their

[190] Quoted in Theodor White, *America in Search of Itself* (New York, 1982), p. 149.
[191] Worldwide Inflation Data. http://www.inflation.eu/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states.aspx. Accessed March 26, 2017.

departure from the currency sent policymakers across the West scrambling to support the dollar in foreign exchange markets. The Federal Reserve gradually raised interest rates from 6.5% in January 1978 to 9.5% in November, but these moves barely brought interest rates in line with inflation. It was clear that more aid would be needed, so on November 1st Western central banks unveiled a dollar "rescue package" aimed at saving the currency. Through further restrictions in monetary policy, increased support from the German Bundesbank and the Bank of Japan, and increased American borrowing from the IMF, Western governments hope to stabilize the global economy's core currency. From all sides, the central banks intervened in foreign exchange markets to prevent the decline from ballooning into a full blown run on the dollar. From October 1977 to December 1978, the Federal Reserve bought $10 billion worth of its own currency and other central banks bought $37 billion just to make sure that the dollar maintained a semblance of its former value. For a time, the coordinated efforts worked and the dollar stabilized at the end of 1978. But for everyone involved, the crisis was a wake up and a harbinger of the far reaching crisis that would come if American domestic policy did not change.[192]

The dawn of 1979 brought renewed challenges, as the crescendo of revolution in Iran led to the ouster of the Shah Mohammed Reza Pahlavi in January and a wave of uncertainty on world oil markets. Iran, the world's second largest oil producer, had stopped exporting oil in December 1978, and the social instability that followed the Shah's departure gave reason to think those exports would not return anytime soon. Panic ensued, and OPEC members took the opportunity to engineer another massive increase in oil prices. From December 1978 to December 1979, crude oil prices rose 150%, this time from $13 a barrel to more than $30. By the time this second oil crisis hit, almost half of the United States' energy came from foreign

[192] James, *International Monetary Cooperation*, pp. 303-306.

imports, so the price increases had a dramatic and immediate effect on the domestic economy. Gas prices within the US climbed 55% in the first half of 1979, and inflation quickly followed suit, rising to 13.4%. If it were allowed to continue, there was no telling when international capital holders might again lose confidence in the United States and precipitate another run on the currency.[193]

Thus, like the pressure that they had applied to many smaller nations since 1973, oil and capital markets conspired in the spring of 1979 to put pressure on the United States to implement austerity. The question, as always, was how to make this policy socially acceptable to the domestic population. "How best to sell publicly a policy of long-term economic austerity" read the coversheet of a memo sent from US Treasury Secretary Michael Blumenthal to President Carter on May 25, 1979. Blumenthal considered the "continuation of tough and austere macroeconomic policies requiring sacrifices by many" to be "the only viable course" for the nation going forward. This path would create, however, "political dissatisfaction among a broad array of interest groups whose support" Carter needed "for re-election." Therefore, the administration would have to find a way to make austerity domestically palatable. "I freely concede," Blumenthal wrote, "that this is no easy task." Nevertheless, it was in the nation's interest "to convince the American people (and electorate) that it makes sense…to sweat through a period of slow economic activity and slowly unwinding inflation." How to do this? To be successful, Blumenthal believed, "an economic program of austerity needs an overarching theme that engages the imagination and deep convictions of the people." The Treasury Secretary believed the best theme to touch these chords within Americans was "<u>American economic</u>

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193 Yergin, *The Prize*, chapter 33. Judith Stein, *Pivotal Decade* (New Haven, CT, 2010), pp. 211-215.

preeminence in the world." In a "frank appeal to national pride," the President needed to present himself "as the leader making the hard choices" to restore the United States' lost dominance of the global economy. Carter would have to tell the nation that "as individuals, a national economy, and as a government, we have been borrowing and consuming – living off deficits in our personal, governmental and trade accounts." The message had to be "We can no longer afford this." In order to return to economic preeminence, Carter would have to tell the country, "We must now sacrifice and rebuild." He would not be able to promise Americans any immediate economic gains, but rather "the creation of more jobs for all in future years!" If Carter adopted this appeal to national pride, Blumenthal believed it could create "genuine excitement and commitment" for difficult economic policies that would otherwise cause "great political problems."[194]

Carter did not adopt Blumenthal's solution, but he certainly shared his Treasury Secretary's sense of the problem. For the President, the question of how to regain control of the country's economic fortunes quite literally produced a period of deep soul searching. For ten days in the summer of 1979, he withdrew to Camp David, the presidential retreat in the foothills of Maryland. There he discussed the nation's dilemmas with a wide array of experts and considered his own journey to that point. He was a Democrat who had risen to the Presidency in 1976 on promises of enacting full employment legislation, fiscal stimulus, and labor law reform to strengthen the bargaining power of unions. And yet circumstances now appeared to dictate that he transgress the interests of the constituents that had elected him. There were three options for controlling inflation – cutting government spending, inducing wage restraint through

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[194] W. Michael Blumenthal, Memorandum for the President, May 25, 1979, Folder "Venice Summit 1980," Box 90, Staff Office – Council of Economic Advisors, Jimmy Carter Presidential Library (JCPL), Atlanta, GA.

negotiations with the nation's labor unions, and tightening monetary policy. At various points during his first two and a half years in office, he had half-heartedly tried all three. But the challenge remained undiminished. Indeed, with Americans now waiting in lines at gas stations across the country, inflation running at 13%, and GDP contracting at a rate of 3.3% in the second quarter of 1979, the task steadying the American economy amid the volatility of the world market appeared more intractable than ever before.

The crisis, Carter decided, was spiritual. When he descended from the mountains of Maryland, he took to the nation's airwaves to tell Americans that they were collectively experiencing "a crisis of confidence" in a nationally televised address. "The erosion of our confidence in the future is threatening to destroy the social and the political fabric of America," he said. Amid a wide ranging diagnosis of the nation's ills, the President told the nation that "too many of us now tend to worship self-indulgence and consumption. Human identity is no longer defined by what one does, but by what one owns. But we've discovered that owning things and consuming things does not satisfy our longing for meaning. We've learned that piling up material goods cannot fill the emptiness of lives which have no confidence or purpose."[195] Although he did not directly say it, the undertone of Carter's speech was a call for the nation to live within its means. Little did he know, it would be the exact same message (minus the appeals to individual ownership) that Brezhnev would deliver more bluntly to his East German comrades a few months later in East Berlin. A healthy nation could only consume what it produced – everybody could agree on that. Both sides in the Cold War believed they had consumed too much; both were distinctly aware of their dependence on global capital and foreign energy to

[195] Jimmy Carter, "Energy and National Goals: Address to the Nation," July 15, 1979, https://www.jimmycarterlibrary.gov/documents/speeches/energy-crisis.phtml, Accessed March 27, 2016.

fund their way of life; and both sides believed their time was running out. The question now was how to remedy these conditions.

Like Western European governments before him, Carter had come to believe that managing the relationship between business and labor held primacy of place. If unions could be made to moderate their wage demands, Carter and his advisors believed, then the long road back to low inflation could slowly begin. To that end, in the summer of 1979 the President launched an initiative to bring business and labor together around a program to moderate wage growth. At the end of September, he signed a National Accord with representatives of the American labor movement that aimed to ensure that "the austerity arising from battling inflation is fairly shared" and that "those members of society who are least able to bear the burden" were protected. Modelled on the social contracts that had been used in Western Europe to try and restrain real wage growth in the 1970s, the National Accord was seen in its immediate aftermath as a decisive step in shifting the country to a more austere footing. As Jefferson Cowie has written of the Accord, "It stood as an inverted homage to the triumphs of the [nineteen] thirties and forties. Rather than FDR's compact for working-class plenty, the accord looked to shared austerity to overcome political hostility."[196]

Rather less consequential in Carter's mind was the nation's monetary policy. In the days following the "crisis of confidence" speech, he shook up his cabinet and asked a number of people, including Treasury Secretary Blumenthal, to resign. He replaced Blumenthal with the current Fed Chairman, William Miller, which in turn left a vacancy at the helm of the central bank. Many names from the world of private business and banking were floated for the job, but Carter eventually settled on Paul Volcker, the head of the Federal Reserve Bank of New York.

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[196] Cowie, *Stayin' Alive*, pp. 300-301.

By all accounts, the President chose Volcker with little sense of his vision for monetary policy beyond a vague knowledge that he was “very tough on inflation.” Volcker’s 6’7’’ stature and cigar smoking habit appear to have made as much of an impression as any thoughts he had about interest rates or inflation.[197]

Carter was not alone in paying relatively little attention to monetary policy and the role of the Fed Chairman. Most observers in the late 1970s believed that there was little central banks could do to stem the tide of inflation in the face of the well-entrenched habits of postwar democratic governance. The politics of the welfare state simply would not allow it. None other than a former Chairman of the Federal Reserve, Arthur Burns, proclaimed as much in a speech to global financial elites in the fall of 1979. Titled “The Anguish of Central Bankers,” Burns’ speech sought to make everyone aware that central banks could not be relied on to solve the inflationary challenge. “It is illusory to expect central banks to put an end to the inflation that now inflicts the industrial democracies,” Burns said. He had governed the Fed during the period when inflation accelerated from 1970-1978, so his words were both an act of self-exoneration and a distillation of the prevailing wisdom at the highest levels of government and finance. The causes of inflation, in Burns’ mind, ran much deeper than mere interest rates and monetary supply targets. “The philosophic and political currents of thought that have impinged on

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[197] Asked to reflect on the decision to select Volcker, which he did not discuss at all in his memoirs, Carter said, “He came into my office with his six-and-a-half foot frame and sprawled on the couch, and I think he was smoking a cigar, and he made it plain, and it was mutual, that if he took the job he would want to do it in accordance with my previously expressed policy, that I wouldn’t try to put pressure on him or interfere with his best judgement.” W. Carl Biven, *Jimmy Carter’s Economy: Policy in the Age of Limits* (Chapel Hill, NC, 2002), pp. 238-239. Carter’s domestic policy advisor, Stuart Einzenstat, said of the Volcker selection, “What was known about him? That he was able and bright and it was also known that he was conservative. What wasn’t known was that he was going to impose some very dramatic changes.” Quoted in Greider, *Secrets of the Temple*, p. 47.

economic life since the Great Depression and particularly since the mid-1960s" were to blame. Across the West, "rising economic expectations, wider citizen participation in the political arena, governmental commitment to full employment, liberal income maintenance programs, expanding governmental regulations, and increasingly pressing demands on government for the solution of economic and social problems" had driven governments to perpetually promise more than their economies could deliver. "Once it was established that the key function of government was to solve problems and relieve hardships – not only for society at large but also for troubled industries, regions, occupations, or social groups – a great and growing body of problems and hardships became candidates for governmental solutions," he said. In such an environment, Burns concluded, central banks "will be able to cope only marginally with the inflation of our times."[198]

Volcker understood the purpose and power of his new office very differently. Inflation, he believed, was a product of people's expectations about the economy. By 1979, rising prices had become such a standard part of life that people had begun to factor them into their behavior. Workers asked for higher wages, consumers borrowed more money, the government ran a larger deficit, and speculators bet against the US dollar because they universally accepted it as fact that US dollars would be worth less tomorrow than they were today. These actions, in turn, were a self-fulfilling prophecy; they created the very inflation that they anticipated. Higher wages, higher borrowing, and higher government spending increased the demand for goods, and prices inevitably rose as a result. Therefore, if inflation was to be vanquished, Volcker believed that expectations would have be altered.

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[198] Arthur Burns, "The Anguish of Central Banking," 1979 *Per Jacobsson Lecture*, September 30, 1979, http://www.perjacobsson.org/lectures/1979.pdf, Accessed March 27, 2017.

To alter expectations, one first had to understand them. Where did they come from? What assumption underlay the universal confidence that inflation would always continue? The answer was, in short, the Politics of Making Promises. If, as I wrote in the previous chapter, inflation was an inherently political phenomenon, then inflationary expectations were by definition assumptions about politics. They signaled widely-shared and unconsciously held beliefs about what society and government valued. By 1979, people in the market had come to believe instinctively what intellectuals in the West had been writing since the mid-1970s: the government, and by extension its central bank, was incapable of breaking its promises. For reasons of public morality and electoral expediency, governments were unable to turn a blind eye to the fates of their constituents. Given the choice between preventing unemployment or fighting inflation, postwar governments had always chosen to prevent unemployment, and there was no reason to think they would not continue to do so.

Volcker believed he had to change precisely this line of thinking. He and the Federal Reserve had to convince the country and the world that they were willing to let Americans suffer economic hardship. As he privately told his colleagues at the Federal Reserve in 1980, "when we take on this inflation fighting job…we should not look around for much of a constituency. If we…go to the brink or let some…things happen that we have not allowed to happen during the entire postwar period, people…are not going to be very happy." But, he said, they could not "change inflationary expectations without it happening. That, I think, is the nature of our problem." To illustrate the point, he recounted a recent conversation he had had with a banker in Chicago. The banker, when pressed on why his bank was aggressively expanding despite the poor economic conditions, responded, "If we get in trouble, the government will protect us." If there was "a real problem in the economy," Volcker concluded, people thought that the Fed was always "going to give way."[199]

Thus, changing inflationary expectations entailed nothing short of changing citizens' assumptions about what they could expect from their government. It was the most political of tasks. Inflation would end once people believed that the Federal Reserve cared more about price stability than it did about full employment or economic growth. The United States government's commitment to breaking promises had to become credible.

If that was the end goal, what were the means by which it could possibly be achieved? As Volcker told his colleagues, it was a task that would invite intense political backlash. During any economic downturn, the popularity of political leadership suffers because people expect the government to do something to fix it. Austerity was different because the source of the economic pain was the government itself. In the Federal Reserve's case, every time it voted to raise interest rates it would look like (and it would indeed be) a conscious decision to inflict economic pain on the American people. With inflation running at 13% and inflationary expectations firmly entrenched, no one at the Federal Reserve knew how high they would have to raise rates or how long they would have to keep them elevated in order to get people to believe that they really were comfortable inflicting pain on American society. All they did know was that every one of their decisions would create a political blowback.

Best then to minimize the number of decisions they had to make. Monetarism, the school of economics promoted in the 1970s by the University of Chicago economist Milton Friedman, posited that the sole responsibility of a central bank was to ensure a constant annual rate of growth in a nation's money supply. Friedman held little faith in the powers of central bankers to

[199] Quoted in William Silber, *Volcker: The Triumph of Persistence* (New York, 2012), p. 197.

accurately understand the economy, so he argued they should give up trying to influence it. The Federal Reserve should simply set a simple target for annual monetary growth - 3% was Friedman's ideal – and call it a day.

Volcker, and most of the other members of the Federal Reserve, found the economic fundamentals of monetarism to be woefully simplistic. The idea that monetary policy was as easy as setting an annual target offended both their self-regard and life experience. But in the face of the horrendous politics of the anti-inflation fight, Volcker became attracted to monetarism because it offered an escape from political culpability. Traditionally, every interest rate increase was the product of a Federal Reserve decision. If, instead, under monetarism the Fed could simply commit to growing the monetary supply at a constant low rate, then the dramatic increases in interest rates that would inevitably result would appear to the public not as active and mean-spirited decisions of the Fed, but rather as unfortunate byproducts of market forces. President Carter's chief economist, Charles Schultze, said of Volcker's embrace of monetarism, "This whole move was, in the broadest sense, a political move, not an economic move. In theory, the Fed could have kept on raising the bejesus out of the interest rates, but that's what it couldn't do politically. The beautiful thing about this new policy was that as interest rates kept going up, the Fed could say…'We're not raising rates, we're only targeting the money supply.' This way they could raise rates and nobody could blame them."[200]

For his first month on the job, however, Volcker found most of his colleagues at the Fed leery of both monetarism and higher interest rates. At a meeting on September 18th, 1979, the Federal Reserve Board publicly split its vote 4-3 on whether to raise the discount interest rate it charged to US banks. The interest rate was raised, but because the board normally reached

[200] Greider, *Secrets of the Temple*, p. 121.

decisions by consensus, the public dissent appeared to signal to the market that the effort to implement a more restrictive monetary policy would eventually fail. This signal of failure held global significance. The East German Foreign Trade Bank wrote the week after the decision, "The Carter government obviously does not want to tolerate such a drastic restriction policy because it fears a slowdown in economic development, a faster rise in unemployment, and all social tensions that result." The fact that the latest "increase in the discount rate on the Federal Reserve Board could only be achieved by a majority of votes" was an indication "that the restrictive monetary and credit policy has reached its climax."[201]

If this was clear to the bankers of the communist world, then it was certainly clear to the speculators of the capitalist world as well. And faced with a political system that appeared unable to implement austerity, speculators did what they always did: bought gold and sold the currency in question. In the weeks following the September split decision, markets lost confidence in Volcker's ability to control inflation and a second run on the dollar began. The price of gold soared more than $25 in a day to a new all-time high of $376.25 an ounce. By early October, it reached $442. Soon the price explosion spread to other metals ranging from silver and platinum to copper, zinc, and lead. The number of entities betting against the dollar rose as well: everyone from American farmers and builders, who bought up every raw material they could get their hands on, to South American and Arab central banks, who started selling their dollars for gold, wanted to get their wealth out of American currency. "Every day you got this sense that the world was coming apart at the seams," said Fed Vice Chairman Fred Schultz. "There was a genuine flight from the currency – people investing in tangibles, art, jewelry,

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[201] "Sonderinformation für leitende Mitarbeiter der Deutschen Aussenhandelsbank Nr. 16/1979," September 24, 1979, DN/11/6127, BArch Berlin.

stamps, gold. Everything that was tangible was increasing in value." The dollar, in turn, was losing its purpose as a store of value. At the Fed, the need for radical change now beckoned.[202]

On Saturday October 6th, Volcker called a secret emergency meeting of the Federal Open Market Committee, the Fed's main governing body, and gained its assent for the switch to monetarism. The wild speculation in the markets since the September split decision had convinced previous doubters that change was needed. The implications of their decision were clear to everyone who gathered around the table. "There wasn't any question that the board knew that recession would follow" the vote, Federal Reserve Governor Phillip Coldwell recalled.[203] At a press conference that evening, Volcker announced the change in policy. A reporter asked him if the new policy meant that the Federal Funds Rate (the rate the Fed used to control interest rates) would be "completely free to go as high as it might?" The Fed Chairman responded, "I don't know what you think is as high as it might. There will be substantial freedom in the market." The United States' fate, Volcker now told the country, rested in the hands of the marketplace.[204]

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[202] Greider, *Secrets of the Temple*, pp. 83-86, Schulz quote at p. 86.
[203] Coldwell quoted in Greider, *Secrets of the Temple*, p. 123.
[204] This wasn't actually true, of course. By controlling the money supply, Volcker was still controlling the total amount of liquidity in the system and thus interest rates. But he was no longer controlling specific interest rate levels. Transcript of Press Conference with Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, October 6, 1979, http://www.federalreservehistory.org/Media/Material/Event/41-253, Accessed March 28, 2017, p. 8.

Figure 2: The course of the US Prime Loan Rate, one of the important interest rates, from 1978-1983 shows the increase in both interest rate levels and interest rate volatility that accompanied the Fed's switch to monetarism. Source: FRED Economic Data, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/MPRIME, Accessed March 28, 2017.

Over the next three years, the United States experienced the highest real interest rates and, from 1981-1982, the deepest recession of the postwar period. Millions lost their jobs, wage growth evaporated, industries went bankrupt, and the entire American savings and loan industry collapsed. By August 1980, an editorial in the *New York Times* titled "Economy as Titanic" howled in outrage at the Fed's "decision to throw two million crew members into the stormy seas of unemployment."[205] At great social, political, and economic cost, Volcker and his colleagues successfully convinced Americans and the world market that they were willing to break promises, and for that, the country was rewarded with renewal. It was, as a following chapter details, a precarious renewal built on unprecedented inflows of foreign capital, but it was renewal nonetheless.

[205] Quoted in Evan A. North, "Saudi Arabia and the US Dollar Crisis of 1978-1980," unpublished paper, Georgetown University, 2008, p. 19.

Of course, the effects of Volcker's actions were hardly limited by national borders or ideological boundaries. Across the Iron Curtain, bankers and policymakers in the communist world watched as their last lifeline of external support began to slip away. On October 25th, three weeks after Volcker's decision, Horst Kaminsky, the President of the East German State Bank, wrote in a memo to Günter Mittag marked "Strictly Confidential," "Recently a dramatic increase in interest rates has commenced on the capitalist financial and credit markets. The current interest rate on the Euromarket stands at about 16%. Further increases in the coming weeks cannot be ruled out." Even if interest rates rose no further, Kaminsky calculated that the prevailing rates would increase the GDR's interest payments by 520 million VM over the next year and a half. The bank president told Mittag that he had informed Schürer, the State Planning Commissioner, of these estimates so that he could include the higher interest rate assumptions in his plans for the economy. Clearly, more would have to be exported and less imported to compensate for Volcker's actions.[206]

Two weeks after Kaminsky's estimates, an event half way around the world that had nothing to do with the Cold War, socialism, or even finance caused the Eastern Bloc's financial predicament to go from bad to worse. On November 4th, 1979, Iranian students stormed the American embassy in Tehran and took fifty two Americans hostage. Ten days later, the Carter administration responded by freezing all Iranian assets in US banks, roughly $11 billion at the time. As the diplomatic crisis between Tehran and Washington played out over the next year, the frozen Iranian assets caused significant uncertainty in the international financial community

[206] Letter and Attachment from Horst Kaminsky to Günter Mittag, October 25, 1979, DY 3023/1093, SAMPO Berlin, 129-131.

and further limited their willingness to lend to socialist states.[207] In December 1979, Polze, the Foreign Bank President, wrote to Mittag, that "the large US banks" had rejected his efforts to organize a new loan for $150 million because of "a confluence of reasons." Among them were "the current uncertainty on the Euromarket that has been triggered by the blockade of Iranian assets in the USA" and "the frequent appearances of the GDR on international financial markets."[208]

Just as Polze was composing his note to Mittag, the final nail was being hammered into the coffin of the Eastern Bloc's access to Western capital. At the end of December 1979, Soviet forces invaded Afghanistan to topple as Islamist government that had recently overthrown a socialist government allied with Moscow. President Carter responded by placing a grain embargo on the Soviet Union and asking all US banks to review their credit policies toward the Eastern Bloc. He also announced a new US defense posture in the Middle East, dubbed the Carter Doctrine, and requested corresponding increases in the US military budget.

The renewal of superpower tensions over Afghanistan destroyed the last semblance of normalcy for socialist borrowing on the Euromarkets. In early February, Polze and Kaminsky produced a new confidential report which began, "The situation on the international finance and credit markets…has significantly tightened in the last few weeks." Because of "the uncertainty arising from the blockade of Iranian assets in the USA" and "the blackmail (*Erpressung*)" launched by the US government against the Soviet Union, banks "temporarily could not grant any new loans" or were "demanding higher credit costs due to the increasing risk." Leading

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[207] Benjamin Cohen, *In Whose Interest? International Banking and US Foreign Policy* (New Haven, CT, 1986), chapter 6.
[208] Letter from Werner Polze to Günter Mittag, December 29, 1979, DY 3023/1093, SAMPO Berlin, 341-342.

capitalist banks believed, Polze and Kaminsky wrote, that "credit granted to socialist countries in the future would be considerably restricted." The entire market continued to suffer from "prolonged high interest rates." "The arms buildup in the USA and other imperialist states" in response to the Soviet invasion of Afghanistan would, they noted, "lead to interest rate increases in the future" because it would force Western governments to spend more money. Thus, "a decline in the high interest rates can hardly be expected in 1980."[209]

The arrival of spring brought no change. In May, Polze was still writing to Mittag, "Currently there is no indication that capitalist banks' position on granting finance credits to socialist states has changed." As always, the telltale sign of market sentiment was Poland. On April 24th, 1980, Bank Handlowy convened a meeting in Warsaw with representatives from the thirty banks that had granted it the $550 million loan the year before. After telling the assemblage that his country had to make $5.8 billion in principle payments and $1.8 billion in interest payments in 1980, Deputy Finance Minister Krzak asked them for new $1 billion loan to help rollover the debts. The representative from National Westminster Bank in London told Krzak that $1 billion was unrealistic and that Poland was more likely to receive a $200 or $300 million loan. Moreover, the interest rate spread that the banks would have to put on the loan "would put Poland in the category of the worst debtors in the world."[210]

[209] Horst Kaminsky and Werner Polze, "Analyse der Lage auf den internationalen Geld- und Kreditmärkten, besonders des US-Dollar als Leit- und Reservewährung und Massnahmen zur Erhöhung des Aufkommens an relative stabilen Wahrungen sowie Sofortmassnahmen fur die Arbeit auf der Leipziger Frühjahrsmesse 1980," February 6, 1980, DY 3023/1094, SAMPO Berlin.
[210] Werner Polze, "Information über die Lage auf den kapitalistichen Geld- und Kreditmärkten und das Verhalten der großen kapitalistischen Geschäftsbanken hinsichtlich der weiteren Kreditgewährung an die DDR," May 7, 1980, DY 3023/1094, SAMPO Berlin.

Their hopes for new credit dashed, Polish officials had no choice but to turn inward and revise the country's domestic policy. Since the June 1976 price increases, Gierek and his government had avoided asking Polish citizens to sacrifice at all costs, but they could avoid it no longer. At the end of May 1980, the Polish Planning Commission urgently warned the party leadership that the "conditions for implementing the national plan" had "deteriorated markedly." "Notably," they wrote, "the payment situation has worsened" because of "credit difficulties." The "main problem" was "the issue of obtaining financial loans for the purchase of raw materials." In the first four months of the year, the planners reported, "we have been able to get financial credits only for the amount of 1.9 billion zł dew. [foreign currency złotys, equivalent to $1] compared to 2.8 billion zł dew. in the same period last year." At the same time, they noted, "the interest rate on those credits has greatly increased, at times exceeding 20%." These conditions led the commission to project a financing shortfall for the remainder of the year of 4.1 billion zł dew. In order to compensate for this difference, the ministers proposed to increase the exports to the West by about 3 billion zł dew and to restrict hard currency imports by 1-1.5 billion zł dew. If these corrections could be achieved, the planners wrote, they would compensate for "the current evaluation of the deterioration in credit possibilities."[211]

In addition to restricting imports and boosting exports, the Planning Commission noted that "determining the correct level of employment" was "an important socio-political problem."[212] According to their calculations, 338,000 people needed to be fired across the economy in order to produce the growth in labor productivity that would be necessary to drive

[211] "Notatka w sprawie aktualnej oceny warunków realizacji Narodowego Planu Społe-czno-Gospodarczego na rok 1980 i wniosków wynikających z tej oceny," May 31, 1980, in *Tajne Dokumenty Biura Politycznego* (London, UK, 1992), pp. 7-13.
[212] Here they spoke directly about the socialized sector of the economy.

economic growth. The planners noted that “the task of reducing employment is extremely difficult due to certain socio-political repercussions, especially since layoffs on such a scale would have to affect many workplaces.” But failure to implement these cutbacks would “negatively affect productivity, economic relations, and the increase in national income.” And it was only going to get worse. “The preliminary analysis of the conditions of payment in 1981, which will be characterized by even higher set debt payments, indicates that the plan for 1981 will also be very difficult.”[213] In short, the challenge of breaking promises had arrived in the Eastern Bloc.

Even in the first moments of the onrushing crisis, a decisive weakness of the state socialist system was already apparent. When contemplating the fate of democratic welfare states in the doldrums of the mid-1970s, Fred Hirsch had approvingly written of the capitalist system, “A great strength of liberal capitalism has been its ability to dispense with an explicit ethical standard for the distribution of awards. Justification is provided by the benign outcome of autonomous unregulated processes.”[214] Under the postwar ethos of the welfare state, this “great strength” had been supplemented by, if not submerged under, explicit government commitments to distribute economic gains fairly and broadly throughout society. Volcker’s fight against inflation dispensed with these government commitments - the commitment to full employment foremost among them - and his embrace of monetarism allowed the US government to claim that it was no longer responsible for social outcomes. Once more, “autonomous

[213] “Notatka w sprawie aktualnej oceny warunków realizacji Narodowego Planu Społe-czno-Gospodarczego na rok 1980 i wniosków wynikających z tej oceny,” May 31, 1980, in *Tajne Dokumenty Biura Politycznego* (London, UK, 1992), pp. 13-15.
[214] Hirsch, *The Social Limits of Growth*, p. 175.

unregulated processes" were producing social outcomes, benign or otherwise. As a member of the Fed put it, "Everyone could say: 'Look, no hands.'"[215]

Under state socialism, by contrast, the Party's hands were in everything, and explicit ethical standards for the distribution of economic benefits formed the ideological foundation of the state. The communist parties of the Eastern Bloc had spent the entire postwar period purposefully creating states in which they were responsible for everyone's fate. This would make their promises immensely more difficult to break.

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[215] Greider, *Secrets of the Temple*, p. 107.

Figure 1: Citicorp, "Freedom and Peace on Earth," *New York Times*, 27 December 1981, 24.

Chapter 3

Fugitive Leverage:

Sovereign Debt and Cold War Crisis in Poland, 1980-1982

In time, critics would say it was all a mirage. But as Americans opened their newspapers on December 27th, 1981, they were sure to see a message from President Ronald Reagan splashed across a full-page Citicorp advertisement in their daily broadsheet. Below a picture of the bank's flagship building in New York made to look like a giant candle, Reagan proclaimed, "Let the light of millions of candles in American homes give notice that the light of freedom is not going to be extinguished."[216] Four days earlier, the president had delivered a nationally televised speech from the Oval Office in response to a declaration of martial law in Poland. On December 13th, the Polish military, led by General Wojciech Jaruzelski, had declared martial law with the intention of dismantling the national trade union, *Solidarność* (Solidarity), whose protests against the government had destabilized the country since its founding in the Gdańsk shipyards during the summer of 1980. Reagan took to the nation's airwaves to announce a series of policy responses and to ask Americans to show their support for the Polish people by placing a candle in their home window. Citicorp CEO Walter Wriston saw both commercial and political opportunity in Reagan's speech, and he crafted the ad to position his bank as a leading force of anticommunism in an evidently worsening Cold War.[217]

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[216] Citibank/Citicorp, "Freedom and Peace on Earth," *New York Times*, 27 December 1981, 24.
[217] Zweig, *Wriston*, 740.

The rapidly changing role of banks in international politics necessitated such public relations.[218] At the moment General Jaruzelski declared martial law, his government stood on the brink of defaulting on the $26 billion it owed international banks and Western governments. Since the early 1970s, the Polish government had borrowed enormous sums of hard currency on Western capital markets to fund industrial development and subsidize domestic consumption.[219] Often with the encouragement of government loan guarantees, but primarily of their own accord, Western commercial banks had eagerly funneled capital into Poland to meet the government's needs. This borrowing and lending binge came to a grinding halt in 1980 when banks lost confidence in Poland's ability to repay its debts, and the Polish government raised food prices throughout the country in the hope of restoring international market confidence in the country's creditworthiness. Striking workers in Gdańsk responded by forming Solidarity, and for the next fifteen months the banks, governments, and the Polish people vied for influence over the country's future.

[218] The relationship between commercial banks and U.S. foreign policy, and financial globalization and international politics more broadly, was the subject of much scholarship and debate during and after the international debt crisis of the 1980s. See, among others, Spindler, *The Politics of International Credit*; Cohen, *In Whose Interest?*; Frieden, *Banking on the World*; Lissakers, *Banks, Borrowers, and the Establishment*. The history of sovereign debt and debt crises are the subject of Eichengreen, "Historical Research on International Lending and Debt;" Reinhart and Rogoff, *This Time is Different*; Suter, *Debt Cycles in the World Economy*. A recent treatment of bankers and foreign policy that parallels the analysis presented here is Kirshner, *Appeasing Bankers.* The history of international finance has generally not claimed the interest of historians of US foreign relations and the Cold War, particularly for the post-Bretton Woods era. That is slowly changing, with recent works such as Ferguson et al, eds. *The Shock of the Global* and Sargent, *A Superpower Transformed* leading the way.

[219] Hard currency is currency that can be freely converted into other currency, such as U.S. Dollars, Deutsche Marks, and Pound Sterling. Throughout the Cold War, Eastern Bloc countries maintained non-convertible currencies, and thus had to use Western currencies to finance trade and investment from Western countries.

Scholars who have analyzed the international relations of the Polish Crisis have overwhelmingly examined it through the analytical lens of the Cold War.[220] This has led them to focus on the diplomatic and military maneuverings of the Soviet, American, and Polish governments during the crisis, and to frame the motivations of all parties involved in the crisis in ideological or national security terms.[221] But the role of Western commercial banks and sovereign debt in the crisis has not been examined in detail, and thus the financial motivations and concerns of each party have gone largely unnoticed. This chapter foregrounds these interests by analyzing how international financial relations between banks and governments triggered the outbreak of the crisis, affected the Polish government's response to Solidarity, and guided Western governments' responses to events. In tracing the history of Poland's international borrowing and the delicate multilateral financial diplomacy that accompanied the tumultuous months of crisis from the summer of 1980 to the spring of 1982, this article details a game of financial brinksmanship that unfolded alongside the crisis on the ground, as banks, Western governments, the Polish government, and the Soviet government all sought to force the others to bear the burden of Poland's financial folly. Indeed, the crisis on the ground in Poland and the

[220] The most recent treatment in English of Poland in the late Cold War is Domber, *Empowering Revolution*. Other works include MacEachin, *U.S. Intellegence*, Mastny, "Soviet Non-Invasion of Poland in 1980/81 and the End of the Cold War," Ouimet, *The Rise and Fall of the Brezhnev Doctrine*. Essential primary documents and editorial insight are found in Paczkowski and Byrne, eds. *From Solidarity to Martial Law* and Kramer, ed. *Soviet Deliberations During the Polish Crisis*. The issue of sovereign debt in Eastern Europe is given great causal weight and succinct analysis in Kotkin, *Uncivil Society*. Poland's foreign debt was an issue of great concern for scholars and practitioners during the Cold War. See Rynarzewski, *The Debt Crisis in Poland*; Siwiński, *Creditworthiness and Reform in Poland*; and Zloch-Christy, *East-West Financial Relations*.

[221] An exception to this trend is Sara Tavani, "The Détente Crisis and the Emergence of a Common European Foreign Policy. The 'Common European Polish Policy" as a Case Study." Although Tavani notes the financial interests of Western European governments in their response to the Polish crisis, she does not examine the competing interests of Western banks and governments as I have attempted to do here.

international diplomacy over Poland's debt were directly linked because everything for which Solidarity fought in Polish workplaces – higher wages, free trade unions, no work on Saturdays – stood to worsen rather than improve the country's sovereign debt position.

This connection between the crisis on the ground and the politics of debt brought the economic and political interests of Western actors into direct conflict. The financial globalization that followed the breakdown of the Bretton Woods system in 1971 provided the United States with new opportunities to extend its influence behind the Iron Curtain. But these opportunities entailed new risks as well. In Poland, an unprecedented reality of the late Cold War emerged: by 1980, the Eastern and Western blocs had become financially interdependent. In response to these circumstances, a new strand of American strategic thought, one that sought to compel banks and countries to "share the burden" of supporting delinquent debtor nations, crystallized in this period and undercut the traditional Cold War priority of sustaining Poland's liberalization. As will be shown below, Western governments oscillated between policies aimed at sharing the burden and those aimed at sustaining Poland's liberalization, and they ultimately chose a policy of sharing the burden. Despite this strategy, interdependence largely foiled American attempts to exert leverage over putative subordinates, long-standing allies, and ideological enemies. Banks, allied governments, the debtor government of Poland, and the Soviet Union all maintained independent and competing interests in Poland's debt, and each achieved a partial measure of success in pursuit of these objectives.

The Polish Crisis also marks a turning point in the international financial history that led to the Sovereign Debt Crisis of the 1980s. Scholars have traditionally looked to the Mexican default in August 1982 as the starting point of crisis, but this article demonstrates that it was in fact Poland's debt troubles from 1980 to 1982 that caused commercial banks to lose confidence in sovereign lending and central banks to worry about the financial viability of sovereign borrowers. Beneath the veneer of Cold War politics and rhetoric, the Polish Crisis exhibited the traditional traits of a debt crisis – actors attempted to spread the burden of the delinquent debt to other stakeholders, and financial interdependence led to a muddled outcome. What made the Polish debt crisis different from other debt crises was the radically new context within which it unfolded, namely the Eastern Bloc during a particularly tense moment in the Cold War. In focusing on this new context, this article argues that the history of the late Cold War and the history of global finance after the collapse of the Bretton Woods system did not unfold independently, but were instead intimately linked. To understand the financial history of the Polish Crisis is to gain greater insight into a turning point of two of the defining historical processes of the 1980s: the Sovereign Debt Crisis and the last years of the Cold War.

Austerity Arrives

As the last chapter made clear, by the spring of 1980, Polish officials were well aware that their financial lifeline to the Euromarkets had been cut. Market confidence would return only once the government had shown the ability to impose austerity on the Polish population. So for a third time in a decade, the regime attempted to raise the price of food on July 1st, 1980. Within three weeks, strikes had consumed the nation's industrial centers with the help and coordination of KOR. In mid-August, unrest returned to the Lenin Shipyard in Gdańsk where activists now made both economic and political demands, including the reinstatement of two workers who had been fired for union organizing. One of these workers, Lech Wałęsa, went on to lead the local strike committee and eventually the Solidarity movement as a whole. The speed and size of the protests overwhelmed the normal state apparatuses of repression, so just as they had done in 1970, the regime sought to appease the protesters with a change in leadership and a recognition of some of their basic demands for wage increases. Most importantly, on August 31st the government and the fledgling opposition signed what became known as the Gdańsk Accords, which acknowledged the right of workers to form free labor unions. In September, Stanisław Kania replaced Gierek as party secretary and conceded the workers' right to form independent labor unions. But by November, the disparate network of independent unions had coalesced around Solidarity, which eventually counted 10 million members, and the crisis showed no signs of abatement.[222] Clearly, the government did not have the domestic legitimacy to impose economic austerity on its own people. Indeed, the economic concessions granted to Solidarity only exacerbated the country's hard currency problems. As the British Foreign Office noted in an analysis of the first months of Solidarity's existence, "The whole thrust of the concessions won by the workers is towards greater consumption at home.…[I]t is evident that Polish authorities will have to make every effort at least partially to redeem the promises they have made and therefore to divert goods from the export to the home market."[223] For the next fifteen months, Poland's economic and political future hung in the balance, and banks, governments, and the Polish people competed to determine the country's fate.

A Game of Chicken

Ronald Reagan and his senior advisors entered the White House believing that Poland would be the first test of their Cold War mettle. Recalling the transition period of December 1980, Casper Weinberger wrote that Reagan believed Poland would be his "first test" and "that a

[222] Judt, *Postwar*, 587-589.
[223] Balfour to Fall, Untitled Letter, Oct. 22, 1980, 61167/1, Bank of England Archives.

great deal would depend, for at least the next four years, on how he, and the nation, reacted to Soviet pressures in Poland."[224] Reagan's first National Intelligence Estimate for Poland as president legitimately feared that "a swift and steep decline in living standards – capable of triggering civil disorder that could cause Soviet intervention" was a real possibility in the year ahead. The only way to prevent this precipitous decline, the report told the new president, was for Poland to receive a new round of financing from Western banks to stave off default and dramatic alterations in the price and availability of basic staples. But banks were likely to make new loans "only if they received government guarantees." Therefore, Poland would "require prompt financial assistance from either Western governments or the Soviet Union, and probably from both. Large-scale assistance may be required very soon."[225]

Very soon indeed. Two months into Reagan's term, Jaruzelski issued a "cry for help" to the West and formally requested a rescheduling of the country's debt.[226] This request brought the thorny issue of sharing the financial burden among governments and banks to a head. Although Western governments were eager to sustain Poland's nascent experiment with liberalization, they did not want the rescheduling to turn into an opportunity for the Soviet Union or Western banks to gain financially from the governments' politically motivated generosity. Western governments, who gathered in Paris to discuss the Polish situation, demanded that Poland seek "parallel action by the CMEA countries and by Western banks."[227] At the end of

[224] Weinberger, *Fighting For Freedom*, 25.
[225] Central Intelligence Agency, "Poland's Prospects Over the Next Six Months," Jan. 27, 1981, Box 4, SFC, NSA.
[226] American Embassy Bonn to Secretary of State, "Poland: Debt Rescheduling," March 24, 1981, Box 3, SFC, NSA.
[227] The Council of Mutual Economic Assistance (known as CMEA or Comecon) included the Soviet Union, East Germany, Poland, Romania, Bulgaria, Hungary, and Czechoslovakia. "Official Group on Economic Assistance to Poland: Discussions in Paris February 23-23, 1981"

February 1981, the Soviet Union granted Poland a four-year moratorium on its debt, thus assuring Western officials that "the Soviets were playing their part."[228] Soon after, the banks indicated their willingness to follow the governments' lead in rescheduling, and in April the governments rescheduled 90% of the $2.3 billion in principle and interest due in 1981. Rescheduling 90% of the debt was unusually generous (agreements with other debtor countries had rescheduled 75%), and the governments chose such a high percentage on encouragement from the Reagan administration, which wanted to both support Solidarity and ensure that the US government would not have to provide new credits in 1981.[229] Only one condition was attached to the agreement, "the exceptional circumstances clause." Under this clause, which was known as "the Tank Clause" by the time it entered public discourse after the declaration of martial law, the creditor governments could suspend the rescheduling agreement if exceptional circumstances, such as a political crackdown or Soviet intervention, occurred in Poland.[230] Only

CAB 130/1154, Records of the Cabinet Office, United Kingdom National Archives (UKNA), Kew, England.

[228] Felix Kessler, "Soviet Willingness to Delay Polish Debt Assures Western Lenders of Fair Treatment," *Wall Street Journal*, Feb. 24, 1981, p. 31.

229 Memorandum by William Milam, "Draft Issues Paper for Cabinet Council on Economic Affairs; Polish Debt Rescheduling," March 16, 1981, Box 25, SFC, NSA.

[230] It is not clear the extent to which the US government believed this clause could actually be used in a time of crisis. It would, after all, send Poland into default and force Western banks to write down their Polish loans as losses. Early in 1981, the NSC wrote "Any debt assistance could be made contingent on a Soviet written diplomatic promise not to intervene. They might invade anyway, but the cost would be enormous." By the end of the year, the NSC was writing, "This clause was inserted because the official creditors did not want to be in the position of providing financial assistance to the GOP [Government of Poland] if the Soviets intervened directly or if the GOP acted to reimpose a repressive regime." Cf. "Actions for Dealing with the Crisis in Poland," Box "1981", Executive Secretariat, NSC Meeting Files, Ronald Reagan Presidential Library (RRPL), Simi Valley, California, and "Analysis of 'Exceptional Circumstances Clause' Invocation," The Reagan Files, http://www.thereaganfiles.com/nsc-36-attachment.pdf. Accessed on December 17, 2013.

in the face of actual repression would it become clear whether Western governments could bring themselves to invoke the clause.

For at least a year after Solidarity's formation, the Polish government and the Soviet Union navigated the competing pressures of the crisis with an eye toward pleasing Western creditors. In the fall of 1980, the Soviets reduced shipments of oil to all Comecon countries except Poland so that it could be sold on the world market for hard currency.[231] These earnings were in turn given to the Polish government in the form of $1.1 billion in hard currency loans.[232] But the scale of the Soviet aid paled in comparison with the scale of Poland's financing problem. Kania told the leaders of the Ministry of Internal Affairs in January 1981, "In order to exist it is necessary to borrow, this and next year, 10 billion dollars…This is also why, in our internal actions, we must take into account the kind of repercussions they may engender in the West."[233] Soviet officials were helpless to discourage the regard their Polish colleagues showed for Western opinion because they could not meet all, or even most, Polish requests.[234] Their advice was therefore consistently rebuffed. At an August, 1981 meeting between the Polish and Soviet leaderships in the Soviet province of Crimea, Kania and Jaruzelski told Soviet Premier Leonid Brezhnev that they could not take more stringent repressive measures because they needed Western financial aid. This prompted Brezhnev to respond, "it is necessary for each Pole to

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[231] Kramer, "Soviet Deliberations," pp. 60 and 135 n.216.
[232] Milam, "Draft Issues Paper for Cabinet Council on Economic Affairs; Polish Debt Rescheduling," 26 March 1981, Box 25, SFC, NSA. Kramer cites a Soviet report on the Polish crisis that places total Soviet support for Poland for 1980 and 1981 at $2.934 billion. See Kramer, "Soviet Deliberations," 135 n.216.
[233] "Protocol of Meeting of Leading *Aktiv* Members of Ministry of Internal Affairs," Jan. 5, 1981, in Paczkowski and Byrne, *From Solidarity to Martial Law*, 171.
[234] A March 1981 Politburo transcript notes, "[The Poles] are asking us for 700 million dollars. Of course, we cannot find that kind of sum…They do not attach great importance to raw material deliveries from the Soviet Union. They regard this matter as somehow trivial." March 26, 1981, *Ibid*, 235.

understand that the credits extended by Western banks and governments are by no means a gift but a commercial transaction for which it is necessary to pay enormous interest. For Poland this is bondage."[235]

But though they needed further financial support, the Poles also held leverage over the banks that made them far from slaves of Western masters. The Poles feared a loss of Western aid, but the banks dreaded a Polish bankruptcy. All international loans included what was known as a "cross-default clause," which was supposed to provide creditors with the legal means to seize a debtor's assets and recover a portion of their loss, if a default were to occur. The problem was that Poland had virtually no assets in Western countries. "What good would declaring default do?" a banker rhetorically asked in *Euromoney*, "There aren't any funds to seize."[236] Therefore, the banks would do all they could to prevent a declaration of default. As long as default had not been called, they could continue pretending that the Poles would one day pay them back and thus continue to count the loans as assets on their balance sheets. The actual prospects for repayment did not matter; as long as no one called a default, their accounting ruse could continue. In previous debt crises, the banks had also been able to turn to the IMF. But as they entered negotiations to reschedule Poland's 1981 debt, no such recourse existed. To make matters worse, government officials in Paris had told the banks that they needed to sign a "comparable" rescheduling agreement to the one that the governments had signed in April so that the burden of Poland's debt would be equitably shared between private and public institutions. Therefore, as the Poles entered negotiations with the banks, they maintained leverage over the

[235] "Information on Brezhnev Meeting with Kania and Jaruzelski on August 14, 1981," August 14 1981, *Ibid*, 346.
[236] "Poles Afloat," *Euromoney*, March 1982, 15.

banks born of a hint of mutually assured destruction – if Poland collapsed, the banks would suffer significant losses of their own.

With these dynamics in mind, bankers gathered throughout the spring to develop a unified policy through the formation of a lead negotiating committee. This proved difficult because American and European bankers had differing economic incentives and diplomatic approaches. With more loans outstanding and pressures to maintain the viability of the Polish export market, the European bankers took no issue with offering the Poles a "comparable" agreement that rescheduled the vast majority of the principle and attached few demands for economic reform. The Americans, who had much less of their balance sheets committed to Poland and were much more concerned about the precedent any Polish agreement would set for other countries' debt reschedulings, demanded that structural economic reforms to be attached and required that Poland still pay all of the interest on its 1981 debt. *Euromoney* reported on "weeks of arduous and often frustrating discussions" during which "committees were formed and re-formed, named and re-named, committee chairmen came and went." The restructuring terms that emerged were a compromise between the two positions: 95% of the debt would be rescheduled over the next seven and a half years with a interest rate margin of 1¾ percent, but Poland would have to retain "a technical advisor" with an "IMF-type role," who would have direct access to the Deputy Prime Minister for Economic Affairs. In what came to be known as "The Polish Memorandum," the banks and the Polish government negotiated this package to reschedule Poland's $2.1 billion debt to private creditors, provided that Poland pay the $500 million in interest on their 1981 debts by the end of the year. *Euromoney* concluded, "On paper, then, bankers have assigned themselves a political role in shaping Poland's economy."[237] As

[237] Martin, "The Secrets of the Polish Memorandum," quotes at 10, 11, 15.

with traditional diplomatic agreements, each side would have to return home and receive their leadership's approval for such a deal. In the meantime, the Polish government would have to find 500 million dollars.

Skepticism abounded that approval would be forthcoming from the communist side, particularly among Europeans. A French banker thought the entire exercise to be a flight of fantasy, "Can you imagine that the Soviets will allow an international expert to roam freely in Poland to look at the performance of the economy?" For some reason, this rather obvious point was lost on American bankers. "The US banks in general see the Polish problem…as no different from International Harvester or Massey-Ferguson."[238] But even those who saw through the illusion of the bankers' control over the Polish economy remained under the illusion of the Soviet Union's ultimate saving grace. The financial community still wondered in July, "With the situation as it is, with the country stumbling along from one crisis to another, how many western bankers would secretly sigh with relief in the event of Soviet intervention, military or otherwise? In that event, would Polish debt become Russian debt?"[239] Only time would tell.

As the multilateral financial brinksmanship progressed on the international level, Poland's debt crisis took a toll on the domestic economy. Foreign creditors from above and Solidarity from below squeezed the government's financial position. As Poland lost access to global capital markets in 1980, the government was forced to dramatically curtail the country imports of investment materials and industrial inputs. This cutback combined with Solidarity's strikes in the second half of 1980 led to a severe decline in economic output. In addition, the wage concessions won by Solidarity through strikes increased the monetary overhang in the

[238] Ibid, 12.
[239] "The Case of the Futile Rescheduling," *Euromoney*, July 1981, 7.

economy. More money chasing fewer goods produced an economy of scarcity. Long lines for basic goods such as milk, cheese, and bread, along with rationing for meat became the reality of daily life across the country. Through the spring of 1981, most segments of society blamed the government for this downward spiral, which only increased Solidarity's social support.[240]

As the domestic economy ground to a halt, the Polish Finance Ministry and Bank Handlowy struggled to keep the nation's international finances afloat. Western banks had long since given up on providing new money to Poland without government guarantees,[241] so Finance Minister Marian Karcz was forced to turn once again to Western governments for the $500 million in interest payments due to the banks. Throughout the fall, he met with government representatives in Paris to try and extract more concessions from the West. But the same governments that had been so quick and generous with the rescheduling terms earlier in April now told their Polish counterparts that they could not approve any further financial aid.

Why the diplomatic change of heart? In the United States and Western Europe, there had been no loss of support for sustaining Solidarity's experiment with liberalization. On the contrary, the longer Solidarity remained active in Poland and the longer the Soviets refrained from intervening, the more government officials allowed themselves to seriously consider the possibility that Poland might actually escape the Soviet orbit over the long-term. In the United States, the National Security Council sought authorization from President Reagan to begin negotiating a $2.5 billion multilateral aid package with Western European countries that would help Poland through 1983.[242] Many officials doubted that such a program would provide a

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[240] Paczkowski, *The Spring Will Be Ours*, pp. 421-422.
[241] CIA memorandum, "Hard Currency Default Looms," Feb. 20, 1981, FOIA Online Reading Room. Accessed Dec. 14, 2014.
[242] Haig held initial discussions about the challenges of such a package with the foreign ministers of West Germany, France, and the United Kingdom on Dec. 9, 1981. See Document 353,

sustainable solution to the country's economic problems and others still anticipated that the Soviet Union would intervene. But most officials nevertheless believed, as Robert Gates did at the Central Intelligence Agency, that "the Polish experiment…is a crapshoot for enormous stakes," and therefore "we should 'wager on the muddle' and provide the credits" for a long-term aid program.[243]

In Paris, however, the same Western governments that professed to support "the Polish experiment" stonewalled Poland's requests for aid. This, quite simply, was due to banks. "No doubt the banks are hoping to be bailed out," the NSC concluded. "Western assistance must be structured to prevent this."[244] With the banks' debt rescheduling agreement contingent on the Poles paying $500 million in interest by the end of the year, Western governments knew that any assistance they provided would go straight back into the banks' coffers. In a series of meetings throughout the fall, the Polish delegation told the assembled diplomats that the banks were betting "that the governments would find the money." The American delegate in Paris, Robert Meissner, retorted that the banks were "playing a game of chicken." Western governments, he told Karcz, "could not find money to pay off the banks."[245] But because Meissner and his colleagues still wanted Poland "to receive the best deal possible," they sought to tutor their novitiate communist counterparts on the tactics of Western financial negotiation. "The present

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"Gespräch des Bundesministers Genscher mit den Außenministern Lord Carrington (Großbritannien), Cheysson (Frankreich) und Haig (USA) in Brüssel," [Minister Genscher's Discussion with the Foreign Ministers, Lord Carrington (Great Britain), Cheysson (France) and Haig (USA) in Brussels] in *Akten zur Auswärtigen Politik*, 1895-1903.

[243] Robert Gates to Director of the CIA, "Assistance to Poland: Tuesday's NSC Meeting," Dec. 4, 1981, Box 1, SFC, NSA.

[244] "NSC Discussion Paper on Assistance for Poland," Dec. 10, 1981, Folder "NSC Meeting 12/10/1981 (1)", Box "1981", Executive Secretariat, NSC Meeting Files, RRPL.

[245] "Meetings of the Poland Creditor Group Taskforce 27-29 October," Oct. 29, 1981, CAB 130/1154, Records of the Cabinet Office, UKNA.

terms should be seen as the opening bid from the banks, not their final offer," he said. "Poland should not rush into a resettlement." The French and British representatives reassured the Polish delegation that obstinacy in negotiation would not lead the banks to declare default. "Larger banks normally dissuaded smaller banks from taking legal action and legal action would only be taken if the debtor possessed substantial assets abroad, which Poland did not."[246] Having coached the Poles on how best to deal with their own banks, the Western diplomats told them that "it was up to them" to strike a new deal with the banks or come up with the $500 million by December 10th.[247]

As his diplomats were stonewalled in Paris, General Jaruzelski began to sense that the course of domestic events was turning in his favor. Although the population had initially blamed the government for the decline of the economy at the start of the crisis, many segments of society began to hold Solidarity at least partially responsible for the prolonged economic chaos and uncertainty by the fall of 1981. Andrzej Paczkowski has written, "the authorities were helped by the overall social mood, which by the fall of 1981 had become less supportive of Solidarity's most far reaching demands. A considerable proportion of the population was tired of the unending difficulty of everyday life, of the chaos and constant tension."[248] Sensing his moment to discipline Solidarity had arrived, Jaruzelski removed the final institutional roadblock to suppression on October 18th, when he replaced Kania as party chief, adding that title to his previous roles of premier and defense minister.

[246] "Task Force Meeting 9-11 September: Summary of Main Points," Sept. 11, 1981, CAB 130/1154, Records of the Cabinet Office, UKNA.
[247] "Meetings of the Poland Creditor Group Taskforce 27-29 October," Oct. 29, 1981, CAB 130/1154, Records of the Cabinet Office, UKNA.
[248] Paczkowski, *The Spring Will Be Ours*, p. 453.

When the declaration of martial law came on December 13th, Poland was bankrupt. The military action that came was swift and surprising. Claiming that his decision saved the nation from a political and economic "abyss," Jaruzelski appeared on state television early in the morning to announce the decision.[249] The implementation of the operation against Solidarity was so successful that few union activists perished. All foreign communication was cut, a curfew was imposed, and the nation's borders were sealed. Soldiers patrolled the streets of all major cities, but there was little organized resistance.

The Polish Crisis had begun with Gierek's attempt to impose economic austerity on Polish consumers through price hikes, and it ended with Jaruzelski's attempt to impose discipline on the nation's workforce. Over its fifteen-month existence, Solidarity had led many nationwide strikes and garnered wage increases that had severely hampered the government's ability to earn the hard currency required to repay its debts. The strikes had become so commonplace that bankers crafted an oft-told joke out of the workplace strife: "There is a rational and a miraculous solution to the debt crisis in Poland," they said, "The rational involves the Archangel Michael coming down from heaven with bags of money and paying off Poland's creditors…The miraculous involves the Poles actually working again."[250]

Martial law was no miracle, but the government did portray it both domestically and internationally as a way to implement economic reforms. In his speech announcing martial law, Jaruzelski argued, "blows are continuously being dealt to the flagging economy….distressing lines of division run through every workplace….Respect for man's labor must be restored."[251]

[249] Maxwell, *Jaruzelski*, 28 and 34.
[250] Author's interview with Phillip Sherman, a commercial banker who worked at Citicorp during the period. Oct. 30, 2014.
[251] Maxwell, *Jaruzelski*, 28, 31.

The Polish Vice Premier Mieczyslaw Rakowski told the head of the German Chamber of Commerce in the days following the martial law declaration that the government had taken action because "worker discipline" needed to be restored.[252] One of Jaruzelski's advisors, Wiesław Gornicki, told American officials in Warsaw that Poland's gross national product had fallen 35% in 1981 and "a continued decline would ruin any chance of Poland's repaying its debt…without swift action no plan for economic reform could be introduced."[253] Two months after the martial law declaration, the government introduced another round of severe price increases. Unlike 1970, 1976, and 1980, however, these price increases spawned only scattered resistance. Martial law had decisively, if only temporarily, broken the back of the resistance.[254]

Bankers in the West agreed with the Polish government's contention that martial law was the best way of implementing reform. "Most bankers think authoritarian governments are good because they impose discipline," one financier anonymously told *The Wall Street Journal*. Thomas Theobold, the head of Wriston's international division at Citibank, told the *New York Times*, "Who knows what political system works? The only test we care about is: Can they pay their bills?"[255] A Frankfurt banker told *The New Republic* that he saw "the chance for Poland to return to a more normal working schedule" in the declaration of martial law, and "this could be a good thing for the banks."[256]

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[252] Telegram from American Embassy in Bonn to State Department, "Rakowski Meeting December 30 with German Industrialist Wolff von Amerogen," Jan. 4, 1982, Box 1, SFC, NSA.
[253] Telegram from American Embassy in Warsaw to State Department, "Jaruzelski Adviser on Current Situation," Dec. 18, 1981, SFC, NSA.
[254] Paczkowski, *The Spring Will Be Ours*, p. 454.
[255] Quoted in John Van Meer, "Banks, Tanks, and Freedom," *Commentary*, December 1982, 17.
[256] Quoted in William Quirk, "The Banks Cover Their Assets," *The New Republic*, February 17, 1982, 13.

The banks, however, were sure not to let their approbation sully their firm stance in the negotiations over Poland's 1981 interest payments. On the contrary, the game of chicken between East, West, and the banks over Poland's private debts to banks continued unabated. December 10th had come and gone with the Poles only paying the banks $150 million of the $500 in interest that they owed. Betting that the banks would extend new loans before writing off their old loans as losses, Bank Handlowy requested a $350 million loan from Western banks just days after the martial law declaration. To further increase the pressure on the banks, Jaruzelski wrote the head of the West German banking association that Poland would "not be able to pay interest on its loans this year."[257] The banks viewed the maneuver as an irritating "negotiating ploy" and quickly rejected the request.[258] In turn, the banks increased the pressure on Western governments, informing them that they would only lend new money if they received a full government guarantee, which stood no chance of happening in the tense days following the imposition of martial law.[259] Other bankers still expected the Soviet Union to step in and save its ally, as the umbrella theory predicted. But the Soviets took comfort in making the banks wait. US embassy officials in Moscow reported an "oft-expressed private Soviet view" that "Western banks are so exposed in Poland that they will do anything to avoid the collapse of their position there."[260] Some Western diplomats even began to postulate that the Soviets were not paying the

[257] Telegram from State Department to American Embassy in Warsaw, "Poland – Sitrep No19," Dec. 21, 1981, Box 1, SFC, NSA.
[258] Telegram from State Department to American Embassy in Warsaw, "Sitrep 10 as of 1200 December 16," Dec. 16, 1981, SFC, NSA.
[259] Telegram from American Embassy in Bonn to State Department, "Non-Governmental Reaction in the FRG to Poland," Dec. 28, 1981, Box 1, SFC, NSA.
[260] Telegram from US Embassy in Moscow to State Department, "USA Institute Official on Polish Economy," Dec. 24, 1981, Box 1, SFC, NSA.

Poles' interest to Western banks because "it would set precedent for establishing [the] Soviet 'umbrella' theory for Eastern European debt."[261]

In reality, the lack of Soviet support for Poland was a product of a paucity of resources rather than diplomatic maneuvering. In the weeks following the crackdown, Jaruzelski made great hay out of reorienting the Polish economy away from the West and toward the other communist states of Comecon. On January 6th, 1982, the Soviet and Polish governments announced a new Trade and Payments Protocol in Moscow, which promised to deliver increased Soviet natural gas, oil, iron ore, and agricultural machinery to Poland in its time of need. Beyond the diplomatic fanfare, however, the agreement did little to change the material realities of Soviet support. A week after signing the agreement, Leonid Brezhnev told his Politburo colleagues that the Polish economic reorientation posed "a difficult question" for the Soviet Union's allocation of scarce resources. "We find ourselves at the limit of our abilities in terms of assistance to the Poles, yet they are submitting new requests. Perhaps we still have to do something, but we can no longer afford major advances."[262] And so major advances never came. In time, the US Defense Intelligence Agency would conclude that far from increasing their support, Comecon countries actually decreased their aid to Poland in the first months of 1982.[263] The Polish Ministry of Foreign Trade similarly concluded, "The items Poland needs to replace [Western imports] are not available from other Comecon countries."[264]

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[261] Telegram from US Embassy in Brussels to State Department, "U.S.-EC Discussions on Poland," Jan. 2, 1982, Box 4, SFC, NSA.
[262] "Transcript of CPSU CC Politburo Meeting," Jan. 14, 1982, in *From Solidarity to Martial Law*, 505.
[263] Defense Intelligence Agency, "Intelligence Appraisal Poland: Six Months After Martial Law," June 23, 1982, Folder "May-June 1982," Box 27, SFC, NSA.
[264] Polish Foreign Trade Ministry report cited in memorandum from W. Allen Holmes to the Secretary of State, "Poland: Effectiveness of Economic Sanctions," May 28, 1982, Folder "May-June 1982," Box 27, SFC, NSA.

Default: An Ace in the Hole or a Joker in the Deck?

President Reagan viewed the martial law declaration as nothing more than naked Cold War aggression. Upon hearing of the crackdown, he scratched in his diary, "Our intelligence is that it was engineered & ordered by the Soviet [*sic*]. If so, and I believe it is, the situation is really grave." At a series of NSC meetings in the days following the crackdown, the administration groped for a response that befitted the gravity of events. After one such meeting, Reagan committed his conviction to his diary. "I took a stand that this may be the last chance in our lifetime to see a change in the Soviet Empire's colonial policy re Eastern Europe. We should take a stand & tell them unless & until martial law is lifted in Poland…We would quarantine the Soviets & Poland with no trade…Also tell our NATO allies…to join us in such sanctions or risk estrangement from us."[265] On December 23rd he gave the nationally televised speech that prompted Wriston's candle advertisement, telling the Polish government that its "crimes [would] cost them dearly."[266]

Conspicuously absent from Reagan's speech was any mention of Poland's outstanding debt to banks and rescheduled debt to Western countries. Early in the administration's deliberations, Reagan ruled out invoking the Tank Clause written into the 1981 government agreement. He told the NSC, the exception circumstances clause "seems more disruptive to our side" than to the Poles.[267] Because invoking the clause would send Poland into default, administration officials in the State and Treasury Departments agreed with Reagan and felt a Polish default would cause significant harm to the Western financial system.

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[265] Brinkley, *The Reagan Diaries*, 55, 57.
[266] Quotes from "Reagan Tells Polish Regime 'Its Crime Will Cost Dearly," *New York Times*, Dec. 24, 1981, p. A1, A10.
[267] Minutes of National Security Council Meeting, Jan. 5 1982, Folder "NSC Meeting 1/5/82," Section 1982, Executive Secretariat, NSC Meeting Files, RRPL.

Defense Secretary Casper Weinberger thought differently. As he watched events unfold in Poland, he became convinced that the martial law declaration presented the United States with a unique opportunity to inflict economic ruin on the Soviet Union and its allies. In the days after December 13th, Weinberger gathered a team of economic and financial experts at the Pentagon for an all-day conference to weigh the prospects and implications of calling a default on Polish debt. Undersecretary of Defense Fred Iklé, economists from the RAND Corporation, Henry Rowen and Charles Wolf, and a vice president of Chase Manhattan Bank, Roger Robinson, debated "a strategy for virtually killing off the Polish economy already in poor health." Most of the individuals present favored calling the default, but Robinson argued that "a politically driven default" could lead to "'instant relays' of sovereign default throughout the world."[268] In time, Robinson's position would win the day. The threat of debt contagion – a concept more familiar to the post-Cold War world – had begun to impress upon the minds of government policymakers. And rightly so. Even without default, the financial implications of Poland's martial law declaration did indeed relay quickly throughout the world, as will be discussed below.

The private musings of Reagan's diary, and even the public declarations of an Oval Office speech, were a long way from a coordinated response from the NATO alliance. Reagan and Secretary of State Alexander Haig found a reluctant cohort as they began to build a case for unified Western action. As the economic center of Europe, West Germany held the keys to any movement. The victim of unfortunate circumstance, Prime Minister Helmut Schmidt had been in the midst of a twelve-day visit to East Germany when Jaruzelski declared martial law. Either out of respect for his hosts or his business constituents, Schmidt had first told the East German

[268] Schweizer, *Victory*, 71.

press that Jaruzelski had done what was "necessary."[269] This caused few problems for him in Bonn, where the Bundestag decried the Polish transgressions of the Helsinki Final Act and temporarily suspended further financial aid, but generally showed little interest in economic sanctions. Across the Atlantic, however, one would have thought that Schmidt had switched sides in the Cold War. The *Wall Street Journal* lampooned, "Mr. Schmidt's stance toward Moscow speaks of a demoralized leadership whose best vision of West Germany's future is as a Finlandized industrial vassal of a totalitarian empire." Another commentator reprised an old favorite, "No more Munichs!"[270]

It is no wonder, then, that Schmidt believed the Reagan administration's response to Poland had been driven by the pathologies of "television" (read populist) democracy and the "emotionalism" of American domestic politics. As he arrived in Washington on January 5th, 1982 for talks with the Reagan administration, he sought to make two points to U.S. officials. First, he reminded his hosts that these things happen from time to time in the Cold War and there wasn't much that could be done to stop them. To partake in a hollow crusade, he later wrote, would be to raise the hopes of "freedom-loving Poles and tempt them to risk their lives," only to find out that "the entire dramatic effort was in vain." Second, he reminded his hosts that he was German, and history was not on his side. "Any West German attempt to drive a wedge between the Polish people and its government…would provide the Communist propagandists in Warsaw with arguments against alleged 'German revanchism.'"[271]

After another week of diplomatic negotiations, the core of the Western response coalesced at a NATO foreign ministers meeting in Brussels on January 11th, 1982. At the strong

[269] "A Christmas Lesson," *The Economist*, Dec. 26, 1981, 8.
[270] Quoted in Schmidt, *Men and Powers*, 252.
[271] Ibid, 253-255.

encouragement of the Reagan administration, alliance members agreed to publicly hold the Soviet Union responsible for the crackdown on Solidarity. The allies also agreed to "not undermine" Reagan's decision to deny Poland new credits and supported the American call to delay the rescheduling negotiations of Poland's 1982 government debt indefinitely. All parties agreed that these sanctions would be lifted once Jaruzelski had lifted martial law, released all political prisoners, and begun a meaningful dialogue with the opposition.[272]

A thorn remained stuck in the side of the Western response: Poland still had not paid the interest on its 1981 debt to banks, and the risk of one of Poland's 500 creditor banks calling a default increased with each passing day. The largest banks did all they could, including buying out the Polish debt portfolios of smaller banks, to ensure that none of institutions holding Polish loans declared default. But by the end of January, the situation had reached a breaking point.

One way for the banks to recoup a portion of their money was to call in the government guarantees on their loans. In the United States, however, standard CCC regulations required banks to declare default before the agency could reimburse their loans. In the heat of the crisis, it was now clear that a declaration of default could bring down the Western economy. If Reagan wanted to avoid financial catastrophe, he would have to wave the default declaration requirement and begin paying Poland's debt with U.S. government funds. In this decision, the president found the two foundational principles of his worldview – capitalism and anti-communism - in direct conflict. A default would bring the wrath of the global marketplace to bear on the Soviet empire, but it would also severely damage the global capitalist system.[273] Frustrated by a choice

[272] "Alliance Policy Declaration on Poland," memorandum, Jan. 10, 1982, Box 27, SFC, NSA. For adherence of all NATO parties to January 11th agreement, see Telegram from Secretary of State to American Embassy in Bonn, "Allied Pledge to Not Undermine Our Sanctions," Feb. 16, 1982, Box 27, SFC, NSA.
[273] Zweig, *Wriston*, 741.

with no good options, Reagan chose the preservation of capitalism, and authorized the CCC to make the first payment of $71 million to banks to cover maturing Polish debt without declaring default.[274] In the long running game of chicken between the banks, Western governments, and the Eastern Bloc, it was thus Ronald Reagan that swerved off the collision course set by the prospect of a Polish default.

This was a decision best kept private, considering the disruption it would cause to Reagan's domestic Cold Warrior image. William Safire of *The New York Times* ensured that no such luxury would be enjoyed. Based on documents leaked to Safire "by officials in defiance of lie-detector tests," the paper reported news of the CCC payments on its front page, while Safire fumed over the developments in his weekly column. "In an eyeball-to-eyeball confrontation, the Reagan administration has just blinked. Poland's rulers can afford to dismiss the Reagan rhetoric because they have seen that the U.S. is ready to do regulatory nip-ups to save them from default."[275]

Safire's revelation added fuel to an already frenzied debate among political elites and the American labor movement over the merits of default and the proper course of U.S. foreign policy in the new era of financial interdependence. In the early months of 1982, American Cold War politics began to catch up to the new financial dynamics that had been changing the East-West

[274] There is no direct record of the meeting at which this decision was made, but the minutes of the NSC meeting in the days after the decision make clear Reagan's and the administration's discomfort with having been put in such a position. Weinberger says, "We should not be paying Poland's debts." A few minutes later, the following exchange ensues: Edwin Meese, "A briefing on [the CCC Polish case] is necessary." Secretary Haig, "We need a detailed explanation." Donald Regan, "Either way the government has to pay up." President Reagan, "We were keeping control of the timing on this matter." Weinberger, "This is not a final decision." See Minutes of National Security Council Meeting, Feb. 4, 1982, Folder "NSC Meeting 2/4/1982 (1)," Section 1982, Executive Secretariat, NSC Meeting Files, RRPL.
[275] William Safire, "Payoff for Repression," *New York Times*, Feb. 1, 1982, A15.

conflict over the previous ten years. George Ball declared in *The Washington Post* that "default would wreck the Western Alliance," and "no useful purpose could be served by a measure that would only further grind down the Poles," not the Soviets. On the very same page, George Will demurred that real Cold War "tough[ness]" necessitated default.[276] Lane Kirkland, the president of the AFL-CIO, labeled Western banks "the soft underbelly of freedom," and pressured the Reagan administration to call the default.[277] Zbigniew Brzezinski and Henry Kissinger were on the lookout for American credibility. Brzezinski concluded that the U.S. and its allies may "have to bite the bullet" on default, because "anything less than steps like these will not be credible."[278] Kissinger saw default as the West's ace-in-the-hole. Like the nuclear-tipped aces of an earlier era, it was only useful if the other side believed the trigger could actually be pulled.[279]

With such rhetoric in the air, it was only a matter of time before the debate found its way to the halls of Congress. A week after the *Times* broke the news of the CCC payments, Senators Robert Kastens, Jr. of Wisconsin and Daniel Patrick Moynihan of New York convened hearings to investigate the administration's policy toward Poland. Officials from Defense, State, Treasury, and Agriculture, including Weinberger's default advocate Fred Iklé, massaged their internal differences into a united public front that attempted to portray Reagan's decision as tough and strategic. This led to a truly illogical series of statements. First, Iklé let slip that he (rightly) believed that "declaring default does not relieve the debtor of his obligations."

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[276] George Ball, "Default Would Wreck the Western Alliance," and George Will, "No, It Would Only Hurt Some Foolish Banks," *The Washington Post*, Feb. 7, 1982, R8.
[277] Quote in Van Meer, "Banks, Tanks, and Freedom," 17. For pressure on Reagan administration, see Robert Blackwell to Lawrence Eagleburger, "Your Meeting Wednesday September 8 with Lane Kirkland, President, AFL-CIO: AFL-CIO/Administration Divergences on Poland," Folder "July-Sept. 1982," Box 28, SFC, NSA.
[278] Zbigniew Brzezinski, "A More Punitive Policy Toward Poland Needed," *The Los Angeles Times*, March 21, 1982, E2.
[279] Henry Kissinger, "Poland's Lessons for Mr. Reagan," *New York Times*, Jan. 17, 1982, E23.

Undersecretary of State Robert Hormats walked this back to the official premise of administration action - that the Polish government might use default "as an excuse to relieve itself of its obligation to make any payments." Under this revised premise, the administration believed that "best way of keeping pressure on the Polish government and indirectly on the Soviet Government" was to insist that they pay their debts by withholding the default get-out-of-jail-free card. Nevertheless, Iklé assured the committee that the administration wanted to "deliberately retain" default as "a live option" in case events in Poland took a turn for the worse.[280] It seemed, implausibly, that the financial nuclear option – default – was at once a strategy of appeasement and the ultimate deterrent.

Needless to say, Kastens and Moynihan were not impressed. In their eyes, the decision not to call a default was motivated not by a desire to gain leverage over Poland but by a desire to save banks from writing down bad loans. Kastens took to the pages of *The Wall Street Journal* to make his case. "The crisis in Poland provides an unprecedented opportunity to hasten the breakdown of the Soviet Communist system," he wrote. "Now is the time to declare Poland in default."[281] Around him, the neoconservative estrangement from Reagan came into full view. Norman Podhoretz confessed in the *New York Times*, that he looked "with never failing amazement" on Reagan's decision to pay the interest on Polish loans. "To say that neo-conservatives were disappointed by all this understates the case to an incalculable degree."[282]

Bankers paid no mind to the heated politics building in the United States. Their focus remained solely on maintaining their own profitability and (financial) credibility by finally

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[280] Committee of Appropriations, United States Senate, "Polish Debt Crisis," (Washington, 1983) 7, 11, 22.
[281] Robert Kastens, Jr. "Poland: Declare the Default," *The Wall Street Journal*, May 7, 1982, 26.
[282] Norman Podhoretz, "The Neo-Conservative Anguish Over Reagan's Foreign Policy," *New York Times*, May 2, 1982, 89.

signing a rescheduling of Poland's 1981 debts. In early March, the Poles announced that they would pay all of the 1981 interest by the end of the month, and indeed they did. This cleared the way for the long awaited pageantry of formally signing the rescheduling agreement on April 6th at the Frankfurt headquarters of Dresdner Bank. While U.S. newspapers reported on the growing rebellion in Congress to the Reagan administration's inaction, *Euromoney* covered the Frankfurt signing as though it were the Versailles Treaty. Across a two-page picture of Wołoszyn and Karcz signing the rescheduling agreement, the banner read, "Signed: The First Comecon Rescheduling…The camera catches a moment in Euromarket history." Having signed the agreement for 1981, the banks and the Polish government were in the absurd position of having to turn around immediately and begin the negotiations to reschedule the loans for 1982, which were already months overdue. The Poles did not let the absurdity deter them. "We will need up to $3 billion of fresh money this year," Karcz told the magazine soberly. If his country received the money, he believed "this year's rescheduling will be easier."[283]

What Debt Hath Wrought

In the months that followed, fresh money never came. In fact, the months of crisis in Poland had precipitated profound changes in the international financial system that decisively influenced the last decade of the Cold War. "Fundamental change is sweeping the Euromarkets," *Euromoney* reported in its May 1982 issue. "The era of the government borrower, the main prop of international bank lending in the 'seventies, is dying." The president

[283] "Signed: The First Comecon Rescheduling," *Euromoney*, May 1982, 12-14. On 3 November 1982 Western banks rescheduled 95 percent of the principal for Poland's 1982 debt. Payment was deferred until 1986 with repayment over four years. "Fact Sheet on Polish Debt," Poland Debt Rescheduling (5), Series 1 – Country File, Paula Dobriansky Files, RRPL.

of the Bank of Tokyo told the magazine that "the Eastern European economic situation" had generated "a change in attitude" among banks toward the sovereign loan market.[284] At the June 1982 Annual Meeting of the Bank for International Settlements (BIS), the President of the BIS, Fritz Leutwiler, told his colleagues on the Board of Directors, "I do see signs that the banks' perception of the risks involved in their international lending may be changing. There have been indications that the banks are reassessing the creditworthiness of a number of sovereign borrowers."[285]

In turning away from their previous state clients, the banks were unwittingly sowing the seeds of their own potential destruction. A decline in sovereign loans did not mean a decline in sovereign debt. If capitalism was to avert a global crisis, sovereign borrowers were still going to have to find someway to repay their debt obligations. Otherwise the accounting ruse that propped up the banks' house of cards would collapse in a downward spiral of defaults, write-downs of losses, insolvencies, bank runs, and global depression. This spiral began with Poland's financial crisis, accelerated after Mexico became insolvent in August 1982, and eventually grew into the global financial phenomenon that defined the decade – the so called Third World debt crisis.[286]

The Polish crisis and its aftermath also exposed the "umbrella theory" for what it was – a theory, with little basis in reality. As the illusion of a Soviet umbrella crumbled, banks stopped

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[284] Peter Field, "The Shunning of the Sovereign Borrower," *Euromoney*, May 1982, 27-41. Quote at 30.
[285] Minutes of the Fifty-Second Annual General Meeting, Bank for International Settlements, June 14, 1982, 4A106/5 BoE Archives, p. 7.
[286] On the debt crisis, see James, *International Monetary Cooperation*; Boughton, *The Silent Revolution*; Barry Eichengreen, "Historical Research on International Lending and Debt;" Reinhart and Rogoff, *This Time is Different*; Cohen, *In Whose Interest?*; Frieden, *Banking on the World*; and Lissakers, *Banks, Borrowers, and the Establishment*.

granting communist states new loans and global investors pulled their money out of the Eastern Bloc. The problems began in Hungary, which throughout the 1970s had been known as "a model Comecon economy." In the first quarter of 1982, foreign institutions, particularly Arab investors, removed $1.1 billion of the $1.5 billion in convertible currency that they had deposited in the country. "Sometime during the winter," *Euromoney* reported, "banks across the globe had not only decided that they did not wish to participate in syndicated loans to Comecon borrowers, but that they wished to cut all exposure to the area as much as possible."[287] Just as in Poland, the question became who would step in to bail the country out. The answer was the central banks of the economies with the most to lose from a Hungarian collapse: West Germany, France, and Great Britain, but not the Soviet Union or the United States. Through the Bank of International Settlements, these three central banks cobbled together a "lifeboat loan" of $510 million.[288] The problems did not end with Hungary, however. Because of the fears of debt contagion caused by Poland, Romania lost all access to private Western credit and had over $1 billion in overdue interest payments by the end of 1981. By April, those outstanding interest payments had reached $3 billion. Again, the question became who would be the country's lender of last resort, and this time the IMF broke its own conditionality rules to provide the country with a "token drawing" on its funds to pay creditors in July.[289]

In each case, Western institutions stepped in to stem the tide, but they could not fix the underlying problem. The basic challenge of structural adjustment - reducing national living standards and increasing production of internationally competitive products - remained the

[287] Padraic Fallon and David Sheriff, "The Betrayal of Eastern Europe," *Euromoney*, September 1982, 18-30. Quotes at 22.
[288] "BIS Operation for Hungary," April 1, 1982, 3A161/20, BoE Archives.
[289] Boughton, *Silent Revolution*, 323.

responsibility of Eastern Bloc governments themselves. Eastern Europe, *Euromoney* concluded, "had entered a deflationary period" in which the ability to implement structural adjustment would decide the long-term fate of the bloc. In this matter, no one held out confidence for the future,[290] and indeed from the declaration of martial law until the Berlin Wall's fall in 1989, Comecon nations struggled to regain their former position in Western capital markets.

The financial history of the Polish crisis demonstrates that the reemergence of financial globalization after the breakdown of the Bretton Woods system deeply affected the last years of the Cold War. The founding of Solidarity in the shipyards of Gdańsk contributed to the end of the Cold War not only because it stoked the confidence of millions of Poles and other Eastern Europeans living under the yoke of communism, but also because it shook the confidence of the Western financial community in the economic viability of communism. After the crisis broke out in the summer of 1980, commercial banks rethought the profitability of lending to sovereign countries in general, and to communist states in particular, and the Eastern Bloc lost the easy access to global capital markets it had enjoyed throughout the 1970s. With limited access to the ever-deepening pools of global capital that took shape during the 1980s, communist states struggled to impose the austerity on their populations that their Western creditors demanded. Thus, when the end of the Cold War came in the fall of 1989, it was the result not only of communism's loss of legitimacy among the peoples of Eastern Europe, but its loss of creditworthiness on global financial markets.

[290] Fallon and Sheriff, "The Betrayal of Eastern Europe," 30. For the IMF's views, see "Application of Fund Policies in Planned Economies," Minutes of Executive Board Seminar, June 25, 1982, SEM 82/3 and 82/4, IMF Archives.

Chapter 4

Inverting Foreign Aid: The Reagan Financial Buildup

"We are on a spending binge," liberal Congressman James Scheuer (D-NY) admonished Reagan administration officials in the waning days of Reagan's presidency in January 1989. "Through the grace and tolerance of Japan, West Germany, and a few other countries," Scheuer said, "we are spending about $140 billion or $150 billion a year more than we are producing." Japan and West Germany, the cornerstones of the American imperium in Asia and Europe, were "producing approximately $140 billion more than they are spending" and "giving that to us," Scheuer said. "They are taking our credit. They are taking our T-bills."[291]

It was one of the most unexpected developments of the 1980s. Ronald Reagan, who had risen to the presidency decrying deficit spending and promising to balance the budget by 1984, had overseen an explosion of the federal budget deficit during his eight years in office. Additionally, the United States had transformed from a net exporter of capital into the world's largest debtor nation under his tenure. The U.S. current account balance – the overall measure of how much capital a country imports or exports – went from a slight surplus of $8.5 billion in Jimmy Carter's last year in office to unprecedented annual deficits of more than $100 billion under Reagan. Mediated by the increasingly deregulated financial markets of the era, the citizens and governments of the United States' wealthy allies in Europe and Japan covered these massive differences between national income and expenditure. Foreign capital poured into the

[291] "The 1989 Economic Report of the President: Hearings Before the Joint Economic Committee," January 18, 1989 (Washington, DC, 1989), p. 28.

United States during the 1980s at a rate previously unimaginable. Attracted to the U.S. by the high real interest rates implemented by Federal Reserve Chairman Paul Volcker, net foreign capital inflows skyrocketed from $6 billion in 1982 to $165 billion in 1986.[292] Like a massive vacuum cleaner on the world stage, the United States swallowed up the world's capital in the 1980s to serve the nation's domestic and international purposes.

Thus, an immense Reagan financial buildup underwrote the renewal of American prosperity at home and the projection of American power abroad. Unlike its more famous counterpart, the Reagan military buildup, the financial buildup was not an intentional strategy of Reagan or his administration. Indeed, at the turn of the 1980s nobody thought such a buildup was even possible.[293] As unexpected structural gaps opened between the government's revenues and expenditures as well as the nation's exports and imports during Reagan's first term, administration officials and outside observers predicted that the emerging 'twin deficits' on the budget and current account would wreak havoc on the American economy and force significant changes in policy. The newly globalized economy of the 1980s defied their expectations, and foreign capital began its great migration to the United States to cover the gaps.

The ramifications of the buildup for the United States and the world were profound. Within the United States, the financial buildup erased the traditional choice between guns and butter. Reagan was able to pursue both the largest tax cuts and the largest peacetime military buildup in the nation's history only through "the grace and tolerance" of foreigners. Abroad, the financial buildup not only enhanced the projection of American power by funding the military

[292] Harold James, *International Monetary Cooperation Since Bretton Woods* (Washington, 1996), p. 419.
[293] For a thorough discussion of American economic policy and the US economy in the 1980s, including the idea that no one foresaw the possibility of sustained budget and current account deficits, see Martin Feldstein, ed., *American Economic Policy in the 1980s* (Chicago, 1994).

buildup; it also fundamentally altered the geopolitics of the decade by *preventing* the flow of capital to other countries. The more that the United States monopolized the world's surplus capital, the harder other governments found it to attract capital to their own countries. Capital scarcity, in turn, altered the power relations between lenders and borrowers in the world economy, and significantly contributed to the many political revolutions in the Global South and the Eastern Bloc during the 1980s. In this way, the Reagan financial buildup proved to be one of the most powerful – if also unintended – tools of American foreign policy under Reagan. Most of all, the financial buildup signaled a new era of American leadership in the world. The traditional direction of foreign aid was inverted, and the United States became a Foreign-Aided Empire: one no longer based on the provision of resources to other countries, but rather on foreigners' provision of resources back to the United States. While I recognize that there is an important difference between capital flows based on return on investment and traditional intergovernmental foreign aid based on geopolitical and humanitarian considerations, capital inflows nevertheless represent an important form of foreign assistance.[294] Since the 1980s, the American empire has relied on the aid of foreigners, an imperial structure that originated with the Reagan financial buildup.[295]

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[294] The economist Nouriel Roubini has famously said, "Once you run a current account deficit, you depend on the kindness of strangers." See Stephen Mihm, "Dr. Doom," Aug. 15, 2008, http://www.nytimes.com/2008/08/17/magazine/17pessimist-t.html, Accessed December 28, 2016.

[295] The budget deficits, current account deficits, and capital inflows of the Reagan years have generally attracted little attention among scholars of international relations history. Charles Maier usefully described the United States since 1980 as an "Empire of Consumption" in *Among Empires* (Cambridge, 2006). Although his analysis included discussion of the foreign capital inflows that underwrote the American empire, Maier's conceptual focus on consumption failed to draw explicit attention to the fact that this new imperial formation depended on the capital of foreign citizens and governments. In his various works, including "The World Economy and the End of the Cold War, 1970-1990" in *The Cambridge History of the Cold War*, Giovanni Arrighi portrayed Volcker's interest rates and Reagan's economic policy as an intentional "neoliberal

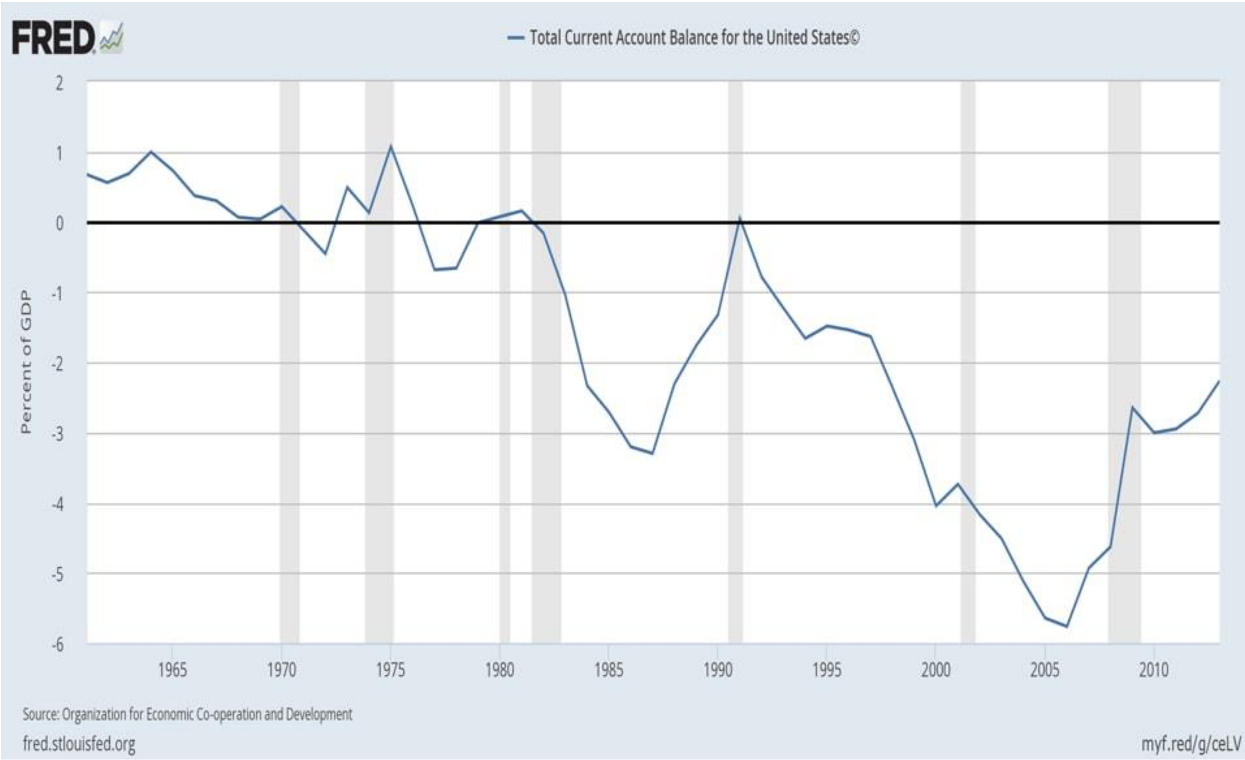

Figure 1: Charting the history of the U.S. current account balance as a percentage of GDP points to the early 1980s as a significant turning point in the structure of the American empire – the point at which the inflow of foreign capital became a permanent component the maintenance of American power and prosperity. Source: https://fred.stlouisfed.org/series/BPBLTT01USQ188S#0

The Reagan Half-Revolution

"The true Reagan Revolution never had a chance," David Stockman, a leader of the supply-side movement and Ronald Reagan's first Director of the Office of Management and

(counter)revolution" meant to reassert capitalist power in the world economy. While this was undoubtedly the outcome of the Volcker/Reagan era, Arrighi significantly overstates the extent to which this was an intentional and coordinated strategy of American officials. The historical sociologist Greta Krippner more accurately argues that the Reagan administration unintentionally "discovered the global economy" during the 1980s in *Capitalizing on Crisis* (Cambridge, 2011). In *Making the Unipolar Moment* (Ithaca, NY, 2016), Hal Brands recognizes globalizing capital flows as one of the structural trends that "created tremendous opportunities for U.S. policymakers to exploit" in the 1980s, but he ultimately strikes an ambiguous balance between structures and agents (by equally crediting both) in the making of the United States' unipolar moment at the end of the Cold War.

Budget, wrote in his 1986 memoirs, *The Triumph of Politics: How the Reagan Revolution Failed*. What started as an "ideas-based" movement to create "minimalist government" turned into "an unintended exercise in free lunch economics," Stockman wrote. The extensive tax cuts of Reagan's first term combined with the inability to reduce federal spending "unleashed" a "massive fiscal error…on the national and world economy."[296] The Reagan Revolution, Stockman concluded, was "only a half-revolution – and a fiscal disaster."[297]

The budget director's views had not always been so dour. A central tenet of at least the rhetoric of supply-side economics on the eve of the Reagan administration was that significant income tax cuts would pay for themselves by spurring a boom in economic growth. In the first budget forecast of the Reagan presidential campaign in August 1980, Stockman appeared to provide proof of this tenet by producing budget projections that led to a budget surplus in 1985 of $60 billion. These projections included Reagan's plan for a 30% cut in income tax rates, a 7% annual increase in military spending, and no significant cuts in domestic spending. Stockman would later call these projections "neither logical, careful, nor accurate within a country mile," but he achieved such a logic-defying budget miracle because of the dramatic effect of inflation on tax revenue through 'bracket creep.' As inflation raised Americans' incomes, it also pushed them into new tax brackets, which led them to pay a higher share of their income in taxes. Stockman's forecasts were based on the Carter administration's projection of 10% annual inflation for the first half of the 1980s. In the summer of 1980, this was not an unreasonable assumption – inflation had been the scourge of the American economy throughout the 1970s, and Paul Volcker's efforts at the Federal Reserve to tame it had not yet produced results. With 10%

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296 Stockman, *The Triumph of Politics*, p. 8
297 Ibid., 265.

inflation, Stockman recalled, “fiscal miracles were easy. You could have a whopping big tax cut and not create a deficit. Essentially, high inflation was raising projected taxes as fast as you were cutting them.”[298] In September, campaign economic advisors Alan Greenspan and Martin Anderson produced similarly pristine budget results in a “Fact Sheet” for the Reagan economic plan based on similar inflation numbers. Critics ranging from Jimmy Carter in the White House, to George Bush in the Republican presidential primary, to Henry Kaufman, one of the leading wise men of Wall Street, painted Reagan’s program as inflationary “voodoo economics” that would increase the budget deficit.[299] But with the economy still growing and inflation running at 12.5% in 1980, Reagan’s economic team could produce budget projections to refute the charge. Most importantly, the more the Reagan team told itself and the country that it could cut taxes, increase military spending, and balance the budget, the more they (including Reagan himself) actually *believed* such a combination was possible.[300] Reagan sincerely proclaimed in the early moments of his inaugural address in January 1981, “For decades we have piled deficit upon deficit, mortgaging our future and our children's future for the temporary convenience of the present.” Normal citizens, he said, “can, by borrowing, live beyond our means, but for only a limited period of time. Why, then, should we think that collectively, as a nation, we're not bound by that same limitation?”[301]

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[298] Ibid., p. 67.

[299] John Anderson, a liberal Republican and Independent presidential candidate in 1980, famously declared in a debate in 1980 that the only way to cut taxes, raise defense spending, and balance the budget was with “smoke and mirrors.”

[300] With regard to Republicans in the summer of 1980, Stockman writes, “A basic lesson had now been learned. ‘It might be possible to cut taxes, raise defense, and balance the budget,’ they began to think.” Stockman, *The Triumph of Politics*, p. 60.

[301] Ronald Reagan Inaugural Address, 20 January 1981, https://www.reaganlibrary.archives.gov/archives/speeches/1981/12081a.htm, Accessed December 26, 2016.

Before 1981, there was little reason to think that the nation was not bound by the same limitation, but the changes wrought in Reagan's first term would permanently change that. In August 1981, Congress passed and Reagan signed the Economic Recovery Tax Act (ERTA), which included a twenty-five percent reduction in personal income tax rates over three years, a significant cut in the capital gains tax, and an enormous reduction in corporate taxes through extremely favorable changes in depreciation rules. Combined with financial innovations taking place on Wall Street, including the creation of the collateralized mortgage obligation (CMO),[302] the ERTA created two of the economic conditions that would define the Reagan financial buildup – an extremely hospitable environment for debt investments and an unprecedented hole in federal tax revenues. In retrospect, the Reagan economic team would estimate that the ERTA reduced the effective tax rate on capital by 50%,[303] and the Office of Management and Budget would calculate the cumulative federal revenue loss of the ERTA over the course of the 1980s at almost $1.5 trillion.[304]

This decline in tax revenue only became apparent as inflation swiftly receded and the economy fell into recession in 1981. Throughout much of that year, Volcker kept the Federal Funds rate at over 19%, which choked off the nation's money supply and produced economic contraction. While the Reagan team was working to pass the ERTA in the summer of 1981, the

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302 These innovations and the resulting explosion of debt and foreign capital inflows are the subject of Michael Lewis's famous Wall Street memoir *Liar's Poker* (New York, 1989). Lewis writes that the "CMO burst the dam between several trillion investable dollars looking for a home and nearly two trillion of home mortgages looking for an investor." P. 170.

303 The ERTA favored debt investment over equity investment much more than the law's authors initially intended. 50% estimation from *1989 Economic Report of the President* (Washington, 1989), p. 87.

304 Calculation based on current dollar figures provided in Table 4.5 in James Poterba, "Federal Budget Policy in the 1980s," in Feldstein, ed. *American Economic Policy in the 1980s*, p. 248.

inflation rate was falling faster than anyone thought possible – from a high of 12.4% in 1980 to 3.9% in 1982.[305]

As inflation declined and the economy ground to a halt in the fall of 1981, administration officials ran new budget projections for the next five years based on lower inflation and economic growth numbers. They discovered, to their surprise, that the fiscal policy they had just enacted would produce, in Stockman's memorable formulation, "deficits as far as the eye can see." The new projections were "horrifying," Stockman recalled. They "showed cumulative red ink over five years of more than *$700 billion*. That was nearly as much national debt as it had taken America two hundred years to accumulate. It just took your breath away. No government official had ever seen such a thing."[306] In his diary, Reagan called the new deficit projections a "bomb." "Inflation is a tax," he wrote with apparent surprise, "We have brought down inflation so much faster than we anticipated that tax revenues will be lower than we figured."[307] By December 1981, he had resigned himself to the fact that, "we who were going to balance the budget face the biggest budget deficits ever."[308]

The question on everyone's mind at the end of 1981 was how to fund these deficits. In a closed economy, economic theory posited that government budget deficits would harm the economy by "crowding out" private investment, driving up interest rates, and killing economic growth. Reagan's chair of the Council of Economic Advisors wrote in an internal memo, "foreign portfolio flows are *potentially* useful in easing deficit pressures in domestic markets."[309]

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[305] Michael Mussa, "U.S. Monetary Policy in the 1980s," in Feldstein, ed., *American Economic Policy*, p. 104.
[306] Emphasis in the original. Stockman, *The Triumph of Politics*, p. 343.
[307] Reagan, October 17, 1981, in Douglas Brinkley, ed., *The Reagan Diaries* (New York, 2007), p. 44
[308] Ibid., 53.
[309] Quoted in Krippner, *Capitalizing on Crisis*, p. 95. Emphasis added.

But this was far from certain, and smart minds across the political and economic spectrum doubted its feasibility.[310] William Niskanen, a member of the Reagan economic staff, speculated to an audience at the American Enterprise Institute in December 1981 that "the opportunity to import capital" might save the economy from the harm of the deficits. But, he recalled, "the audience rejected the plausibility of net capital inflows in any substantial magnitude."[311]

The Birth of the Foreign-Aided Empire

Throughout 1982, the question of the role of foreign capital in funding the U.S. deficits lay dormant as the economy entered the deepest recession of the postwar period. Real output contracted by 3.3% and unemployment reached a peak of 10.8% in 1982.[312] In this context, there was little danger of government borrowing crowding out private investment because there was little private investment to speak of. The now widespread recognition that the ERTA would lead to unprecedented deficits led to loud political debates and a number of "piecemeal" efforts to close the gap between revenues and expenditures, including the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[313] But, importantly, neither Republicans nor Democrats were forced to fold on any of their core commitments: Reagan never retreated from the income tax cuts at the heart of the 1981 bill or the military buildup that bore his name, and Democrats never retreated from their defense of the major transfer payments (Social Security and Medicare)

[310] Henry Kaufman and Paul Volcker being the two of the most prominent doubters. See Volcker's "The Twin Deficits," *Challenge* 26 (March/April 1984), pp. 4-9, and Kaufman, *Interest Rates, Markets, and the New Financial World* (New York, 1986).
[311] William Niskanen, *Reaganomics* (New York, 1988), p. 110.
[312] Michael Mussa, "U.S. Monetary Policy in the 1980s," in Feldstein, ed., *American Economic Policy in the 1980s,* p. 104.
[313] The 1984 Deficit Reduction Act and the Tax Reform Act of 1986 also followed. "Piecemeal" is James Poterba's characterization in his article in Feldstein, ed., *American Economic Policy in the 1980s,* p. 250.

at the heart of the American welfare state. These piecemeal efforts consequently reduced the deficit by far less than the ERTA had added to it. Thus, despite much bluster and consternation, the long-term picture remained basically unaltered through the remainder of the Reagan administration: a structural budget deficit and current account deficit funded by foreign capital.

Volcker's interest rate policy held the keys to unlocking access to this surplus foreign savings. Throughout Reagan's first term, the Fed chairman was highly critical of the administration's fiscal policy, and publicly warned that the growing budget deficits were forcing the Fed to keep interest rates high to fight the inflationary pressures of fiscal policy. Yet, ironically, it was precisely Volcker's high interest rate policy that attracted the foreign capital to the United States. Volcker himself recognized this reality, and keeping rates high enough to attract foreign capital became an important element of Fed policy. All of the leading members of the Federal Reserve in the 1980s later admitted that attracting foreign capital played a key role in their decision making. Vice Chairman Preston Martin explained, "We have to have rates high enough to bring in the capital. All of us have to consider the government financing very seriously…. Keeping the rates high enough to attract foreign investors is the argument that's made and it's an awareness we all had." Governor Charles Partee concurred. "We let conditions exist that made U.S. interest rates look favorable compared to foreign investments," he said. "We stayed above the foreign interest rates so that foreign investors would be attracted to the U.S."[314] Japanese investors were by far the most important to attract. Martin explained how the Federal Reserve set interest rates just high enough to attract Japanese capital, "How are the

[314] Greider, *The Secrets of the Temple*, p. 561.

Japanese reacting to these new thirty-year securities?" he asked his colleagues. "What mattered was the Japanese. Are the Japanese buying? Fine, if they are, we don't have to raise rates."[315]

By 1983, the Japanese, along with their West German, French, Swiss, and British counterparts, were indeed buying US government bonds. $85 billion in foreign capital entered the United States in 1983, followed by $103 billion in 1984, $129 billion in 1985, and $221 billion in 1986. The federal budget deficit in these years ranged from $208 billion in 1983 to $221 billion in 1986, so by the end of this period, foreign capital inflows were directly or indirectly covering *all* of the federal government's borrowing.[316] Because the capital inflow prevented the government from crowding out domestic private investment, interest rates also remained much lower than they otherwise would have been – 5% lower by one estimate.[317] The global attraction to U.S. investments also dramatically increased the exchange value of the dollar. While this development severely hurt U.S. exporters, it kept inflation low and boosted domestic consumption as the economy started to grow after the recession.

By 1984, Reagan administration officials had caught on to the new realities of the global economy, and they actively sought to exploit them. In the May 1984 Yen/Dollar Agreement, the Treasury Department successfully negotiated a liberalization of the Japanese capital market with the Japanese government that made untapped Japanese surplus saving available for U.S. investment. In the summer of that year, the 30% withholding tax on interest earned by foreigners on U.S. investments was eliminated in 1984 to further increase foreign inflows. By the fall, the Treasury had initiated a "foreign-targeted securities program" to issue U.S. government debt

[315] Ibid.. p. 561.
[316] Krippner, *Capitalizing on Crisis*, p. 189, n. 34.
[317] Stephen Marris, *Deficits and the Dollar: The World Economy at Risk* (Washington, 1985), p. 44.

specifically to Japanese and European investors. Treasury officials went on the road to make their case, travelling to Tokyo and Frankfurt to promote the purchase of U.S Treasury bills. Such efforts led one analyst to give the Reagan Treasury leadership the title of "the greatest bond salesmen in history."[318] In the sheer size of the debt they issued, they no doubt had earned the designation.

In a clear sign of the changing financial landscape, Reagan called for the United States to become "the investment capital of the world" in his 1985 State of the Union Address. Clearly, he and the country had changed dramatically since he had questioned how long the nation could live beyond its means in his first inaugural. In the same year, *Business Week* summed up the transformation in economic thinking and practice that had occurred since Reagan had taken office. "The nation's financial foundation was supposed to shake when a growing economy collided with the huge budget deficit," the magazine noted in February 1985, "Credit demand would soar, driving interest rates into the stratosphere. Instead…the experience of the last two years [has] shown that the U.S. does not have a closed system. Inflows of foreign capital can sustain private and public borrowers alike."[319] In other words, foreign capital was now sustaining the American empire. The Foreign-Aided Empire had been born.

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[318] I.M Destler and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, 1989), p. 29. The particulars of these efforts to target US Treasury bills to foreigners are detailed in "The Eurodollar Market and Capital Flows to the U.S.," Memo from Undersecretary Beryl Sprinkel to Secretary Regan, July 13, 1984, Box 143, File 2, Donald Regan Papers, Library of Congress, Washington, D.C.
[319] Quoted in Krippner, *Capitalizing on Crisis*, p. 101.

The Global Crowding Out

Just because the US economy was not suffering from crowding out effects did not mean that the crowding out was not happening. It only meant that it was not happening in the United States. As economists and policymakers adjusted their frame of reference to accommodate the reality of the Reagan financial buildup, they realized that it was the rest of the world, rather than the private American economy, that was suffering from the unprecedented government borrowing. As William Niskanen, the Reagan administration economist, wrote in 1988, "there is evidence that government deficits have substantial 'crowding out' effects somewhere in the world."[320] That 'somewhere' was the Global South and the Communist Bloc. It is not possible to detail the global reach of the crowding out in the confines of this paper, so I will take two examples, one general and one specific, to point to the effects of U.S. borrowing on the rest of the world.

First, at the general level of the global economy, the International Monetary Fund's 1985 *Global Economic Outlook* noted the historic change in capital flows between developed and developing nations that had unfolded since the beginning of the decade. "The emergence of the United States as an unprecedentedly large international borrower," the authors wrote, "is a dominant feature of the present pattern of global capital movements. In 1984, absorption of surplus savings by the United States dwarfed the combined absorption by all developing countries." The authors warned that "continued credit demand from the United States on the present scale could severely limit expanded access to external financial resources by many developing countries, even if they manage their own economies satisfactorily."

[320] Niskanen, *Reaganomics*, p. 112.

The consequences of the explosion in First World debt for the developing world were enormous, the Fund economists wrote. In the years ahead, developing countries would "have no option but to adjust their absorption of external goods and services to levels dictated by their actual export earnings and the greatly reduced net financial flows that remain available to them." What did this mean in plain language? Developing countries had no choice but to impose domestic austerity and greatly reduce their level of imports. Net capital flows to developing countries would only return to their former levels "as government credit demands recede in the United States and other industrial countries." The persistence of such credit demands from developed nations "would seriously set back the development efforts of [developing] countries." Lower net capital flows, the authors wrote, "would limit the scope for gains in the productivity and real income" of developing countries.[321] Through the rest of the decade, the credit demands of the United States did not significantly recede, and consequently, the developing world suffered tremendously. It is strictly true in theory and roughly true in practice that international current accounts must balance out at a global level. For every current account deficit, there must be a current account surplus. International finance in the 1980s was Newtonian: every action produced an equal and opposite reaction. The equal and opposite reaction to the Reagan financial buildup was "The Lost Decade" of development in the Global South.

The 1985 *Global Economic Outlook* also discussed how the new demand for credit from industrial nations had caused an important shift in power relations between debtor countries in the Global South and their creditors. Because developed countries were now universally running large annual budget deficits, the Fund viewed an increase in foreign aid to the developing world

[321] "Trends in Capital Flows to Developing Countries," Supplementary Note 9, in *World Economic Outlook* (Washington, 1985), p. 188-193.

as unlikely. Indeed, Fund economists foresaw a decline in First World development assistance. The authors therefore believed that new capital for developing countries would "probably have to come mainly through a revival of confidence and of lending operations on the part of private banking institutions." Renewed capital flows could not "proceed at all unless the potential lenders gain confidence in the policies of borrowing countries."[322] In other words, because the sources of public finance from developed countries had all but dried up, it was up to the governments of developing countries to make their domestic policies attractive to the interests of private foreign capital. In a world of capital scarcity, lenders hold enormous power over borrowers because they are the gatekeepers of capital. By creating the environment of capital scarcity that prevailed for the Second and Third Worlds in the 1980s, the Reagan financial buildup helped bring these power relations between lenders and borrowers into existence.

The general dynamics of the global economy described by the Fund come alive in the specific example of the German Democratic Republic (GDR) in the 1980s. I have chosen East Germany both because it is a country that I have researched relatively well, and because it is what could be considered "a hard case." If the Reagan financial buildup had significant effects on the GDR, a country relatively isolated from the global capitalist economy compared to the nations of Latin America or Africa, then we can be reasonably certain that it also had significant effects on the Global South. During the 1970s, the GDR had joined the many nations of the socialist bloc and the Global South that borrowed heavily on global capital markets to minimize the effects of the 1973-74 oil crisis. By 1978, the country was so dependent on Western capital

[322] Ibid, p. 193.

that East German financial officials were writing to the party leadership, “Ensuring the solvency [of the country] largely depends on the willingness of capitalist banks to grant us loans.”[323]

The Reagan financial buildup fundamentally altered the willingness of global capital holders (including banks) to funnel capital to the GDR. Werner Polze, the President of the East German Foreign Trade Bank, laid out the new international financial environment for the party leadership in an early January 1984 memo. Over the previous two years, he wrote, “capitalist banks showed no readiness to increase their credit volumes” to the GDR. He blamed U.S. borrowing for the banks’ intransigence. “The government deficit in the US amounted to $207.2 billion in the 1982/83 fiscal year,” he detailed, “and is estimated to be about $200 billion in the next two years.” Funding the U.S. budget deficit, Polze reported, would “require” the United States to borrow “about $660 billion U.S. dollars in the years 1984-1986.” The Reagan financial buildup was, in short, crowding East Germany out of global capital markets.

Polze foresaw no end to heavy American borrowing on global capital markets because such borrowing served the interests of American power. “The United States will continue to pursue its high-interest policy in the future without any regard for its allies, since it corresponds to the interests of U.S. imperialism. With the help of the high interest rate policy and the associated higher real interest rate of the U.S. dollar against other capitalist currencies, capital flows are being directed to the USA,” he wrote. “In this way, U.S. imperialism succeeds in financing a considerable part of the rearmament [the Reagan military buildup] through international capital markets and limits the risks of the rearmament resulting in inflation.”[324] As

[323] “Memo für Genossen Schürer,” undated, but in folder from 1978, in DE/1/58656, BArch/Berlin.
[324] Werner Polze, “Einschätzung der Lage auf den kapitalistischen Geld- und Kreditmärkten einschließlich der Entwicklung der Zinssätze und Schlußfolgerungen für die Zahlungsbilanz 1984,” 5.1.1984, DY 3023/982, BArch/Berlin, pp. 265-272.

the head of a communist central bank, it is not surprising that Polze focused on how capital inflows were funding the Reagan military buildup. In reality, American borrowing was funding much more than just the rearmament; it was also funding all manner of domestic spending, tax cuts, and private debt accumulation in the United States. But the fundamentals of Polze's perspective were correct, and observers from around the world shared his viewpoint. West German Prime Minister Helmut Schmidt famously decried in 1981 that U.S. economic policy had led to "the highest interest rates since Jesus Christ" and to an outflow of capital from Europe to the United States.[325] Harold MacMillan, the former British Prime Minister, viewed U.S. policy in a similar vein, as he told the House of Lords in a 1984 speech. "In a word Reagan (to reverse Keynes) has called in the resources of the old world in order to finance the expansion of the new."[326] America's European allies constantly criticized U.S. fiscal policy, but the Reagan administration refused to alter course because it had discovered that tight monetary policy and loose fiscal policy served its domestic and international interests quite well.[327]

Polze's policy recommendation to the leadership mirrored precisely what the IMF's 1985 *Global Outlook* deemed "the only option" for developing countries – to reduce their demand for borrowed capital by creating export surpluses. "<u>The long-term high interest rate policy of the USA</u>," Polze concluded, "<u>makes it necessary to reduce [the GDR's] total borrowing through</u>

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[325] Harold James writes, "European savings, drawn by higher returns, were financing American not European investment." *International Monetary Cooperation*, p. 421.
[326] MacMillan quoted in *Deficits and the Dollar: The World Economy at Risk* (Washington, 1985), p. 1.
[327] Important American policymakers, including Secretary of State George Schultz and Paul Volcker, readily recognized that the high value of the US dollar significantly hurt the American economy, but their pleas for policy change did not take hold until Reagan's second term. In the fall of 1985, Volcker successfully negotiated a managed reduction in the exchange value of the dollar in the Plaza Accord with the central banks of Japan, West Germany, the U.K., and France. Even this, though, did little to stem the tide of foreign capital inflow, which remained drawn to the US by the relatively high real interest rates.

export surpluses and to use credits, as a rule, only for economically viable projects."[328] As I have argued elsewhere, the GDR would spend the rest of the 1980s trying and failing to produce export surpluses to pay down its debt, and its ultimate inability to do so would lead to a debt crisis, the opening of the Berlin Wall, and the collapse of the state in 1989.[329]

A Hidden Hand of American Power

Trying to achieve export surpluses may sound like a fairly innocuous policy goal, but for the debtor nations of the 1980s it was a process fraught with social and political implications. For these nations, export surpluses most often had to be achieved through drastic reductions in imports and the imposition of domestic austerity. On the orders of the International Monetary Fund, such austerity programs occurred throughout the Global South – most prominently in Latin America - during the 1980s as the region dealt with the Sovereign Debt Crisis. Political revolution, usually in the form of democratization, followed in austerity's wake. Samuel Huntington titled this global phenomenon "the third wave" of democratization in a 1991 book by that name.[330] While Huntington listed changes in global capital flows as one among many causes of the third wave, recent scholarship has drawn a stronger connection. In his book, *Latin America's Cold War*, Hal Brands concludes that the democratization of Latin America in the

[328] Underlining in the original. Polze, "Einschätzung der Lage auf den kapitalistischen Geld- und Kreditmärkten einschließlich der Entwicklung der Zinssätze und Schlußfolgerungen für die Zahlungsbilanz 1984," p. 272.
[329] This is the argument I put forth in "Exit, Violence, or Austerity: A New History of the Fall of the Berlin Wall," unpublished dissertation chapter.
[330] Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman, OK, 1991).

1980s "was a product of debt" and the austerity programs that arrived with the debt crisis.[331] As I have briefly suggested here and develop more fully in my dissertation, a similar process unfolded in the Eastern Bloc and resulted in the revolutions of 1989. Deprived of global capital and facing their own debt crises by the late 1980s, Poland and Hungary implemented IMF austerity programs and tried to legitimize them through Round Table democratization. Fearing the consequences of an IMF austerity program, the GDR sought to escape its own debt crisis in the same year by trying to ransom the opening of the Berlin Wall for billions of Deutsch Marks from West Germany. Put very simply, democratization in Eastern Europe was, too, a product of debt.[332]

Debt is only a tool of power in international relations when a country has no new capital with which to service it. It is here that the international power of the Reagan financial buildup lies. In crowding the Global South and the communist bloc out of global capital markets, American borrowing on global capital markets subjected countries in these regions to the stringent demands of their creditors. In this way, the failure (in David Stockman's sense of the term) of the Reagan Revolution within the United States contributed to revolutions abroad during the 1980s. Many of these revolutions were extremely favorable to U.S. national interests, and thus, the Reagan financial buildup proved to be a powerful, if unintended, source of American influence in the 1980s.

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[331] Hal Brands, *Latin America's Cold War* (Cambridge, MA, 2010), p. 224 and chapter 8 more generally. See also, Kurt Weyland, "Neoliberalism and Democracy in Latin America: A Mixed Record," *Latin American Politics and Society* 46:1 (Spring 2004), 135-157.

[332] "The Privatization of the Cold War: Oil, Finance, and the Collapse of Communism," forthcoming.

Chapter 5

Bystander to Revolution:

Bankruptcy, Democracy, and the Collapse of the Soviet Empire

In the final days before martial law was declared in Poland in December 1981, the leadership of the Soviet Union was unsure whether General Wocjiech Jaruzelski would indeed go through with his plan to crush Solidarity. In the Politburo, Soviet officials discussed their options. They had already funneled billions of dollars and millions of barrels of oil into the country to prop up their ally in Warsaw, but the crisis had only worsened. Now they were left to consider how they would react if Jaruzelski failed to move ahead with martial law. Would they use the Red Army to crush the "counterrevolution" as they had done in Hungary in 1956 and Czechoslovakia in 1968? Yuri Andropov, the formidable head of the KGB and acting leader of the Politburo in the absence of the increasingly infirmed Leonid Brezhnev, provided the definitive answer. "We don't intend to introduce troops into Poland," he said, "That is the proper position, and we must adhere to it until the end. I don't know how things will turn out in Poland, but even if Poland falls under the control of 'Solidarity,' that is the way it will be." Intervention, he said, would "be very burdensome for us. We must be concerned above all with our own country and about strengthening the Soviet Union. That is our main line."[333] Days later, Jaruzelski saved the Politburo from reckoning with the implications of Andropov's conclusion when he declared martial law and ordered tanks to roll into Warsaw.

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[333] Quoted in Matthew Ouimet, *The Rise and Fall of the Brezhnev Doctrine in Soviet Foreign Policy* (Chapel Hill, 2003), p. 234.

Almost a year later, the Hungarian government found itself on the brink of bankruptcy, and sent Minister Jozsef Marjai to Moscow to plead for economic support. Without more oil or hard currency from the Soviet Union, Marjai told the Soviet leadership, his country would face a crisis. After forging their resolve in the Polish Crisis the previous year, Andropov and his colleagues were unpersuaded, and they stoically turned away the Hungarian plea. Left empty handed, Marjai could only warn his Soviet comrades about the costs of their inaction. "We are talking about the fate of the socialist system," he said. The system could easily "collapse." For this to happen, he said, the Soviet Union "simply has to do nothing."[334]

Seven years later, the Soviet Union stood idly by as its Eastern European empire collapsed in 1989. Observers watched in wonder, and asked how it was possible that one of the world's superpowers could peacefully accept its own defeat in an imperial and ideological rivalry that had spanned the forty-five years since the Second World War. The outcome was so puzzling and unexpected that it forced practitioners of international relations theory, whose job it was to predict these sorts of seismic shifts in the international system, into a period of deep soul searching.[335] By the twenty-year anniversary of the fall of the Soviet empire, the outcome was

[334] Ibid, p. 252. I will cover these two episodes in Chapter 3 and 4, but reproduce them as points of reference for the continuity between Gorbachev's policy and that of his predecessors.
[335] As Alexander Wendt notes, "Mainstream IR theory simply had difficulty explaining the end of the Cold War, or systemic change more generally. It seemed to many that these difficulties stemmed from IR's materialist and individualist orientation, such that a more ideational and holistic view of international politics might do better." Wendt, Peter Katzenstein, and others led a turn toward constructivist IR theory in response to the end of the Cold War. Wendt, *Social Theory of International Politics* (Cambridge, 1999), p. 4. See also Peter J. Katzenstein, Robert 0. Keohane, and Stephen D. Krasner, "International Organization at Its Golden Anniversary," International Organization, Vol. 52, No. 4 (Autumn 1998); and Katzenstein, "Introduction: Alternative Perspectives on National Security," in Katzenstein, ed., *The Culture of National Security* (New York, 1996). Matthew Evangelista, *Unarmed Forces* (Ithaca, NY: 2002) and Robert English, *Russia and the Idea of the West* (New York, 2000) take historical approaches in support of constructivist theory. The leading materialist explanation for the end of the Cold War

no less astonishing and finding an explanation remained as pressing as ever. Summing up the conundrum, one author wrote in 2009, "No other empire in history had ever abandoned its dominions so quickly or so peacefully. Why did the Soviet Union surrender without a fight? And why at the end of the 1980s?"[336]

Answers to these questions have overwhelming focused on the influence of one man, Soviet General Secretary Mikhail Gorbachev, and his ideas of reform, perestroika (restructuring) and glasnost (opening up). Indeed, with only a few exceptions, the study of the fall of communism has been anchored in the study of men and ideas.[337] Scholars have argued that a small band of Soviet reformers, led by Gorbachev himself, mobilized a radical set of ideas, including a policy of non-intervention in the affairs of other states, disarmament, non-violence, and a respect for electoral democracy and human rights, to end the Cold War and push Eastern Europe into revolution. Mark Kramer, perhaps the leading historian of the collapse of communism, has long argued that there was a "spillover" from perestroika into Eastern Europe.[338] Others speak of Gorbachev "coaxing" and "pushing" Eastern Bloc leaders to reform

within IR remains, "Power, Globalization, and the End of the Cold War," Stephen G. Brooks and William C. Wohlforth, *International Security*, Vol. 25, No. 3 (Winter, 2000-2001), pp. 5-53.

[336] Victor Sebestyen, *Revolutions 1989: The Fall of the Soviet Empire* (New York, 2009), p. xix. Sebestyen's answers to these questions, which include that "the USSR lost its will to run an empire" because it was "exhausted" and "bankrupt;" and "Communism in Europe survived only as long as capitalist bankers from the West were willing to bankroll it" (p. xix) are on the mark, but his account still lacks a sense of how Eastern Bloc leaders used democratic politics to gain legitimacy for economic austerity.

[337] Robert English, *Russia and the Idea of the West* (New York, 2000), Stephen Kotkin, *Armageddon Averted* (Oxford, 2001) and the works of Archie Brown, including most prominently, *The Gorbachev Factor* (Oxford, 1996).

[338] "The sweeping political reforms launched by Gorbachev within the USSR and the bold changes he carried out in Soviet foreign policy helped generate unrest and instability in Eastern Europe," he writes. Kramer, "The Collapse of East European Communism and the Repercussions within the Soviet Union, Part 1," *Journal of Cold War Studies,* Vol. 5, No. 4 Fall 2005, pp. 178-256, quote at 180. This article, along with Kramer, "The Demise of the Soviet Bloc," *Journal of Modern History,* Vol. 83, No. 4 (Dec. 2011), pp. 788-854, are viewed as the

or "export[ing] perestroika to Eastern Europe."[339] In these histories, a small group of unique individuals at the top of the Soviet hierarchy channeled radical ideas to bring about the end of the Cold War and the revolutions in Eastern Europe. These were revolutions that they did not foresee or intend, but they endorsed them nonetheless because of their idealistic vision of the world. Without these reformers and their ideas, the prevailing viewpoint holds, the collapse of communism would not have happened.

But what if Marjai was right? What if the collapse of communism in Eastern Europe depended only on the Soviet Union doing nothing? What if it was not Gorbachev's action, but rather his inaction, that was the primary Soviet influence on the revolutions of 1989? The current scholarship already recognizes Gorbachev's inaction as decisive, but again attributes it to the power of his "new thinking."[340] But what if the reasons for Gorbachev's inaction were not to be found in his idealistic acceptance of the principles of state sovereignty, democracy, and human rights, but rather in the economics of the Soviet empire he oversaw?

There is good reason to explore such a line of argument further. At a high-profile conference of leading Cold War scholars and diplomatic practitioners as far back as 1998

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definitive works to date on the Soviet role in 1989. Another important early contribution was Jacques Lévesque, *The Enigma of 1989: The USSR and the Liberation of Eastern Europe* (Berkeley, 1997), in which the author traces a "Gorbachev effect" that decisively tipped the political balance of power in Eastern European regimes in favor of reform, thus inviting destabilization and revolution. See p. 68. Elsewhere,

339 English, *The End of the Cold War*, p. 326, 400. Helen Hardman, *Gorbachev's Export of Perestroika to Eastern Europe: Democratisation Recondsidered* (New York, 2012).

340 Lévesque has argued "Soviet acceptance of the collapse of East European Communist regimes in 1989 must be considered the single most significant event leading to the end of the Cold War." This framing of the Soviet Union accepting, rather than causing 1989 aligns with the argument presented here, but Lévesque stresses the special role of Gorbachev and ideas in creating the conditions for such an acceptance. See Lévesque, "The East European Revolutions of 1989," in *The Cambridge History of the Cold War*, Vol. 3, p. 311. Also Kramer, "The Demise of the Soviet Bloc."

devoted to exploring the end of the Cold War, most participants spent their time discussing the importance of Gorbachev and his ideas. After hours of discussion, Georgy Shakhnazarov, a man who had become intimately involved with these issues as Gorbachev's assistant for Eastern European affairs, told the assembled group, "We are underestimating the economic factor." Rhetorically he asked, "When did our leadership become ready…to release the leash by which Moscow held its satellites?" At a certain point, he said, the economic "burden became too much for the Soviet Union; we could not carry it anymore."[341] Almost twenty years after his comments, scholars have finally begun to follow Shakhnazarov's lead, but fundamental aspects of the economic dimensions of Soviet policy remain unexplored.[342] Most importantly, the scholarship continues to view perestroika as radical revolution in Soviet foreign policy rather than an outgrowth of a long-term evolution in Soviet thinking about the material burden of empire. This chapter will argue that in foreign policy, particularly with regard to Eastern Europe, perestroika was an extension of the "main line" first articulated by Andropov: Gorbachev and the rest of the Soviet leadership sought to jettison the material drain of the Soviet

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[341] Shakhnazarov, "Musgrove Transcript," in *Masterpieces of History*, p. 156. In 2014, a leading scholar was still writing, "The economic side of Soviet relations with the region [Eastern Europe] has not attracted the attention it deserves." See Alex Pravda, "Moscow and Eastern Europe, 1988-1989: A Policy of Optimism and Caution," in Mark Kramer and Vít Smetana, eds., *Imposing, Maintaining, and Tearing Open the Iron Curtain: The Cold War and East-Centrla Europe, 1945-1989* (Lanham, MD, 2014).

[342] In his extremely well-researched, *The End of the Cold War, 1985-1991* (New York, 2015), Robert Service correctly argues, "Soviet leaders concluded that they could no longer afford their geopolitical pretensions" (p. 496). My differences with Service lie in what caused the revolutions of 1989, rather than the reasons that the Soviet Union did not intervene to stop them. Svetlana Savranskaya's introductory article in *Masterpieces of History: The Peaceful End of the Cold War in Europe* (New York, 2009) does acknowledge the importance of economics and the domestic Soviet context, but does not provide an in depth discussion of each. Yegor Gaidar's *Collapse of an Empire: Lessons for Modern Russia* (Washington, D.C., 2006). Chris Miller's *The Struggle to Save the Soviet Economy* (Chapel Hill, NC, 2016) is the most recent and complete scholarly treatment of the Soviet economic collapse, but it does not deal with foreign policy.

empire in order to prioritize Soviet domestic interests. They accepted changes in the political identity of satellite governments out of the fear that military, political, or economic intervention would only add to their imperial burden.

The domestic history of perestroika reinforced this change in Soviet thinking. As Gorbachev completed an evolution in Soviet policy abroad, he launched a revolution at home. Perestroika and glasnost upended seven decades of thought and practice within the Soviet Union. By 1989, these changes had unambiguously achieved two results, both of which only provided further reason for the Soviet leadership not to intervene in the revolutions of that year in Eastern Europe. First, the economic reforms had set the country on a path to bankruptcy, and second, Gorbachev had succeeded in introducing a system of limited electoral democracy in order to gain momentum and legitimacy for his economic reforms. Domestic bankruptcy and democracy loomed over Soviet decision-making in 1989, and further deterred the Soviet leadership from intervening to stop the revolutions of that year.

Thus, this chapter proceeds just as Soviet officials during this period did: primarily focused on the domestic context, and considering foreign policy only in light of how it would affect their domestic interests. It traces the history of how the Soviet Union came to the brink of bankruptcy and democracy, and it considers foreign policy as a subplot of this domestic story. The results of such a history stand in contrast to the prevailing historiography on "the Soviet Factor" in the collapse of communism: Mikhail Gorbachev and the Soviet leadership were bystanders to, rather than causes of, the revolutions of 1989. Within the Soviet Union, Gorbachev authored a revolution within the Soviet Union, but abroad he wrote the final chapter of a book begun by his predecessors. He and the rest of the Soviet leadership, including those who despised Gorbachev's domestic revolution, accepted the revolutions of 1989 not out of a newfound commitment to Western-style democracy and human rights, but because they were no longer capable of bearing the economic burden of empire. In 1982, Jozsef Marjai had warned Andropov that the socialist system would collapse if the Soviet Union did nothing. Because of the economics of that system, nothing is precisely what the Soviet Union did.

The Reasons for Reform

"We can't go on living like this," Mikhail Gorbachev told his wife Raissa the night before he was elected General Secretary of the Communist Party of the Soviet Union (CPSU) on March 11, 1985. Everywhere one looked in the Soviet Union the need for change beckoned, but for Gorbachev, the signs coming from the Soviet economy were the most troubling. National income growth, which Soviet economists used as "the summary indicator of the country's economic development," had declined from 41% during the 8th Five Year Plan in the late 1960s to 17% during the 11th Five Year Plan in the early 1980s.[343] Although they did not broadcast it widely, Soviet economists knew that the economy had not grown at all from 1979-1982 during the global economic recession, and it had recovered to achieve at most a 1.5% real growth rate since then.[344] Far from catching up with the capitalist West, the Soviet economy had clearly stagnated, and things were about to get even worse. Soviet economic growth had always been based on an extensive growth model – increasing inputs of labor, capital, and energy to produce economic growth without increasing the efficiency of their use. But by the mid-1980s, new inputs to add to the economy were dwindling. Because the population size had stagnated, there

[343] A.G. Aganbegyan, "The Economic Strategy of the 27th CPSU Congress: Social Aspects," *Rabochiy Klass i Sovremennyy* Nov-Dec 1986, translated in JPRS-UEA, March 1987, pp. 1-16, quotes at 2.
[344] Anders Aslund, *Gorbachev's Struggle for Economic Reform* (Ithaca, NY, 1991), p. 71.

were no more Soviet laborers to add to the workforce, and because new Soviet oil and natural gas reserves were harder and more expensive to extract than earlier energy deposits, there was less economic growth to be gained from increases in energy supplies. As the leading Soviet economist and advisor to Gorbachev, Abel Aganbegyan explained in 1986, “Up to now, as is well known, we have been developing with a predominance of extensive factors – by bringing new resources into production: fixed productive capital, capital investments, fuel and raw materials, and manpower.” But this model had “no future” because growth in “productive resources” – new labor and energy resources – had stagnated in the early 1980s, and “in the [nineteen] nineties the growth of productive resources will hardly increase.”[345]

On top of this faltering economic foundation, Soviet leaders had built an ever more expensive global imperial system. The Soviet Union’s status as the leader of the worldwide communist movement and military counterweight to the United States placed unique economic burdens on the Soviet state: massive defense spending to counterbalance “the capitalist imperialist threat” and the subsidization of the Soviet satellites with energy and raw materials. Parity in military forces and nuclear arms with the United States had come at the cost of creating a massive military-industrial complex that trapped the nation’s best people in the production of the destructive tools of war. Now that he was General Secretary, Gorbachev could see that the military-industrial complex consumed forty percent of the Soviet budget, and military production comprised twenty percent of GDP.[346] Unlike the West, the planned economy had failed to turn its advances in military technology into useful civilian products, so the military industrial complex remained a world unto itself within Soviet society. The confidential excesses of the

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[345] Soviet labor and energy inputs grew at 0% and 8% respectively from 1981-1985. Aganbegyan, “The Economic Strategy of the 27th CPSU Congress: Social Aspects,” 3.
[346] Gorbachev, *Memoirs*, p. 215.

military budget were matched by the very public drain of Soviet blood and treasure in Afghanistan, where Gorbachev's predecessors had sent the Red Army to prop up the country's socialist government in 1979, only to get bogged down in a costly and unwinnable war against the mujahedeen insurgency.

Since the 1970s, the Soviet leadership had paired economic subsidy with military might to secure their leadership of the socialist world. Through the Council of Mutual Economic Assistance (CMEA or Comecon), the Soviet Union had provided its allies with energy and raw materials at prices far below the world market. The 1973-74 oil crisis had exploded the world price of all manner of raw materials, but to aid their Eastern European allies, the Soviet government had established what was known as "the Bucharest formula," whereby all prices within CMEA would be determined based on an average of world market prices from the previous five years. Throughout the 1970s and early 1980s, this meant that the Soviet Union provided the world's most valuable natural resources, especially oil and natural gas, at significantly reduced prices. Under this system, Soviet economists calculated that their country had given the Eastern Bloc 37 billion rubles in subsidies from 1976 to 1985.[347]

Impenetrable superpower defense and massive imperial subsidy had come at the expense of the Soviet population. By the mid-1980s, the age-old Soviet promise that socialism would one day deliver a better material life than the capitalist West had long rung hollow. Now it was a challenge to simply keep pace with the rest of the world. American intelligence agencies

[347] I hope to do more research on this figure in Russian archives and to establish for myself what I think the ruble/dollar exchange rate would have been over this period, but I don't know enough yet. Officially the ruble was slightly stronger than the dollar, so this would be over 40 billion dollars. I actually think this understates the subsidy, but I have to confirm in the archives. Memorandum for Files, "USSR: CMEA System," Sept 10, 1990, File 3, Box 3, Office of Managing Director - Alan Whittome Papers (Whittome Papers), IMF Archive, Washington, D.C.

estimated Soviet consumption per capita to be one third of the United States and 55% of Japan and Western Europe in 1985. In fact, the intelligence community concluded, the Soviet Union "was more comparable to countries such as Mexico, Brazil, and Argentina" in per capita consumption than the developed West, and the Soviet position relative to the rest of the world had "not improved in two decades." Because the quality of the products produced in the Soviet Union was "particularly poor," the intelligence agencies concluded that even such ominous quantitative measures of the Soviet standard of living "probably overstat[ed] the Soviet position."[348] Worse than its position in the global economy, the Soviet Union also had the lowest standard of living among its own socialist allies. In 1987, Gorbachev would report with great frustration to the Politburo, "In real standard of living, we are now in last place among the CMEA countries." In the early 1970s, their standard of living had at least been "higher than Bulgaria and Romania," but no longer.[349] As the rest of the world's citizens had reaped the rewards of economic growth, Soviet citizens had been left behind, and their plight made a daily mockery of enthusiastic official proclamations regarding the achievements of socialism.

This was the system that Gorbachev inherited – economically stagnant, imperially overburdened, and underperforming for its own citizens. The Soviet model of extensive growth had reached a plateau and would only produce worse results in the years ahead. To fix it,

[348] US Intelligence Agencies (Unidentified), "The Soviet Economy in Global Perspective," March 1989, Box 3, End of the Cold War Collection, NSA, pp. 1-21, quotes at 7.
[349] A. S. Chernyaev, Georgy Shakhnazarov, and Vadim Medvedev, eds., *V Politburo TsK KPSS* (Moskva, 2006) [Hereafter, *Politburo*], p. 147. This is the most important collection of Politburo documents from 1985-1991 published to date. Because Gorbachev and his advisors had control over which documents were included, it cannot be considered a comprehensive record, but it is a wide ranging and immensely helpful collection nonetheless. The copy I used came from Germany, and somehow the page numbers are slightly different in the German version than the American version, so the page numbers I cite are slightly different from Americans who use this source. When I have time, I will go back and change them.

Gorbachev turned to two concepts, *uskorenie* (acceleration) and perestroika, to make economic growth faster and more efficient. To continue to meet its imperial and defense obligations while also delivering a higher domestic standard of living, Soviet officials believed they needed to accelerate the nominal annual growth rate from three to four percent in the 1986-1990 Five Year Plan. This growth target was ambitious and, in retrospect, too optimistic, but Gorbachev felt that the weight of the country's foreign and domestic responsibilities necessitated such ambition. Two months after taking office, he told East German leader Erich Honecker that if the Soviet economy did not achieve a 4-5% growth rate in the late 1980s, "cutbacks in either the social program or national defense would have to be made. But how could you go on if you cut social expenditure or have to tell the people that you can no longer guarantee their security?" This was a "serious conclusion," Gorbachev told Honecker, which now was "the basis of all work in the USSR."[350] As acceleration pushed growth targets higher, perestroika pushed the economic model from extensive to intensive growth. Abel Aganbegyan, Gorbachev's economic advisor, framed the challenge that lay ahead. The "only alternative" to the current system was to move the economy to a model of intensive development that would require "making the rise in efficiency of social production the main source of development." Intensive growth – the production of more outputs with fewer inputs – was now "the key problem of our future development."[351]

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[350] "Vermerk über ein Gespäch des Genossen Erich Honecker, Generalsekretär des ZK der SED und Vorsitzender des Staatsrates der DDR, mit Genossen Michail Gorbachow, Generalsekretär des ZK der KPdSU, am 5.5.1985 in Kreml in Moskau," May 5, 1985, DY 30/2381, SAMPO, p. 63.

[351] A.G. Aganbegyan, "The Economic Strategy of the 27th CPSU Congress: Social Aspects," *Rabochiy Klass i Sovremennyy* Nov-Dec 1986, translated in JPRS-UEA, March 1987, pp. 1-16, quotes at 2-3.

Despite the firmness of his conviction and the ambition of his ultimate goal, the new General Secretary's initial policies fit squarely within the tradition of Soviet economic management. His close aide Anatoly Chernyaev has written that when Gorbachev entered office he "had some ideas about how to 'live better,' but they didn't go beyond the limits of the existing order."[352] He and his aides were wildly optimistic that the Soviet economy would take off after some tinkering to investment allocation, wage policy, and quality control systems. They believed that vast "reserves" of societal potential had gone untapped during the staid and incompetent Brezhnev years, and all they had to do was activate them. "We can really obtain rapid returns," Gorbachev told a Leningrad audience in May 1985, "if we put all organizational, economic and social reserves into operation." Over his first two years, he introduced a series of measures to increase investment at an annual rate of 4.9% rather than the 3.5% annual increase of the 1981-1985 period and focus new investment on "retooling" Soviet factories with modern equipment in order to increase labor productivity. In 1986, the government introduced a decree on the wage system, which aimed to increase the incentive to work by basing wages on performance to a greater degree and to make it slightly easier for managers to fire poor performing employees. To improve the quality of Soviet products, the government created a new agency, *Gospriemka*, to enforce quality control measures that aimed to bring 95% of Soviet products up to "the highest world standards" by 1991-93.[353] By the end of 1986, however, these traditional measures had run aground, as bottlenecks in the machine production industry hampered the planned investment increases, and *Gospriemka* took to its new quality control role

[352] Chernyaev, *My Six Years With Gorbachev*, p. 22.
[353] For a discussion of these traditional measures, see Aslund, *Gorbachev's Struggle for Economic Reform*, chapter 3, and the IMF's *A Study of the Soviet Economy* (February 1991), Chapter II.2.

with vigor and rejected vast amounts of industrial output as inadequate. Although the wage increases put more rubles in Soviet pockets, there remained few consumer goods to buy with their newfound wealth, so workers were forced to save their money and failed to increase their productivity.

These setbacks certainly did not help the Soviet Union's economy, but they were not what brought it into crisis. Rather three developments during Gorbachev's first two years in office dramatically altered the fiscal and financial health of the Soviet Union and forced the leadership to reach for more radical solutions. First, almost immediately after Gorbachev' entered office, the party leadership launched a strict anti-alcohol campaign aimed at increasing labor productivity by decreasing drunkenness. It was, as one author has written, "a full-fledged disciplinary campaign of the old style," and Gorbachev fully supported it.[354] Between 1955 and 1979, alcohol consumption per person doubled in the Soviet Union. By the mid-1980s, people regularly showed up to work drunk or failed to show up at all. 90% of missed workdays were caused by drinking.[355] Gorbachev believed a more productive workforce would only come with a soberer workforce. So, in May 1985, the government dramatically increased alcohol prices and penalties for public drunkenness, cutting back the hours and venues at which alcohol could be sold, and launching a massive propaganda campaign against drinking. The Finance Minister politely advised the new General Secretary that the campaign would cause a drop in state budget revenue of 51.5 billion rubles in over the next five years, and leave Soviet citizens with few things to spend their money on (alcohol, sadly, was one of the few consumer goods that was readily available). Gorbachev was undeterred. "There is nothing new in what you have just

[354] Aslund, *Gorbachev's Struggle*, p. 78.
[355] Miller, *The Struggle to Save the Soviet Economy*, p. 96.

said," he responded. "Each of us knows that there is nothing to be purchased [with] the cash held by the people. But you are not proposing anything other than forcing people to drink."[356] With that, the debate soon ended.

Official sales of alcohol plummeted. By 1988, they were half their 1980 level. But bootlegging quickly filled the gap left by the fall in official sales, and workplace drunkenness failed to decline as workers simply turned to the black market to meet their drinking habits.[357] The social effects of the campaign were modest, but the economic effects were dramatic. With much less alcohol in stores, Soviet workers had even fewer goods to buy with their wages and even less reason to work harder. And with the precipitous decline in official alcohol sales, tax revenue from alcohol sales collapsed as predicted, and a gaping hole opened in the state budget.

World markets compounded Gorbachev's burgeoning budgetary problems. From November 1985 to March 1986, the price of oil on global markets declined by 66%. The leadership grappled with the implications of this decline immediately. On July 11, 1986, Prime Minister Nikolai Ryzhkov informed the Politburo that the decline in the oil price had cut export earnings by 9 billion rubles and added four billion dollars to the country's hard currency debt.[358] In response, the government increased oil exports to the world market and slashed hard currency imports to stabilize the balance of payments, but this left less fuel for domestic production, exacerbated domestic bottlenecks in production, and prohibited the import of Western consumer goods to incentivize Soviet workers to greater productivity.

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[356] "Session of the Politburo of the CC CPSU," 4 April 1985, in "Perestroika in the Soviet Union: 30 Years On," National Security Archive Electronic Briefing Book No. 504, http://nsarchive.gwu.edu/NSAEBB/NSAEBB504/, Accessed December 4, 2016, p. 11-2.
[357] Asland, *Gorbachev's Struggle*, p. 79.
[358] *Politburo*, p. 58.

As the changing winds of the world economy battered the Soviet economy from the outside, disaster struck in the Soviet heartland to cripple it from within. Just after 1 A.M. on April 26, 1986, the No. 4 light water nuclear reactor at the Chernobyl nuclear power plant in Ukraine exploded, sending flames over one kilometer in the air and launching a massive cloud of radioactive dust in the direction of Europe. The Chernobyl accident was a catastrophe of many dimensions – human, ecological, and ideological. Over time the radiation it released would kill 8,000 people and affect the health of 435,000 more. The secretive and disorganized response to the crisis shook Gorbachev's confidence in the soundness of the Soviet system, and the human and ecological toll sharpened his fear of nuclear war.[359] The economic dimensions of the crisis were not the most important, but they were immediate and dramatic nonetheless. A little more than a month after the accident, Gorbachev was already calculating the cost at three billion rubles.[360] Over time, the costs would only escalate.

With the setbacks compounding, Gorbachev and the Politburo sounded like they were overseeing an escalating crisis, not a budding economic revolution, by the fall of 1986. On October 30th, Gorbachev told his colleagues that the country had "lost 13 billion rubles in 1985 from the fall of export prices," which had left an annual deficit of 5 to 6 billion rubles. In the past two years, imports had declined from 24 to 13 billion rubles. "Never before in the history of the country has this happened," he rued. Yegor Ligachev, the man who would soon lead the conservative resistance to Gorbachev, could only agree with the General Secretary at this stage. He pointed out that in 1984, 54 billion rubles of vodka had been sold, but in 1985 that figure had

[359] For statistics and affect on Gorbachev, see Vladislav Zubok, *A Failed Empire* (Chapel Hill, NC, 2007).
[360] "На отдельной встрече, где были только генеральные секретари, и рассказал о Чернобыле. Их ошарашили цифры потерь: 3 млрд уже сейчас." *Politburo*, p. 44.

dropped to 11 billion rubles. "The financial economy of the country is in a very difficult situation, to say the least," he said. Gorbachev concurred that the nation's finances were "in a dire position," and blamed it on "the fact that a gap has emerged between wages and labor productivity." There was "more money than goods in the country," he said. "The situation has us by the throat. People have a weakened interest in work. In fact, if there is nothing to buy with the money, why earn it, why work? This is a very serious matter."

At this moment of crisis, Gorbachev professed convictions to his comrades that would come to define his entire foreign and domestic policy. First, with regard to perestroika, "the main thing [is] do not retreat, do not waver, no matter how difficult, hard, [or] painful" the tasks might be. Where others may have turned back, he committed to press onward. Except in one area, the most difficult of all. "Some demand price increases. We will not go down this road. The people have not received anything from perestroika. It has not been felt financially. And if we raise prices, you can imagine the political consequences – it would discredit perestroika." Instead, the country needed to return to economic health by paring down its international commitments. "We must be extremely careful in matters of assistance to other countries." There should be "no promises to anyone." Military spending was also too high and hurting perestroika. "The peculiarity of this five-year plan is that it is necessary to combine 'both guns and butter.' It is difficult, very difficult."[361] In order to produce more butter, Gorbachev believed, the country would have to produce fewer guns. To this task, the General Secretary devoted the entirety of his foreign policy.

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[361] All preceding quotes from *Politburo*, p 89-90.

Peace Dividends

"Perestroika," Gorbachev writes in his memoirs, "would have been impossible without…the creation of propitious international conditions."[362] From his very first day in office, Gorbachev held to this fundamental view. His foreign policy was meant to serve his domestic plans, and those plans required a de-escalation of the Cold War and a scaling back of the nuclear arms race. Scholars have long recognized this. The debate, instead, has centered on the question of whether new ideas or the material conditions of the Soviet Union pushed Gorbachev to view foreign policy in these terms. So far, the power of ideas has dominated this debate.[363] Evidence clearly suggests, however, that Gorbachev's ideas derived directly from his perception of the Soviet Union's weak and worsening material capabilities relative to the capitalist system.

As the chapter "The Reagan Financial Buildup" detailed, the Reagan administration had launched a massive military build up in the early 1980s in the hope of bankrupting the Soviet Union. The most talked about program in this buildup was the Strategic Defense Initiative (SDI), which planned to use the United States' advantages in science and technology to develop a missile defense system capable of shooting down incoming Soviet nuclear weapons, thereby erasing the threat of mutually assured destruction that had kept the peace in the Cold War since

[362] Gorbachev, *Memoirs*, p. 401.

[363] In his book, *The Enigma of 1989*, which set the standard for histories of the end of the Cold War back in 1997, Jacques Lévesque wrote, "rarely in history" has the foreign policy of a great power been "guided by such an idealistic view of the world, based on universal reconciliation." Vladislav Zubok concluded that Gorbachev "took ideas too seriously." And in one of the most recent retreatment of Gorbachev's foreign policy, James Wilson writes that Gorbachev was "the critical agent of change" in ending the superpower confrontation because "he deferred to ideas over power." Lévesque, *The Enigma of 1989*, p. 2. Zubok, *A Failed Empire,* p. 309. James Graham Wilson, *The Triumph of Improvisation: Gorbachev's Adaptability, Reagan's Engagement, and the End of the Cold War* (Ithaca, NY, 2014), p. 88.

the 1950s. Many doubted that such a system was even scientifically possible, but everyone agreed that it would be economically and technologically difficult for the Soviet Union to develop a similar program. Reagan had funded this buildup by borrowing hundreds of billions of dollars on global capital markets, particularly from investors in West Germany and Japan.

For the Soviet Union, no such recourse existed. If it wanted to match the United States by devoting even more resources to its already massive military-industrial complex, it would have to take resources away from investment in its civilian economy and the standard of living of the Soviet people. Although Reagan had found a way to eliminate the choice between guns and butter for the United States, it remained an all too real consideration for the Soviet leadership. From these structural considerations, Gorbachev formulated the foundational goal of his foreign policy: to prevent a new stage of the nuclear arms race with the United States. "We are at the limits of our capabilities," he told the Politburo in October 1986.[364] Therefore, "the most important task is to disrupt the new phase of the arms race." If a new stage began, it would be "a loss everywhere, especially wearing down of our economy. And this is unacceptable." This led him to a simple, yet vital conclusion, "If we impose a second stage of the [arms] race, we will lose!"[365]

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[364] Quoted in Zubok, p. 307.

[365] "Рейкьявик позволит улучшить облик нашей внешней политики. Подчеркнет ее конструктивизм, наше стремление развязать узлы, выйти из тупика, в который заведена Женева. Что-то ведь надо делать на этом центральном направлении, сдвинуть с места. Соединенные Штаты заинтересованы в том, чтобы машина переговоров крутилась на холостом ходу, а гонка вооружений перегружала нашу экономику. Поэтому нужен прорыв, нужно, чтобы начался процесс….Сверхзадача — сорвать новый этап гонки вооружений. Ибо иначе - модернизация стратегического оружия, «Трайденты», «минитмены», выход с оружием в космос... Тогда - снижение нашей экологической, стратегической и политической безопасности, проигрыш везде, прежде всего изматывание нашей экономики….А это недопустимо.Если нам навяжут второй этап гонки, мы проиграем!" *Politburo*, p. 75-76.

Gorbachev pursued this strategic conviction with tactical brilliance and a great deal of ideological innovation and rhetorical flourish. First, he recognized that his policy would get no where unless it was implemented by people who shared his vision. So, one of his first acts as General Secretary was to replace the long-standing Soviet Foreign Minister Andrei Gromyko with Eduard Shevardnadze, the First Secretary of the Georgian Communist party. Shevardnadze had no foreign policy experience, but Gorbachev had come to know and trust his vision as they rose through the ranks of the Soviet bureaucracy together. The General Secretary also brought on Anatoly Chernyaev and Georgy Shakhnazarov as personal aides for foreign and security affairs. Lastly, he elevated Alexander Yakovlev, a leading voice of reform, to the Politburo and tasked him with leading the party ideology department. From that perch, Yakovlev was to oversee the entire process of *glasnost* to open the Soviet public sphere, but his influence extended far beyond that role to the formulation of foreign policy as well. Together, these four would be Gorbachev's primary support as he pursued his disarmament agenda with vigor.

It began in Geneva, Switzerland. In November 1985, Reagan and Gorbachev converged on an eighteenth-century chateau on the shores of Lake Geneva to respectively size up the opposition and present their first proposals. In what would become a recurring (and increasingly untenable) theme of his public diplomacy, Gorbachev stridently denied to his American counterpart that the Soviet economy was in any serious trouble and rejected the idea that the arms race could bring the Soviet Union to capitulate. Both sides agreed that strategic nuclear weapons should be dramatically reduced, but Gorbachev irritably told the president that he would never countenance reducing the Soviet Union's defenses as long as SDI existed. The next day, Reagan made a formal proposal to reduce each side's offensive nuclear stockpile by 50% and cutback both sides' capabilities in other categories of weapons as well. Gorbachev again assented, but only if Reagan committed to abandon SDI. This Reagan would not do, so the conference ended short on results. Nevertheless, both sides felt it had been a success merely for having established a rapport between the two leaders.[366]

Gorbachev regularly talked about the importance of "the human factor" in his superpower diplomacy with Reagan, and scholars have generally followed his lead to argue that the personal relationship between the two leaders was essential to ending the Cold War.[367] While there is no doubt that the warm working relationship between the two leaders was important, it is difficult to avoid the fact that all the breakthroughs in arms control were based on strategic concessions from the Soviet Union that stemmed from the desire to ease the military burden on the Soviet economy.

The history of the Soviet policy in 1986 makes this clear. Motivated by the knowledge that "industry devoted to the military would have to be cutback to fill shops with goods consumers needed,"[368] Gorbachev announced a plan in January 1986 that called for a three-stage process to eliminate all nuclear weapons by the year 2000. The Americans rejected the proposal because it failed their longstanding litmus tests in any disarmament talks: it said nothing of the massive Soviet advantage of conventional military forces in Europe, it failed to independently address the intermediate-range nuclear missiles that the Soviets had deployed in Europe since the late 1970s, and it continued to insist that the British and French nuclear arsenals be included in the mutual reductions. These had all long been nonstarters for the American side, and they had held up arms negotiations since the early 1980s.

[366] For a summary, see Service, *The End of the Cold War,* chapter 14.
[367] See Matlock, Wilson, Tom Blanton, among many others.
[368] Service, p. 163.

So, Gorbachev gave ground. Over the spring and summer of 1986, as the oil price collapsed, alcohol tax revenues evaporated, and Chernobyl demonstrated the costs and consequences of nuclear fallout, the General Secretary matched the drama of his public call for complete nuclear abolition with a series of specific concessions. The British and the French arsenals would not have to be included, he told the Americans. Conventional forces could be considered as part of a general reduction and balancing of the two blocs' armed forces. Most important of all, laboratory research on SDI could continue, so long as the Americans renounced external testing and deployment.[369] For Gorbachev, the reasoning behind these moves was clear. "If we don't back down on some specific, maybe even important issues, if we won't budge from the positions we've held for a long time, we will lose in the end," he told the Politburo, "We will be drawn into an arms race that we cannot manage. We will lose, because right now we are already at the end of our tether."[370]

The trail of concessions led to Reykjavik, Iceland, where Gorbachev and Reagan held their second summit in October 1986. Before leaving, Gorbachev sketched out his strategy to the Politburo, "The United States is interested in keeping the negotiations machine running idle, while the arms race overloads our economy. Therefore, we need a breakthrough; we need the process to start moving."[371] Boldness would beget breakthroughs, he thought, so he flew to Iceland with a proposal to immediately halve both sides strategic nuclear weapons and to remove all intermediate range missiles from Europe. When Gorbachev presented his proposal to the Americans, they were elated at the extent of the concessions. Over the course of two days of negotiations, the two sides approached the precipice of an agreement to eliminate *all* nuclear

[369] Service, *The End of the Cold War*, chapters 17 and 18.
[370] Quoted in Chernyaev, *My Years with Gorbachev*, p. 84.
[371] *Politburo*, p. 75.

weapons over the next ten years, but it foundered once again on the Strategic Defense Initiative. Reagan could not bring himself to permanently cede the right to deploy the system, and Gorbachev was unwilling to sign away all of the Soviet Union's nuclear weapons without such an assurance.[372] The two sides left Iceland stunned at how close they had come to agreement and acrimonious about the mutually perceived absurdities that had kept them apart.

Three weeks later, the Politburo gathered for their October 30th meeting where all agreed that the economy was "in a dire position" and lamented "the necessity to combine both 'guns and butter.'" Reykjavik had now taught them that if they wanted to escape the burden of guns in order to produce more butter, they would have to make more concessions in the years to come.

Shedding Dead Weight

By the mid-1980s, a tension lay at the heart of the Soviet Union's relations with its socialist allies. As Gorbachev told the Politburo on August 14, 1986, the Soviet Union's imperial role was "to extract raw materials and supply them to other countries." Under the Bucharest formula in effect since 1975, they had supplied these raw materials at highly subsidized prices in exchange for globally uncompetitive finished products – machinery, basic electronics, automobiles – from bloc countries. This system artificially propped up the USSR's allies, but it made the Soviet Union's economy weaker with each passing year. It left the Soviet Union, according to Gorbachev, "harnessed into slave labor."[373] The clearest solution to this problem would have been simple: jettison the system under which intra-bloc trade was determined under the Five Year Plans and settle trade within Comecon in hard currencies at

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[372] See Service, *The End of the Cold War*, chapter 20, among many others.
[373] "Получилось так, что нас фактически запрягли в рабскую работу — добывать сырье и снабжать им другие страны," *Politburo*, p. 68.

world market prices, as was standard practice in the rest of the world. But every Soviet leader since the 1970s had known that doing so was sure to bring about one thing - the collapse of their empire in Eastern Europe. The poor quality of Eastern European finished products would be immediately exposed as soon as Soviet consumers were no longer forced to buy them because of the dictates of the Five Year Plans, and the relative price of Soviet oil would increase dramatically, destroying the extensive economic growth models of all the Soviet Union's satellites. Forcing bloc countries "to pay in [hard] currency," Gorbachev recognized, "would be catastrophic for them."[374]

Alongside the basic structure of economics in the bloc, the Soviet experience in the Polish Crisis and its aftermath had provided the leadership with two other uncomfortable yet unavoidable facts. First, the entire bloc had sovereign debt problems with the West that the Soviet Union was financially powerless to resolve. Second, bloc countries' attempts to solve their debt problems through austerity were likely to lead to social crises. The Polish Crisis had proven that the material burden of supporting allied governments during such crises was expensive, and that military intervention to preserve socialism would only add to the material burden. The Soviets had poured $4 billion into Poland during its time of crisis to no evident effect, and the leadership had ultimately ruled out military intervention because of its prohibitive cost, even if that meant accepting a Solidarity led government.[375]

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[374] "Document No. 9: Notes of CC CPSU Politburo Session, January 29, 1987," in *Masterpieces of History*, pp. 241-243.

[375] The "Polish Crisis" chapter will soon be revised to include the extensive Soviet discussions about how much economic aid to give to Poland during the Solidarity crisis. Andropov and the other members of the leadership ultimately decided a month before martial law was declared that they would rather accept a Solidarity government than accept the costs of invading Poland to restore communist rule.

Thus, even before Gorbachev became General Secretary, these economic structures and historical experiences left few in the Soviet leadership with an appetite to spend further blood and treasure propping up Eastern European governments. Gorbachev's overarching conviction that his foreign policy should serve the domestic goals of perestroika removed this appetite altogether. From this emerged the "new thinking" for Eastern Europe. As with other areas of his policy, Gorbachev's "new thinking" for Eastern Europe partially stemmed from his genuine belief in the primacy of "shared human interests" over "class interests," his respect for human rights, and his general aversion to the old "administrative methods" of Soviet governance. But the cornerstones of the new policy were derived not from the inclinations of idealism, but from the realities of economics: the Soviet Union would gradually campaign to move the bloc toward mutually beneficial trade; it would encourage bloc countries to solve their debt problems, but would provide no further economic aid or preferential treatment to bloc allies under any circumstances. Most of all, it would repeal the Brezhnev Doctrine and respect the sovereignty of bloc countries because it could no longer bear the burden of empire.[376]

At his first meeting of the Political Consultative Committee, the Warsaw Pact's highest governing body, in October 1985, Gorbachev analyzed the bloc in economic terms and pushed for fundamental changes to its economic system. He began by telling his fellow General

[376] This line of argument and the section that follows works against the arguments put for by Mark Kramer in his various articles on the collapse of the Soviet empire in Eastern Europe, which still largely define the scholarly literature. Kramer, "The Collapse of East European Communism and the Repercussions within the Soviet Union, Part 1," *Journal of Cold War Studies*, Vol. 5, No. 4 Fall 2005, pp. 178-256, quote at 180. This article, along with Kramer, "The Demise of the Soviet Bloc," *Journal of Modern History*, Vol. 83, No. 4 (Dec. 2011), pp. 788-854. More recently, Svetlana Savranskaya has begun to publish works on the Soviet role in 1989 that take economics seriously, but she does not actually detail how the Comecon system disadvantaged the Soviet Union and does not use much of the Politburo evidence I present here. See her introductory article, "The Logic of History," in *Masterpieces of History: The Peaceful End of the Cold War in Europe* (New York, 2009)

Secretaries, "The possibilities of the Soviet Union supplying raw materials in exchange for finished products from other countries are exhausted." He reminded his colleagues that "the Soviet Union fulfills a special responsibility for the defense of socialism," and that this "burden inevitably has an effect on the country's economic and social tasks." By many indicators "the Soviet Union lagged behind other socialist countries in standard of living." Going forward, the Soviet leadership would meet its economic "obligations" to its allies, but it would now also aim for "balanced foreign trade" in the bloc. "It would "approach the socialists' countries problems as it did its own" and "expected the same" in return.

That did not yet mean that he had resigned himself to a weakening of the socialist bloc. Far from it. "The West attaches great importance to dividing the socialist countries," he said. Therefore, "a strengthening of nationalism" in the bloc "would be very negative for the Soviet Union and the [socialist] community." Instead, he called on the parties to renew their commitment to the deeper integration of the bloc by establishing direct connections between enterprises in their countries. He was "surprised that in Romania and Hungary there were dozens of joint enterprises with capitalist firms," but few within CMEA. "Apparently," he said, "it is easier to come to terms with capitalist firms than it is with socialist ones." Integration also needed to be promoted through the "price and financial systems" of the bloc. "We are all on a single ship, on the same team" he told them. "The course and the goal are clear. Now it is necessary to consistently work to solve problems."[377] In place of commodity exchange, economic integration was now the only way forward, Gorbachev was telling his allies.

[377] ""Niederschrift über das Treffen der Generalsekretäre und Ersten Sekretäre der Zentralkomitees der Bruderparteien der Teilnehmerstaaten des Warschauer Vertrages am 23. October 1985 in Sofia," DY 30/2352, BArch Berlin, 103-109.

As with every other area of policy, the drop in oil prices in late 1985 and early 1986 did not aid this work. Just as the five year average made the intra-bloc oil price rise more slowly than the world price when oil prices were rising, it now slowed the fall of the intra-bloc price as well. At first glance, this should have increased the value of Eastern Europe to the Soviet Union by making oil exports to the bloc relatively more valuable than exports to the world market. At nominal prices, this is what happened. Bloc countries paid prices above the world market for their oil from the Soviet Union from 1987 onwards. But real prices told a different story. The average selling price of a Soviet barrel of oil within the bloc in 1987 (the first year that the new lower world prices were factored into the price average) was 22 rubles per barrel. At the official dollar/ruble exchange rate, this valued the oil at $32 a barrel, 74% higher than the world market price. But because the world valued a ruble much less than the Soviet Union did, the actual dollar/ruble exchange rate was much lower than the official exchange rate, and thus the price of the oil was much lower as well. At the market ruble/dollar exchange rate of $.60 to a ruble,[378] Soviet oil was only $12 a barrel, quite a bargain compared to the world market price of $17. As prices stayed low in the late 1980s, the Comecon price kept dropping too, reaching roughly $10 a barrel in 1988 at market exchange rates. As the staff of *PlanEcon* wrote in 1988, "It is hardly surprising that no Eastern European country [has] walked away from 'overpriced' Soviet oil – it's not such a bad deal after all."[379] Indeed, it was a great deal for Eastern Europe because on top of the cheap oil at the real exchange rates, the declining price at the official exchange rate meant that the Soviet Union fell into annual trade deficits with its allies in the late 1980s. With

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[378] The market ruble/dollar rate was only available in Hungary because of its limited economic liberalization.
[379] Calculations and quote from "Soviet Energy Trade During 1986-87," *PlanEcon*, Vol 4, No 28, July 15, 1988, p. 5.

Gorbachev's professed desire to have "balanced trade" within the bloc, these deficits, rather absurdly, put pressure on Soviet officials to *increase* their exports to the bloc, even as they (and every Eastern European official) knew that the Soviet Union was already providing more resources to Eastern European countries than they ever would at world market prices. A switch to hard currency trade would have solved this problem, but Soviet officials were all too aware of the consequences that such a move would bring.

Needless to say, the Soviet leadership was not pleased with this development, and in 1986 they began to vent their frustration in the Politburo. In June, Gorbachev lamented that the bloc continued "to be at the commodity exchange stage." It needed to "transition from purely commercial relations to broad cooperation in production," he wrote in a policy paper distributed to the leadership. "A radical *perestroika* of the economic mechanism must be realized, which should result in…the broad development of direct connections among associations, enterprises…and joint firms."[380] By August, he was making his comment about the country being harnessed into slave labor and telling his colleagues that they had "lost their way" in economic relations with the bloc and "needed to clean this mess up."[381]

Hanging like dark clouds over their considerations were the bloc's debt problems with the West. As the Poles worked to join the IMF in the summer of 1986, Gorbachev sensed danger but felt powerless to stop it. "If we don't hold Poland, then we can't keep the GDR," he told the Politburo. "We grumble about the Poles' relationship with the IMF. But what can they do? The

[380] Document No. 6: Memorandum from Mikhail Gorbachev to the CC CPSU Politiburo on Topical Questions regarding Collaboration with Socialist Countries," in *Masterpieces*, pp. 230-233, quote at 232.
[381] *Politburo*, p. 68.

debt is $30 billion."[382] By October, Ryzhkov was worried and resigned. The bloc was "crawling to the West – into a trap." In Poland, "everyone can see what has happened there. Hungary is now on the brink. Bulgaria stopped in front of a precipice. Saved by us." The Soviet Union was offering "a way out – their integration," he said, but "they do not want it." They just wanted "electronics" and "delicacies" from the West, while "we keep supporting them with coal, oil, [and] metal."[383]

All of these economic dynamics led directly to "new thinking" in politics. 1986 was the year that Gorbachev began to advocate letting the bloc countries deal with their problems themselves, no matter the political consequences. In February, he told the Politburo that in the Soviet Union's relations with its allies "instructions, guidelines, teaching - all of this has to go into the past."[384] He told a large gather of Foreign Ministry officials, "the time when we helped [the socialist countries] to form their economy, their parties, and their political institutions is past…. we cannot lead them by the hand to kindergarten as we would little children." There were "objective interests," he continued, "which require the socialist countries to be united." But these interests were "not fulfilled on their own automatically. More and more, their fulfillment comes by means of economic interests." Therefore, "mutual economic gain" needed to be the basis of socialist "cooperation, consolidation, and unity" going forward.[385] In July, he told the Politburo, "What went on before could not continue. The methods that were used in Czechoslovakia [in 1968] and Hungary [in 1956] now are no good; they will not work!" The

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[382] " ...Если Польшу не удержим, тогда и ГДР не сможем удержать. У нас ворчат по поводу связей поляков с МВФ. А что им делать? Долг 30 млрд долл," in *Politburo*, p. 61.
[383] *Politburo*, p. 81.
[384] *Politburo*, p. 27.
[385] "Document No. 4: Speech by Mikhail Gorbachev to Ministry of Foreign Affairs," May 28, 1986, in *Masterpieces*, p. 224.

economy was now “the most important” factor. “Here there is a major lag in coordination and integration. And this hinders, and will continue to hinder, all other aspects of relations.” The CPSU’s influence could “only be ideological, only through example! Everything else is an illusion.” They could no longer use “‘administrative methods of leadership’ with our friends” because “this kind of ‘leadership’…would mean carrying them on our back.”[386]

Lightening the imperial load became the main theme of a meeting of the heads of state of the Comecon countries in Moscow on November 10-11, 1986. After beginning the meeting by laying out the achievements of socialism in a pro forma fashion, Gorbachev quickly added, “but we wouldn’t be true communists if we didn’t also recognize the problems facing our countries and candidly analyze them.” He proceeded to do just that. In the second half of the 1970s and early 1980s the development of the socialist system slowed, Gorbachev said. “The scientific-technological revolution opened new horizons” in economic production, but the bloc had not yet combined these new possibilities “with the advantages of the socialist planned economy.” Bloc countries had “delayed” structural changes in their economies that would lead to intensive economic growth. Most had tried to import technology from the West on credit. But, Gorbachev said, “today one can say that it was false to think that our countries’ problems could be solved through the widespread use of loans and technology from the West.”[387]

“We lived on credit,” he told the assembled leaders. “In the last ten to fifteen years, consumption has grown faster than labor productivity in many countries, which means that [national] income has simply been ‘eaten up.’” He recognized the importance of “the social

[386] “Document No. 7: Notes of CC CPSU Politburo Session,” July 3, 1986, in *Masterpieces*, pp. 234-235. Also, *Politburo*, p. 53-54

[387] “Niederschrift über das Treffen der führenden Repräsentanten der Bruderparteien sozialistischer Länder des RGW am 10. Und 11. November 1986 in Moskau,” November 10-11, 1986, DY 30/2358, BArch Berlin, pp. 5-6.

sphere" in communist societies that had, after all, been "created in the interests of the workers." But socialism could not continue to promise more than it could actually deliver. The problem with living on credit, he told his colleagues, was that "sooner or later one must pay for it."[388]

Whenever the debt bill came, the Soviet Union would not be covering it. Beginning with Andropov's decision not to intervene in Poland in 1981 or provide further economic support to Hungary in 1982, the Soviet leadership had rejected all policies that would add to its Eastern European burden. Gorbachev's speech was the culmination of these efforts. He discussed the Soviet burden in detail. The expenditure required "to maintain the military-strategic balance with imperialism" was "not small," and "nine tenths of it was covered by the Soviet Union." In the area of energy and raw materials, "Soviet deliveries…almost entirely fulfill the needs of the brother countries." But "just maintaining the current level [of deliveries], would require the investment of enormous and growing sums in extraction." The Soviet Union "will do everything possible to maintain the current level of deliveries," Gorbachev said, but it expected "the participation of the brother countries" in the investment in new energy extraction projects. On top of defense and energy, the Soviet Union had also provided the socialist bloc with levels of economic aid that it could not sustain – 47 billion rubles in the last Five Year Plan, including 35 billion rubles alone for the poorest members of Comecon, Cuba, Vietnam, and Mongolia. All of this limited "the possibilities for solving social problems and raising the standard of living" within the Soviet Union. In what was now a familiar reminder, Gorbachev said, "over the last two decades the Soviet Union had lagged behind other Comecon countries in per-capita income

[388] "Rede des Genossen Mikhail Gorbatschow," 10. November 1986, DY 30/2359, BArch/Berlin, pp. 8 - 46, at 14.

and this gap continues to grow."[389] Andropov had concluded in 1981 that Soviet leaders needed to "be concerned above all with [their] own country and about strengthening the Soviet Union." Now Gorbachev was putting his mentor's principle into practice.

The Soviet Politburo had aired "a wide-ranging exchange of opinions," Gorbachev said, and had decided "to transform relations in the socialist community…to coincide with the spirit of the times." This meant putting "the entire system of political relations between the socialist countries on the foundation of equality and mutual benefit." From now on, the "indispensable principles" of relations among socialist countries would be "the independence of each party, their right to sovereign decision-making about problems of development in their own country, and their responsibility to their own people." Most importantly, no county would now "claim a special role in the socialist community."[390]

The Brezhnev Doctrine was dead. Describing the meeting to the Politburo in the days that followed, Gorbachev told the group, "we opened the way for the radical reconstruction of collaboration within the community. Everything will be based on self-reliance."[391] The days of intervening to 'protect' socialism, as the Brezhnev Doctrine mandated, were over. The Soviet

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[389] "Niederschrift über das Treffen der führenden Repräsentanten der Bruderparteien sozialistischer Länder des RGW am 10. Und 11. November 1986 in Moskau," November 10-11, 1986, DY 30/2358, BArch Berlin, pp. 18-20.
[390] "Niederschrift über das Treffen der führenden Repräsentanten der Bruderparteien sozialistischer Länder des RGW am 10. Und 11. November 1986 in Moskau," November 10-11, 1986, DY 30/2358, BArch Berlin, p. 11. As far as I am aware, no scholar has yet used these documents from the East German archives to definitively prove that the Brezhnev Doctrine was renounced at this meeting in November 1986. Kramer, for instance, argues that real change did not come to Soviet policy until 1988 and stemmed from the launch of democratization within the Soviet Union. Service in *The End of the Cold War* does place the repeal at this meeting, but only uses Gorbachev's summary of the meeting to the Politburo as evidence. It is also important in Grachev, *Gorbachev's Gamble,* but the author only uses retrospective interviews to demonstrate the content of the meeting.
[391] "Document 8: Transcript of CC CPSU Politburo Session, November 13, 1986," in *Masterpieces of History*, pp. 236-240.

Union "should hold more firmly to the principle of each communist state being responsible for what happens in its country," he said to the Soviet leadership two months later. "We need this. It is in our interest not to be loaded down with responsibility for what is happening, or could happen, there."[392]

This history of when and why the Brezhnev Doctrine was repealed has important implications. Contrary to those who argue that its repeal stemmed from Gorbachev's unique commitment to self-determination, democracy, non-violence, and human rights, it is clear that the decision was the culmination of a long-running campaign by the collective Soviet leadership to shed the material burden of empire. A policy of non-intervention in the Eastern Bloc conformed to Gorbachev's idealistic plans for *glasnost* and *perestroika* within the Soviet Union, but it also aligned with the economically driven understanding of Soviet national interests that had been coalescing within the Soviet leadership since the Polish Crisis. In fact, combined with Andropov's decision to foreclose the possibility of any military intervention in Poland in 1981,[393] it is possible to conclude that for economic reasons most Soviet leaders in Gorbachev's position would have withdrawn the Soviet Union from its responsibility to "protect" socialism by the mid-1980s. Scholars have long assumed that without Gorbachev's "exceptional" view of the world, the revolutions of 1989 would not have been possible because the Soviet Union would have intervened to stop them. This has it backwards. By the mid-1980s, it was the policy of intervention in Eastern Europe, rather than non-intervention, that was difficult for Soviet leaders to justify. Completing the work that his predecessors started in 1981, Gorbachev withdrew the

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[392] "Document No. 9: Notes of CC CPSU Politburo Session, January 29, 1987," in *Masterpieces of History*, pp. 241-243.

[393] I briefly mention the Andropov decision at the start of this chapter, but I will discuss Soviet deliberations in the early 1980s at greater length in the "The Polish Crisis" chapter.

Soviet Union from its leading role within the socialist bloc to focus on improving the material prosperity of Soviet citizens at home.

The same held true for the war in Afghanistan. Since his days on the Afghan Commission within the Politburo before he was General Secretary, Gorbachev had spoken out in favor of finding a political solution to end the conflict and withdraw Soviet forces. He had received the support of many within the Soviet armed forces for doing so. After becoming General Secretary, he made ending the war an early priority and told the Afghan communist leadership that it would have to begin to rely on its own forces in the summer of 1986. In the fall of 1985, he called for a speedy withdrawal of Soviet forces within the Politburo, and heard no objection from the conservative Defense Minister Sergei Sokolov or Andrei Gromyko, one of the original advocates of the invasion in 1979. By 1986, withdrawal was a consensus issue within the leadership. In June, when the Politburo agreed to withdraw 8,000 troops from the conflict, it was Gromyko declaring "This is not our war," and Gorbachev maintaining that "the result must not look like a shameful defeat." By November, the entire leadership agreed with Chief of the General Staff Sergei Akhromeev, who concluded, "We have lost the struggle." They discussed plans to pull all Soviet troops out of Afghanistan over the next two years. In assenting to withdrawal, Gromyko admitted that the initial invasion had been a mistake. Shevardnadze gave the Foreign Ministry's approval, and Viktor Chebrikov provided the KGB's. Gorbachev said he hoped to turn Afghanistan into a "friendly, neutral country," but was concerned that the United States might "creep into Afghanistan." Akhromeev convinced him that this was highly unlikely.

The war had become an unwinnable drain on Soviet resources, the entire leadership now agreed, and the armed forces needed to come home.[394]

Bankruptcy and Democracy

They would come home to a financial crisis that was accelerating without relent. The budget deficit reached 6.2% of GDP in 1986, and it was funded entirely by "borrowing" from Soviet citizens' savings held at Gosbank, the Soviet state bank.[395] In reality, this meant printing rubles and monetizing the deficit – a surefire recipe for inflation and, in the Soviet system of fixed prices, widespread shortages of basic goods. As he looked to 1987, Gorbachev professed himself "very worried" about the year ahead.[396] And indeed, by springtime, the Finance Minister was informing the Politburo, "The financial situation has reached the point of crisis. Inflationary processes have begun." State budget losses from the decline in alcohol sales and the oil price now totaled 30 billion rubles, he told them.[397] Moreover, government subsidies to consumer retail prices had set the country on a path to bankruptcy. The government paid nearly one-third of the cost of every loaf of bread, over half the cost of every gallon of milk, forty percent of the cost of butter, and seventy percent of the cost of every kilogram of beef.[398] "If nothing changes," he said, "the amount of subsidies for food alone will rise to 100 billion rubles by 1990."[399]

The state's promises to consumers were only one side of the coin. Its promises to producers – the vast network of state enterprises, collective farms, and the military-industrial

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[394] Quotes in this paragraph from *Politburo*, p. 94-95. Also relies on Service, *The End of the Cold War*, pp. 105, 150, and 330-331.
[395] *IMF Study of the Soviet Economy*, p. 22.
[396] *Politburo*, p. 101.
[397] *Politburo*, p. 147.
[398] Chernyaev, *My Years with Gorbachev*, p. 108-109. *Study of the Soviet Economy*, vol. 2, p. 14.
[399] *Politburo*, p. 146-147.

complex - were the other. Gorbachev drew the Politburo's attention here. "For the last fifteen years, 25-30% of enterprises have not been meeting their income targets. And yet they continue to 'work' at the expense of the state."[400] This was the so-called 'soft budget constraint' that the Hungarian economist Janos Kornai had famously argued was the source of all the ills in centrally planned economies. A more pervasive version of the capitalist concept of "too big to fail," soft budget constraints in state socialist economies meant that enterprises did not fear failure; they always knew that the state would save them from bankruptcy.[401] What Kornai had demonstrated in theory, Gorbachev now observed in practice.

Inefficiencies permeated the economy. In the wage system, the process of "levelling" – whereby an enterprise's best employees earned little or nothing more than its worst – "was a terrible scourge," Gorbachev said, that killed initiative and allowed free riders to survive on the work of high achievers.[402] Additionally, the low price of fuel and raw materials gave enterprises no reason to use their resources more efficiently. The Soviet state's guarantee of the right to work and its unwillingness to push underperforming enterprises into bankruptcy meant that few workers were ever fired. Enterprises "are going bankrupt," Politburo member Vitaly Vorotnikov reiterated, "and the state is taking them on its back and keeping them afloat."[403]

This predicament was not new. Indeed, as Kornai's work had argued, it was the essence of the command economy. What made this moment different was the fiscal crisis of the state. Socialism's promises to consumers and producers were no longer just hampering productivity; they were now also an unsustainable burden on the state budget. Because the Soviet Union

[400] Chernyaev, *My Years with Gorbachev*, p. 109.
[401] Janos Kornai, *Economics of Shortage* (Amsterdam, 1980).
[402] Chernyaev, *My Years with Gorbachev*, p. 109.
[403] *Politburo*, p. 147.

published notoriously poor and misleading statistics, this fact was not widely known, even within the Politburo. Gorbachev changed this, and the Finance Minister informed the Politburo that the budget deficit was 80 billion rubles. 21 billion rubles had been printed by Gosbank to help balance the budget, but it was not clear where the other 60 billion rubles would come from. Members were stunned, and their shock aided Gorbachev's push for reform. The numbers "were tantamount to a revelation," Gorbachev later wrote, "because nobody knew about the use of credit as an item of income in the budget."[404] Fiscal crisis was, in a Marxist-Leninist sense, now an objective reality that both conservatives and reformers could agree was a significant problem. Like its Eastern European allies, the Soviet Union was now living on credit, albeit the credit of its own printing presses rather than Western banks. The Leninist question on the minds of Soviet leaders was "What is to be done?"

Gorbachev sought refuge in radicalism. In the first half of 1987, he explicitly transformed *perestroika* into a campaign of "radical reform" to the economy. The reform rested on a cornerstone that was only vaguely hinted at because of its social, political, and ideological implications: incorporating the pursuit of self-interest into socialism. "The chief question in the theory and practice of socialism," Gorbachev told the country's top leadership at the June 1987 Central Committee Plenum, "is how, on a socialist basis, to create more powerful stimuli for economic, scientific, technical, and social progress than under capitalism."[405] Capitalism had four extremely powerful stimuli that produced such progress. For corporations, there was the prospect of profit and the threat of bankruptcy; for individuals, there was the prospect of higher wages for increased productivity and the threat of unemployment for poor performance. On

[404] Gorbachev, *Memoirs*, p. 229.
[405] I have changed the syntax of this sentence to make it less cumbersome than the original translation. "Gorbachev Speech to June Central Committee Plenum, FBIS-SOV- , R28.

ideological and moral grounds, state socialism had labeled all four tools of capitalist exploitation and had used the state to protect enterprises and individuals from their exploitative power. Now Gorbachev sought to redefine them as "powerful stimuli" and reincorporate them into the Soviet economy.

To do so, he would have to get the Communist Party and the state bureaucracy out of the economy. So, severely curtailing the state's role in the economy became the second, and much more explicit, goal of the radicalized reform. Under the command economic system, the state planning commission, Gosplan, set ten to fifteen thousand indicators of production each year to guide every aspect of the economy, and then "line ministries" that dealt with specific sectors of the economy would determine production targets for each enterprise in the economy. Enterprises received their allocation of investment and production inputs from the ministries, and the ministries were their main customers. Over time, this system had hardened into a series of power bases and patronage networks within the ministries, with each becoming its own fiefdom within the Soviet economy. Rather than operating on any principles of economic utility, the economy ran on social and political connections – what Russians called *blat*.[406] "Whoever determined targets and allotted resources was seen as tsar and god, potentate and benefactor," Gorbachev later wrote.[407] If he wanted to activate the "powerful stimuli," Gorbachev knew he would first have to slay the gods and tsars of the command economy.

His weapons of choice were *glasnost* and democracy. At every step of the way, Gorbachev paired his economic reform proposals with increasingly bold moves to democratize Soviet society. At first, this fell within the realm of increasing socialist democracy – expanding

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[406] Miller, *Struggle to Save the Soviet Economy*, chapter 4, particularly p. 124.
[407] Gorbachev, *Memoirs*, p. 230.

worker control over enterprises and holding competitive elections between CPSU candidates at the local level – and allowing great freedom of the press. But by 1988, with the economic crisis deepening and reform still not taking hold, Gorbachev jettisoned the confines of socialist democracy and embraced Western-style competitive elections at a national level. As with so many other areas of his policy, Gorbachev truly believed in the righteousness of *glasnost* and democracy, but that was not why he implemented them. As he said during one of the many Politburo discussions about reform in the spring of 1987, "This is not Bulgaria and this is not an academic debate, it is life itself on the scale of the vast country."[408] In the life of the General Secretary of Communist Party of the Soviet Union, ideas were only applied if they aided the acquisition and maintenance of political power. Gorbachev implemented *glasnost* and democracy because he believed he could attain more political power through democracy than authoritarianism.

Indeed, the first reason democracy and the freedom of expression emerged in the Soviet Union was because of their potential *to coerce*. Alexander Yakovlev, the driving force in the Politburo behind democratization, wrote to his colleagues, "There is sometimes a misunderstanding: when people talk about democracy, they presuppose some amorphous notion, like liberalization, the weakening of certain norms, and so on. However, in reality, democracy is discipline, the strengthening of the rule of law, and the development of self-discipline."[409] Gorbachev echoed his chief of ideology. "We have embarked on the path of democracy,"

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[408] *Politburo*, p. 163

[409] Yakovlev, "Text of Presentation at the CC CPSU Politburo Session," September 28, 1987, in "Perestroika in the Soviet Union 30 Years On," National Security Archive Electronic Briefing Book No. 504, http://nsarchive.gwu.edu/NSAEBB/NSAEBB504/, Accessed December 4, 2016, p. 1.

Gorbachev told the Politburo in June 1987, because “it provides the strongest grip on power.”[410] At that point, he was only talking about democratization in enterprises and within the CPSU. But in his memoirs, Gorbachev writes that he applied much the same thinking to the decision to move to full electoral democracy. He recalls an article published in the Soviet press in 1989, which argued that radical economic reform could only be implemented under “the reliable shield of strong authoritarian power.” He writes, “For me and my circle this argument was no revelation. We were not so simple as not to recognize” that “significant transformations could be carried out” only with “a firm grip on the reins of power.” He knew that he would need political power “to overcome the inevitable opposition to proposed reforms,” and the most power was to be found in *glasnost* and democratic politics.[411]

This was the reasoning that underlay his groundbreaking speech at the January 1987 Central Committee Plenum. There he announced a radical expansion of *glasnost* to include the freedom of expression as well as elections within enterprises and between CPSU candidates at the local level. “We think that electiveness, far from undermining, on the contrary, enhances the authority of the leader,” he told the party leadership. The Soviet system had always been built on “control ‘from above,’” he said, but now it was “of fundamental importance” to increase “control ‘from below.’” This way enterprise and local party officials would “constantly feel their responsibility to and dependence on the electorate.” The activities of trade unions, the supreme and local soviets, and other public organizations needed to be expanded because they had “immense resources for control.” *Glasnost* needed to be expanded, he said, because it was “a powerful lever” for improving performance at all levels of society and “an effective form of

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[410] *Politburo*, p. 171.
[411] Gorbachev, *Memoirs*, p. 315.

control by the whole population."[412] If democracy made enterprise managers, local party bosses, and eventually the entire government and Party leadership accountable to the population, public scrutiny would coerce these authorities into implementing economic reform.

The centerpiece of this reform arrived in the summer of 1987 with the Law on State Enterprises. The law mandated that beginning in 1988, all Soviet enterprises would become independent from the state and operate on what was variously called self-financing or full-cost accounting. Enterprise independence transferred control over enterprises from the state to the enterprises' workers, who were now empowered to elect their management. It also attempted to activate the four "powerful stimuli" of market economies – corporate profit, wage differentiation, bankruptcy, and unemployment – to produce economic and social progress. The "central idea" of the law, Prime Minster Ryzhkov told the Supreme Soviet, was "to comprehensively satisfy the demands of the national economy…at the lowest possible cost." Because the enterprise would retain its profits, he said, it would now have "an economic interest" in ensuring the "highest returns" and "maximum yield" on its capital.[413] Gorbachev addressed the issue of wages. "Each worker's actual wages should be made closely dependent" on productivity and "should not be restricted by any limit." Those were the carrots, but there were also hints of sticks. If an enterprise consistently failed to maintain solvency "it would be possible to raise the question of reorganization or terminating the enterprise's activity." And as enterprises became more efficient, "the scale at which workers are being released will grow considerably."[414]

[412] FBIS-SOV-87-018. *Daily Report*. January 28, 1987, R20.
[413] Ryzhkov speech to the Supreme Soviet, "On the Restructuring of the Manaagement of the National Economy at the Present Stage of the Country's Economic Development," *Pravda*, 30 June, 1987, translated in FBIS-SOV-87-126, p. R6 and R10.
[414] Gorbachev speech, June Plenum, FBIS-SOV.

The echoes of capitalism were easy to hear, and the parallels were not lost on the General Secretary. On May 7, 1987, he recounted for the Politburo his discussions with Western European leaders, most prominently Margaret Thatcher, about economic reform in their countries. "They too are carrying out a *perestroika*," he said. They "act harshly, rudely, the capitalist way, regardless of how it affects the workers. They move ahead because they see that there is nowhere else to go." The Soviet perestroika was different, he said, because it was based on "other ideas." Nevertheless, he told the Politburo that, like Thatcher and the others, "we also cannot waver...we need to ensure the mobility of labor."[415]

But Gorbachev was not the Iron Lady, and perestroika was not Thatcherism. Despite the tough talk, the social impact of perestroika rightly made its advocates both ideologically and politically queasy. Two issues in particular – price adjustments and unemployment – were both economically necessary and politically impossible in equal measure. Because the new system would rely on markets rather than bureaucracies to allocate resources and capital, prices needed to be adjustable to reflect market value. If they were not, the reformers knew, the enterprise reform would fail. "The question of prices is principle, fundamental," Gorbachev told the Politburo in May 1987 as they prepared the Law on State Enterprises. "If it's not solved, there won't be cost accounting for enterprises, nor self-financing, and perestroika will not work."[416] If prices did not "correspond with reality," then they would not "have any mechanism of economic governance," he said.[417] But he could barely finish recognizing their economic necessity before

[415] "Правильно. Я разговаривал со многими деятелями Запада: с Карлссоном*, с Тэтчер, с Гонсалесом**. Они тоже «перестраиваются» и действуют жестко, бесцеремонно, по-капиталистически, не считаясь с тем, как это отражается на трудящихся. Идут напролом, потому что видят, что деваться некуда. У нас другая ситуация и другие идеи. Но нам тоже нельзя дрогнуть." *Politburo*, p. 155-56.
[416] *Politburo*, p. 159.
[417] *Politburo*, p. 161.

lamenting their political consequences. "How hard it is to start a new policy with price increases!" If the leadership announced a price reform, "commotion would erupt. And people will ask, 'Why do we need all this?"[418]

The same held true for unemployment. In April, conservative Politburo member Vitaly Vorotnikov had complained to his colleagues, "surplus labor everywhere is beyond all measure, including the defense industry." Gorbachev concurred. "Foreigners…are very interested in how we will solve the problem of unemployment," he told the Politburo. "We know how they have solved that problem; how will we? This is the crucial question." The scale of the potential problem daunted him. "In some republics millions of 'superfluous' people do not work in production. And if new cuts add to these millions, then will we feed them all for free?"[419] He deferred the question until the 1990s, saying the "question of what to do with those who are released as a result of enterprises working in new ways" would have to be dealt with under the 13th Five Year Plan.[420]

As a result, perestroika's advocates both privately and publicly maintained the illusion that perestroika could be socially painless. Gorbachev told in the Politburo that "the most important thing" about a potential price reform was that it "should not undermine the standard of living."[421] And the documents announcing the Law on State Enterprises to the country contradictorily declared that "prices should be given a cost restricting character" but "the change of retail prices should not lead to a decline in the living standard of the working people."[422] This

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418 *Politburo*, pp. 159.
419 *Politburo*, p. 162.
420 *Politburo*, p. 155.
421 *Politburo*, p. 161.
422 "Basic Provisions for Radical Restructuring of Economic Management," *Pravda*, 27 June 1987, translated in FBIS-SOV-87-125, p. R11-12.

was theoretically possible (the government proposed to compensate low-income people for price increases through subsidies), but ultimately the scale of the subsidies had to be reduced, and this implied a decline in living standards for some segment of the Soviet population. Similarly, the party announcement said that the law would "induce the enterprises…to trim their excessive workforce," but would "not bring about unemployment." The "specter" of unemployment, the document claimed, was only something with which "both our own opponents of perestroika and Western 'Sovietologists' are trying to scare us."[423]

These denials of the social effects of perestroika did not arise out of an ignorance of economics, as many scholars have claimed,[424] but rather the pressures of politics. They were intimately linked to the first purpose of glasnost and democracy: to coerce the state bureaucracy. So long as Gorbachev needed the Soviet masses to exert "control from below," he could not afford to lose their approbation. But as Gorbachev only slowly realized in 1987 and 1988, democracy would have to also serve a second purpose: to legitimize price reform. He came to the conclusion in the spring of 1987, "In general, we should make it a rule now: this kind of questions will no longer ever be resolved without careful discussion with the people, without consulting the people."[425] And so it was. The announcement of the Law on State Enterprises proclaimed, "The reform of price formation should become the subject of the broadest possible

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[423] "Plenum Theses,"

[424] The notion that Gorbachev and the rest of the Soviet leadership were ignorant of market economics pervades the historiography. Zubok characteristically writes, "It is obvious that [Gorbachev] and the rest of the Politburo lacked even basic knowledge of macroeconomics." *A Failed Empire*, p. 299. Miller critiques this trend in the historiography, and writes, "many Soviet officials' understanding of inflation was as monetarist as Milton Friedman's." *Struggle to Save the Soviet Economy*, p. 100.

[425] *Politburo*, p. 159.

discussion in the country."[426] The problem with this purpose was that its politics directly contracted those of using democracy to coerce the bureaucracy. Using democracy to legitimize price reform would have evaporated perestroika's support among the masses and robbed Gorbachev of their use for "control from below."

This was control that he could not afford to lose, because for all the fanfare attached to enterprise independence in the 1987 reforms, the real political battle at its core was between Gorbachev and the government ministries who controlled the economy. Instead of setting firm five-year production targets as they had under the command system, ministries would only issue "control figures" and the new system at the start of the five-year plan to "orient" enterprise business planning. And rather than issuing binding annual production targets, the ministries would now only issue "state orders" for items deemed essential to the state. The rest of the economy would operate under a system of wholesale trade, where production inputs would be bought and sold without state ministries serving as intermediaries. "Budgetary financing" of enterprise operations would be "as a rule, excluded."[427] Instead, enterprises would have to turn to a new system of five state commercial banks, one for each broad sector of the economy (agriculture, industry, construction, social development, and foreign trade). These banks would, according to the new law, only grant credit based on the creditworthiness of the borrower and the proposed investment. The reform aimed, in short, to remove the gods and czars from their perches atop the mountains of the command economy. It was a monumental task, and Gorbachev needed all the public support he could muster to take on the entrenched interests.

[426] "Basic Provisions for Radical Restructuring of Economic Management," *Pravda*, 27 June 1987, translated in FBIS-SOV-87-125, p. R12.
[427] Ibid, p. R5.

Even with public support, the 1987 reforms proved to be a disastrous failure. They did so not because of noisy battles in the public sphere, but because of quiet workings in the state financial system. The reform measures produced two devastating financial problems. First, allowing Soviet enterprises to keep more of their profits also meant significantly lowering their taxes to the Soviet state. The reform dropped the effective tax rate on enterprise profits, and left the government with less money to fund its activities. Enterprises paid on average 63% of their profits to the state in 1986, but that number dropped to 56% in 1987, 46% in 1988, and 40% in 1989.[428] The 1987 reforms were, in essence, a massive tax cut. Like the oil prices decline, the anti-alcohol campaign, and Chernobyl before it, the Law on State Enterprises ripped another hole in state budget revenue. Most observers at the time and historians in retrospect have focused on the Soviet government's proclivity to spend money during perestroika.[429] This was a problem, albeit a relatively small one. The state's increasing inability to collect money, on the other hand, was a huge one. As a percentage of GDP, state budget expenditures crept up from 50% in 1985 to 52% in 1987 before falling back to 50% in 1989. But state budget revenues collapsed during the same period, falling from 47% in 1985 to 41% in 1989. This was in turn reflected in the budget deficit, which jumped from 6.2% of GDP in 1986 to 8.8% in 1987 and 11% in 1988.[430] In exploding the state budget deficit through a massive supply side tax cut, Gorbachev's reforms ironically mirrored those of his rival, Ronald Reagan. But whereas Reagan could use the Federal Reserve's high interest rates and global capital markets to deliver the United States from

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[428] My own calculations done from Table D.6, *IMF Study of the Soviet Economy*, p. 99.
[429] *PlanEcon Report*, August 19, 1988 takes this approach. Miller, *The Struggle to Save the Soviet Economy*, focuses on increased expenditure, particularly on state-controlled investment, as the source of Soviet problems under perestroika.
[430] The 1989 numbers are estimates collected by the IMF from Soviet officials in 1991. Table II.2.3, *IMF Study of the Soviet Economy*, p. 55.

economic ruin, Gorbachev could only turn to his comrades who ran the Gosbank printing presses. Dutifully, they kept printing rubles to fund the General Secretary's vision of a better Soviet future.[431]

For the enterprises on the receiving end of a massive profit windfall, the question became how to spend it. This was the second financial problem that emerged from the radical economic reforms. Enterprise financial assets grew an astounding 32.6% in 1987 and another 22.5% in 1988.[432] As one Gosbank official told the IMF, "because money was only a unit of accounting" enterprise bank deposits "did not have an economic value," were not fully fungible, and "did not even yield interest."[433] This left enterprises with no incentive to hold onto the rubles that were now easily flowing into their coffers. So, they went on a spending spree, and started stockpiling production inputs, giving their employees (who now elected them) wage increases, and approving new investment projects, even without a guarantee that they would ever be completed. Enterprise managers thought it was better to turn their newfound financial wealth into increasingly scarce real assets or boost their popularity with their employees rather than to hold on to rubles that were easily attainable and earned no interest. Income growth skyrocketed, jumping from 4% in 1987 to 9% in 1988 and 13% in 1989.[434] Total enterprise spending ballooned from 243 billion rubles in 1987 to 354 billion rubles in 1988 and 462 billion rubles in 1989.[435]

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[431] Bank credit given to the government grew 19.2% in 1986, 42.7% in 1987, 48.5% in 1988, and 30.9% in 1989. Table K.2, *IMF Study of the Soviet Economy*, p. 127.
[432] Table K.7. "USSR: Financial Assets of Enterprises, 1980-1990," *IMF Study of the Soviet Economy*, p. 131.
[433] "Minutes of Monetary Policy Meeting M-1," Aug. 13, 1990, File 1, Box 3, Alan Whittome Papers, IMF Archives.
[434] Table D3, Ibid., p. 96.
[435] Table D5, Ibid., p. 98.

Far from forcing failing enterprises to become profitable or face bankruptcy, the 1987 reforms gave them a blank check. Gorbachev would eventually conclude that the Law on State Enterprises was, in essence, a massive inflation generator. "When we allowed enterprises to become economically self-sufficient, we didn't think about the mechanisms necessary to keep this process under control," he said at the end of 1988. "Incomes are growing but commodity supply hasn't increased…. There's too much 'funny money.'"[436] Indeed there was. The soft budget constraints of the old command system had given way to no budget constraints at all.

How Do We Keep What We've Won?

Gorbachev "always considered every significant action or initiative from two perspectives – domestic and foreign," his aide Anatoly Chernyaev wrote in his memoirs. Therefore, as he radicalized his domestic reform, "he simultaneously addressed the problem of restraining the arms race and the place of the military-industrial complex in [the] system – above all, its role in the country's entire economy."[437] Cuts to the military could only be made in an increasingly benign international environment, so Gorbachev went abroad in 1987 to foster the conditions that would make this possible. He attempted to use the tools of idealistic and personal diplomacy to keep the international position that the Soviet Union had formerly secured with military power through other means.

It began with an internal campaign to reform Soviet defense doctrine. Reducing the size of the military-industrial complex could not be justified so long as the Soviet Union held to the principle that had grounded the country's defense policy since the 1950s – maintaining strategic

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[436] Quoted in Chernayev, *My Six Years*, p. 231.
[437] Chernyaev, *My Six Years*, p. 192.

parity in armed forces with the United States. “If we start counting – they have a rifle, we have a rifle – then we can forget about building socialism,” he told the Politburo in May 1987 as they worked to craft the Law on State Enterprises. “I ask the question: will we keep turning the country into a military camp in the future as well?” The Americans, Gorbachev said, “clearly want to pull us into another round of the arms race. They are counting on our military exhaustion…. They are pulling us into SDI…. Therefore, the approach of one soldier there, one soldier here, they have a bullet we have a bullet, is not our approach.”[438] Two weeks later, Shevardnadze echoed Gorbachev’s link between the economy and national security in a memorandum to the Foreign Ministry. “Our power lies not in our number of rockets but in a stable and strong economy. It’s not the missile launchers that guarantee the country’s security so much as high labor productivity.”[439] In place of strategic parity, Gorbachev now pushed the leadership to accept a doctrine of strategic sufficiency – the idea that the country did not need to match the United States in armaments, it merely needed to maintain armed forces sufficient to ensure that the Americans would be deterred from launching an attack.

Many in the Soviet armed forces were uncomfortable with such an approach, but a bizarre incident abetted Gorbachev’s initiative on May 27, 1987. West German teenager Mathias Rust flew a small airplane from Helsinki, Finland and landed it on Red Square in Moscow without being turned back by the Soviet military. For Gorbachev and the leadership, it was a humiliating, if harmless, development that reinforced the public’s perception of the government’s overall incompetence. It was also an opportunity for the General Secretary to clean house within the national defense hierarchy. He was sure not to waste it. On May 30, he

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[438] “Document No. 12: Notes of CC CPSU Politburo Session,” April 16, 1987, in *Masterpieces*, pp. 249-252, quote at 251.
[439] Quoted in Service, *The End of the Cold War*, p. 245.

forced the resignation of Defense Minister Sokolov, and in the weeks that followed he pushed hundreds of officers throughout the armed forces into retirement. Gorbachev's hand-picked replacement to lead the Defense Ministry, Dmitri Yazov, now owed his job to the General Secretary, and the defense ministry and armed forces struggled to resist the transition to a policy of strategic sufficiency thereafter.[440]

The move to strategic sufficiency paralleled a continuing evolution in the Soviet position on nuclear arms control. After the close call at Reykjavik in October, 1986, the leadership was in the familiar position of having to make further concessions if they wanted to make progress. Since his January 1986 declaration aiming for a nuclear free world by the year 2000, Gorbachev had tried to attain a comprehensive agreement governing all nuclear weapons. When the Americans had shown no inclination to compromise on the Strategic Defense Initiative at Reykjavik, that strategy had failed. By the spring of 1987, the worsening economic situation led a group of reformers and conservatives within the Politburo - Shevardnadze and Yakovlev as well as Ligachev and Gromyko – to ban together to advocate 'decoupling' negotiations over SDI and long-range strategic nuclear weapons from negotiations over intermediate-range nuclear forces (INF) in Europe. They also proposed to support the so-called 'zero option' in INF negotiations to remove all intermediate nuclear weapons from Europe. This was a significant concession to the Reagan administration, which had first proposed the 'zero option' in 1981 thinking that the Soviet Union would never accept it. Now the Politburo was proposing that the country should, and Gorbachev reluctantly acceded to his colleagues' new strategy and abandoned his earlier comprehensive approach. With the domestic economy faltering and the Americans showing no sign of easing their negotiating position, all Politburo members now

[440] Ibid, p. 246-247.

agreed that the country needed to escape its military burden through nuclear arms control. Piecemeal progress was better than no progress at all. Gorbachev issued a statement to the West proposing to eliminate all intermediate missiles in Europe without linking it to SDI or strategic weapons limitations. In an additional signal of flexibility, his letter railed against the future deployment of SDI, but raised no objection to the prospect of research and testing.[441]

The Americans were happy to pocket the concessions and ask for more. US Secretary of State George Schultz travelled to Moscow in April 1987 to negotiate with Gorbachev on the newly decoupled INF 'zero option.' Just one week after these negotiations, the Politburo would discuss the country's rapidly deteriorating financial position, and the Finance Minister would conclude, "The financial situation has reached the point of crisis."[442] Desperate to come to terms on a treaty that would enable cuts in the Soviet defense budget, Gorbachev gave way on three central American conditions for an INF treaty: he agreed to include Soviet Asia in the agreement so that the agreement applied globally; he agreed to include short-range, battlefield nuclear weapons (an area of Soviet advantage) in the agreement; and he assented to an intrusive inspections regime to verify the treaty. This led the two sides to agreement on the basic shape of the final treaty, and they planned to have Reagan and Gorbachev sign it in December when Gorbachev was scheduled to travel to Washington for a bilateral summit.[443]

As he searched for an escape from the superpower nuclear confrontation, Gorbachev believed that Western Europe held the key to his strategy of securing the Soviet Union's

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[441] "Politburo Session [Excerpt]," February 26, 1987, National Security Archive, "The INF Treaty and the Washington Summit: Twenty Years Later," http://nsarchive.gwu.edu/NSAEBB/NSAEBB238/, Accessed November 22, 2016. Also Service, *The End of the Cold War*, p. 242.
[442] *Politburo*, p. 147.
[443] "Memorandum of Conversation Between M.S. Gorbachev and US Secretary of State George Schultz," April 14, 1987, in "The INF Treaty and the Washington Summit: Twenty Years Later,"

international position through diplomacy. "One thing is clear - no issue can be solved without taking Europe into account," he told the Politburo on March 26, 1987, in a telling conflation of Western Europe with Europe as a whole. "Even in our internal affairs, we need it for perestroika. And in foreign policy, there is no substitute for Europe. Without a partner like Western Europe, we cannot do anything." Better relations with Western Europe would allow the Soviet leadership "to reduce the limits of military confrontation" and "strive to remove U.S. weapons from Europe." Another "important task" of the strategy would be "to use the scientific and technical potential of Western Europe, especially for our friends in Comecon [who are] bogged down there."[444] The Soviet leadership had long tried to drive a wedge between Western Europe and the United States through peace offensives, and with peace and disarmament movements gaining strength in Western Europe in the 1980s, the time looked ripe for success. Western Europeans' perceptions of the Soviet Union as a menacing threat would first have to be transformed into visions of the Soviet Union as a cornerstone of peace. Margaret Thatcher told Gorbachev in a meeting on March 30, 1987, "Soviet troops did not hesitate to enter Hungary in 1956 and Czechoslovakia in 1968, and then Afghanistan. So why would they hesitate before they go somewhere else?"[445] Western Europe would never peel away from the American line so long as this perception persisted, Gorbachev told the Politburo a month later, as he recounted Thatcher's words. The Soviet Union needed "to humanize international relations," he told them.[446] There was a "war of ideas" going on between the superpowers for the hearts and minds

[444] *Politburo*, p. 139.
[445] "Document 15: Record of Conversation between Mikhail Gorbachev and Margaret Thatcher March 30, 1987, Moscow," in "Perestroika in the Soviet Union: 30 Years On," Digital National Security Archive, http://nsarchive.gwu.edu/NSAEBB/NSAEBB504/, Accessed December 8, 2016, p. 7.
[446] *Politburo*, p. 157.

of Western Europeans, Gorbachev said, and if the Soviet Union lost it, it would "lose everything."[447]

He hoped his vision of a "common European home" would win this war. Gorbachev had first casually mentioned the idea in a speech to the British Parliament in 1984, but it took on new life as the "all-European house" during his trip to Czechoslovakia in April 1987. "We are resolutely against the division of the continent into military blocs facing each other, against the accumulation of military arsenals in Europe, against everything that is the source of the threat of war," he said in a speech in Prague. "In the spirit of the new thinking we introduced the idea of the 'all-European house'... [which] signifies, above all, the acknowledgment of a certain integral whole."[448] In combination with the bold Soviet moves on arms control, this call to transcend the military division of Europe served its purpose of changing Western European perceptions of the Soviet Union. By the summer of 1987, Gorbachev's popularity in the West had become a political force unto itself, and by year's end *Time* magazine had named him their Man of the Year.

But the material realities of the Soviet empire remained unchanged. While he publicly proclaimed the need for a common European home in Prague, Gorbachev privately told the Czechoslovak leadership "we will not conduct our perestroika at [your] expense. But do not expect to live at our expense either."[449] Two months later at a meeting of the Warsaw Pact in Budapest, all the leaders of the bloc agreed their economic relations were a serious problem, but achieved no consensus on a solution. Gorbachev told the leaders that their "new stage" of

[447] *Politburo*, p. 140.
[448] Quoted in Milan Svec, "The Prague Spring: 20 Years Later," *Foreign Affairs*, Vol 66, Issue 4, Spring 1988, p. 990.
[449] "В Чехословакии я честно сказал, что не будем делать перестройку за их счет. Но и вы не рассчитывайте жить за наш счет." *Politburo*, p. 144.

relations had brought with it problems, "particularly in economic cooperation." These problems should not stop them from putting new forms of cooperation into practice, he said, because "we can't solve the new tasks with old forms." The Romanian leader Nicolai Ceausescu declared that "economic questions" now had "greater weight than military or international matters" for the bloc. "Questions of finance and price formation" needed to be seriously analyzed, he said, because "the current financial system" did not "correspond with realities." Hungary's Janos Kadar concurred, saying "the question of prices" was essential. "Without real prices," he said, "it is difficult to realize cooperation. Prices must approach world market levels. International cooperation can't be built on anything else." But real prices (and the currency convertibility that would come with it) would submit each country's economy to the pressures of intra-bloc competition and expose the different standards of living prevailing in the alliance. Just like changes in domestic prices, a reform in bloc prices would be accompanied by social pain. It fell to Polish leader Wojciech Jaruzelski, a man intimately familiar with the travails of price reforms, to warn his comrades of the difficulties that lay ahead. After discussing Poland's struggles with domestic reform, he said, "Comrades, we inform you about the problems that might arise, because it will not be a simple operation, particularly with regard to the rationalization of prices, which remain an anachronism and make the rational management of the economy more difficult."[450]

It is no wonder that Gorbachev returned to the Politburo in June to lament, "everyone agrees that something needs to be changed. But we see: when it comes down to it, nothing

[450] "Stenografische Niederschrift des Treffens der Generalsekretäre der Bruderparteien der Staaten des Warschauer Vertrages am Freitag, 29.5.1987," DY 30/2354, BArch/Berin, quotes at 67, 74, 85-86, 99-100, and 121.

changes."[451] His estrangement from the bloc only grew over the summer. Upon hearing a report from Shevardnadze about his difficulties meeting with bloc leaders in July, Gorbachev sarcastically said, "Our relations with the socialist countries remind one of inter-ethnic relations in the Caucasus: the smaller the nation the more rights and respect it demands for itself." He called for "a general assessment of economic relations with the socialist countries" because "the deciding moment is approaching."[452] No such comprehensive analysis has surfaced in the archival record yet, but the trend in Gorbachev's thinking was clear. The Soviet Union could not, he reinforced in November, use "pressure, the slightest manifestation of inequality, disrespect, even the smallest taste of Comintern approaches. That time is long gone. Each party must sort things out itself."[453] This included economic support, which Gorbachev told his allies the Soviet Union could not provide. "Jaruzelski is waiting for a lot of help in economic cooperation," he reported after meeting with the bloc allies at celebrations of the 70th anniversary of the October Revolution, "Zhivkov [in Bulgaria] too."[454]

The Soviet Union, however, had nothing extra to give. On October 9, 1987, Ryzhkov reported to the Politburo that the country was now "a debtor to our friends. We pay them one billion rubles in interest alone…. This is a political issue, a question of national prestige." He went on to report a litany of economic dismay. From 1985 to 1987, the country's annual hard currency earnings from exports dropped from $25 billion to $17 billion, even though the government had diverted increasing numbers of goods, including oil, from the domestic market to exports every year. Income from foreign trade had dropped from 66 billion rubles in 1985 to

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451 *Politburo*, p. 169.
452 "Document No. 14: Report on Eduard Shevardnadze's Visits to Bulgaria, Hungary, and Yugoslavia," July 9, 1987 in *Masterpieces*, pp. 255-56.
453 *Politburo*, p. 236.
454 Ibid, p. 237.

52 billion rubles in 1987. The state budget deficit was now 84 billion rubles.[455] These numbers not only prohibited support for the socialist bloc, they also reinforced the main goal of Soviet foreign policy – to reduce defense spending. Ryzhkov told the Politburo just one week before his bleak economic report, "If we hold the current level of spending on defense, we cannot upgrade industry, we will not give the people welfare.... we must reduce defense spending."[456]

Lowering defense spending would require the completion of the INF Treaty. Since Gorbachev had granted the Americans concessions in April, he had still made vague attempts to link further progress in arms control to SDI. But in September, he abandoned all mention of the program in a letter to Reagan on nuclear matters, leaving the Americans to conclude that the Soviets had learned "that they would just have to live with it." In the fall, the Soviet negotiating team formally recognized that the Soviet Union had more short and intermediate weapons in Europe, and thus would have to give up more weapons than the Americans to get to zero. These "asymmetrical cuts" had long been deal breaker for the Soviet Union, but not under the circumstances that prevailed in the fall of 1987. In October, Gorbachev made one final attempt to tie his attendance at the Washington summit to an American willingness to negotiate on SDI, but after Schultz stonewalled this demand, he readily gave way. Only a year after he had broken off the Reykjavik summit over SDI, he would now travel to the next summit without the program even on the negotiating agenda.[457]

This set the stage for the General Secretary's arrival in Washington and the signing of the INF treaty on December 8th. It was a historic agreement that made the European continent a dramatically safer place, and the crowning achievement to that point of Gorbachev's strategy to

[455] *Politburo*, p. 209.
[456] *Politburo*, p. 199.
[457] Service, *The End of the Cold War*, p. 277-289.

secure the Soviet Union's international position through diplomacy in place of military power. He publicly declared that the treaty demonstrated the importance of "the human factor" in building trust between adversaries, and the Americans congratulated themselves for negotiating a "fantastic agreement."[458] Hours of personal diplomacy had contributed to its signing, but the ultimate source of the treaty lay outside of any negotiating room. The Soviet leadership had drawn a fundamental connection between cutting the country's military burden and improving the domestic economy, and had made a string of concessions in pursuit of that goal. With the signing of INF, Gorbachev had successfully embedded the move to military retrenchment within a superpower treaty, and transformed the Soviet Union's international reputation from menace to peacemaker in the process. At the end of 1987, his strategy of securing through personal diplomacy and idealism what the Soviet Union had formerly won with military power appeared to be paying off handsomely.

The Search for Control and Legitimacy

When Gorbachev recounted the success of his trip to Washington for the Politburo, he said the conference reinforced one of the "foundational" ideas of the new thinking in foreign policy, "namely, that its success and its effectiveness is dependent on the things we are doing at home, on how perestroika is going."[459] On this score, there was great cause for concern. The June 1987 Central Committee Plenum that introduced the Law on State Enterprises left two central issues at the top of the agenda for 1988: price reform and further democratization. The plenum documents had declared that society should undertake a broad discussion of price

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[458] Ibid, pp. 287, 291.
[459] *Politburo*, p. 241-242.

reform, and Gorbachev had announced that an extraordinary party conference, the 19th All-Union Party Conference, would take place in the summer of 1988 to further expand the democratization of Soviet society. He did not announce the extent of that expansion, but made clear that it would depend on whether the party bureaucracy and line ministries relinquished their control over the economy, as called for under the Law on State Enterprises.

By the spring of 1988, it was clear that they had not. The move to enterprise independence exposed the state bureaucracy as even more intransigent than Gorbachev and the reformers had expected. The coercive power of glasnost and limited democracy had been no match for the entrenched patronage networks of the old command system. Gorbachev took stock in April 1988 as he thought about how far to take democracy at the coming party conference. “What have we done so far? We conducted a strong January [1987] Plenum” to expand glasnost and democracy within enterprises. “But…it did not play its intended role.” As for the June Plenum’s economic reform measures, “the results are barely visible.”[460] The “administrative system continues to run the show.”[461] To “overcome its legacy,” the reform would have to “go to the people.”[462] Past reform attempts “failed because they did not include the people.” He returned to the idea that the ultimate attraction of democracy lay in its potential to give power. “How to generate power?” he asked rhetorically as the Politburo debated the 19th Party Conference, “It is necessary to say that it was entrusted to someone.”[463] Wider use of elections would bring “the most active and capable people into power” and allow Soviet citizens to

[460] *Politburo*, p. 272.
[461] *Politburo*, p. 287.
[462] *Politburo*, p. 283.
[463] *Politburo*, p. 256.

interrogate them on a regular basis. If these officials failed to perform as the people wanted, they would lose the next election.

Faced with the problem of an intransigent *nomenklatura*, previous General Secretaries would have used Central Committee Plenums and party conferences to address "cadre policy" and fire party bureaucrats who failed to toe the line. Gorbachev wanted democratic elections to do that work for him. He recounts in his memoirs how many of his advisers wanted him to use the All-Union Conference to undertake a "serious shake-up of the cadres." He declined to do so, he writes, because "it would have been a one-off operation." His plan was different. The conference would instead implement an entirely new system under which "the people could participate in solving these [cadre] issues" through "free elections."[464] Gorbachev hoped, in short, to use the All-Union Party Conference to institutionalize his preferred method of coercion - electoral democracy.

To use the power of democracy as he hoped, Gorbachev knew he would need to retain the support of the masses. This made the prospect of price reform exceedingly daunting. He was well aware, however, that his economic reforms – the entire edifice of market socialism - would fail without it. Enterprise independence without price reform had made the economy severely distorted, a fact readily apparent to the Politburo by the spring of 1988. Many prices were far below their market value; others were far above, particularly state procurement prices. Enterprises had begun to use their newfound independence to stockpile low-priced inputs and shift their production to higher priced goods. With consumer prices still fixed, the inflation pressures of past budget deficits had begun to manifest itself in scarcity, and Soviet citizens were forced to wait in increasingly long lines for all manner of essentials, most of all food. Indeed,

[464] Gorbachev, *Memoirs*, p. 255.

debates about how to solve "the food problem" dominated both private and public debates in the spring and summer of 1988. Shortages threatened to erode perestroika's support among the masses, so Gorbachev took this problem very seriously.

Prices were "the crucial question at the intersection of politics, the economy and the social sphere," Gorbachev told the Politburo in a discussion of price reform in April 1988. In production, the "main issue of economic reform [is] resource conservation," Ryzhkov said, and resources would not be conserved as long as wholesale goods remained fixed at low prices.[465] If the leadership moved to free wholesale prices and allow them to be set contractually between firms, this would force enterprises to use resources more efficiently and discourage hoarding. But if they left consumer prices fixed while doing this, free wholesale prices would only increase the subsidies the state would have to provide to keep consumer prices low. Thus, Gorbachev believed, all prices had to be reformed as a single package.

This meant raising or freeing consumer prices. Making such a decision would both prevent an increase in state subsidies and also solve the problem of shortages. But the politics, of course, were treacherous. "Hands off prices!" was the first rallying cry of the "radical democratic opposition" in 1988, Gorbachev recalled in his memoirs.[466] This made price reform a no-win situation. If the Politburo continued to do nothing, production bottlenecks and consumer shortages would only increase, and perestroika would be blamed for destroying the economy. If they aggressively attacked the problem of prices, the economy would function much better, but they would lose the support of the population. Gorbachev seesawed between these options in the Politburo. "Remove the food problem in the country," he said in April 1988 as the leadership

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[465] *Politburo*, p. 286.
[466] Gorbachev, *Memoirs*, p. 235.

discussed price reform, “and 80% of perestroika’s problems can be considered solved.” But the price increases that would solve the food shortage, would “be felt immediately in communal and factory cafeterias,” the canteens of the working class, and by “56 million pensioners [and] 92 million children under 17 years of age.” 72% of the average household budget was spent on food, he told the leadership, and because salaries were so “egalitarian,” that statistic described most Soviet families. “It is a difficult task,” he concluded, “to stimulate progress in the public interest and at the same time maintain the social balance. But price reform is overdue.”[467] In the face of daunting politics, Gorbachev hoped that his plans to expand democracy at the forthcoming party conference would provide the political legitimacy required to implement the social pain of price reform. “At the Conference, we’ll have to get closer to price reform,” he told a group of regional party secretaries in April. “Without this reform, nothing will work.”[468]

This set the two purposes of glasnost and democracy – to coerce the bureaucracy and legitimize price reform – on a collision course destined for the 19th All-Union Party Conference. It was a conference that would definitively break the country off from the old authoritarian system. Gorbachev called it “the real turning point, when perestroika became irreversible,” and the US ambassador to the Soviet Union, Jack Matlock, viewed it as the definitive point when the Soviet Union entered “a whole new ball game.”[469] These judgements were so definitive because Gorbachev succeeded in gaining the conference’s support for a vast array of changes to the country’s political system, including the creation of a strong presidency (which he would of course occupy), a dramatic increase of the power of local soviets in place of the party bureaucracy, and competitive elections to a newly created parliamentary body, the Congress of

[467] *Politburo*, pp. 286-287.
[468] *Politburo*, p. 272.
[469] Gorbachev, *Memoirs*, p. 237, and *Masterpieces of History*, p. 110.

People's Deputies. It was a total victory for Gorbachev's first purpose of democracy. In the coming elections, scheduled for the spring of 1989, party bureaucrats would have to earn a popular mandate from the Soviet citizenry if they wanted a seat in the new Congress. So long as perestroika remained popular, these elections were bound to punish those who resisted its call to economic reform.

But it also implied a definitive defeat for democracy's second purpose. Gorbachev delivered a detailed call for price reform to the delegates of the 19th Party Congress, but nothing came of it. "Much now rests on the reform of price formation" he said in his opening speech to the conference. "The fact that this problem is unsolved is greatly complicating the implementation of economic reform. Without price reform, we will not be able to create normal economic relations in the national economy." This included the low fixed retail prices for bread, milk, and meat. The state paid out "tens of billions of rubles in subsidies" for retail prices, Gorbachev told the conference and the country, and their low level "undermines incentive to produce these goods and gives rise to thriftlessness toward them." The economic necessity of a reform was unavoidable, Gorbachev said, so it was "simply essential that we deal with this task, however difficult it might be and whatever doubts and fears it might arouse." He tried to reassure the country by reaffirming his belief that "changes in retail prices should in no way be accompanied by a drop in the people's standard of living." Because the population would be fully compensated for the price increases, the state would "obtain no direct financial gain from revising retail prices and the public [would] lose nothing."[470]

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[470] Gorbachev's Opening Speech to the 19th All-Union Conference, 1 July 1988, quoted in full in *Gorbachev's Gamble: The 19th All-Union Party Conference* (Boulder, CO, 1990), pp. 110-111.

The Soviet people did not believe him. In the months following the 19th Party Conference, public opinion hardened against price reform. By the fall of 1988, a series of leading Soviet economists were publishing articles in the newly freed Soviet press arguing that price reform should be delayed for "the next few years" because its implementation would "kill perestroika."[471] Gorbachev could not resist the logic of these arguments, as he too feared losing perestroika's popularity over the issue of prices. He needed that popularity to coerce the bureaucracy. Since the spring of 1987, he had waited for glasnost and democracy to produce broad social consensus on the necessity of price reform, but such a consensus never came. And because it never did, he was left in a conundrum of his own making: his political power depended on his popularity, while his reform plans compelled him to make decisions that were extremely unpopular. He chose to maintain his popularity, and ruined his reforms in the process. In November 1988, the leadership abandoned all efforts to achieve a price reform, and set their focus squarely on the coming elections to the Congress of People's Deputies.

Thus, as the country approached 1989, it was hurtling toward democracy and bankruptcy, and the two destinies were intimately linked. Gorbachev had achieved his goal of using democracy to coerce the bureaucracy, but doing so had prevented him from using it to legitimize the steps that would save the country from bankruptcy. Price reform could be temporarily delayed, but it could not be permanently avoided. With a gaping budget deficit, exploding wage growth, no enterprise budget constraints, and fixed prices, a severe 'monetary overhang' had developed in the country by 1989. Prices would eventually have to be raised to 'mop up' all the extra rubles; it was simply a question of time. *PlanEcon*, a close watcher of socialist economies, wrote in April 1989, "By…delaying the inevitable upward price adjustment," the Soviet

[471] Gorbachev, *Memoirs*, p. 236.

leadership was "only making sure that when the adjustment is made, it will indeed be explosive." Once the leadership had "run out of choices" in the future, prices would be the only place left to turn. At that point, *PlanEcon* warned, "Mr. Gorbachev will face a far greater political threat than anything he has faced up to now."[472]

In the meantime, other choices remained, imperial retrenchment most prominent among them. As the budget deficit grew to an astounding 11% of the economy in 1988, cutting state spending to close this enormous gap and slow inflation became a top priority for the entire leadership.[473] They turned again to Gorbachev to create an international environment that would make imperial retrenchment possible.

Bystanders to Revolution

"Force and the threat of force can no longer be, and should not be, instruments of foreign policy," Gorbachev boldly declared to a meeting of the General Assembly of the United Nations on December 7, 1988. "Freedom of choice is a universal principle to which there should be no exceptions," he continued. "Denying that right to the peoples, no matter what the pretext, no matter what the words are used to conceal it" would transgress peace and justice. "On the whole, our credo is as follows: Political problems should be solved only by political means." To that end, he announced, the Soviet Union would unilaterally reduce the size of its armed forces by 500,000 people over the next two years, withdraw six tank divisions from the Eastern Bloc, and

[472] "Soviet Economic Performance During the First Quarter of 1989," *PlanEcon*, April 28, 1989, Vol. V, No. 17, pp. 1-2.
[473] Vadim Medvedev would later write, by 1989, "The program of economic reforms of 1987 was in effect buried….The main issue was that control over the money supply, over the monetary income of the population, was lost, and that gave a major push to the unwinding of an inflationary spiral, which became more difficult to stop every day." *V Komande Gorbacheva*, p. 103. Translated in Savranskaya, "The Logic of 1989," in *Masterpieces,* p. 25.

reduce its overall military presence in Eastern Europe by 50,000 soldiers and 5,000 tanks. "All remaining Soviet divisions on the territory of our allies…will become unambiguously defensive," he said. The international system would continue to be defined by "the existence and rivalry of various socioeconomic and political systems," he concluded, but the Soviet Union now wanted "to impart to this rivalry the quality of sensible competition in conditions of respect for freedom of choice and a balance of interests."[474]

The speech was a sensation in the Western world, the first definitive proof that Gorbachev could deliver peaceful deeds to go along with his years of peaceful proclamations. It was also a hint, crystal clear in retrospect but only naively trusted at the time, that the Soviet Union no longer sought to control the political and economic destiny of the nations under its orbit. Redefining the longstanding antagonism between the capitalist and socialist worlds as a sensible competition based in respect for the freedom of choice did not sound like the Cold War of old. Indeed, it sounded as though Gorbachev was declaring the Cold War's end.

This was precisely the General Secretary's intention. In planning the speech, he had professed a desire to make his address the "anti-Fulton" – one that reversed Winston Churchill's claim in a 1946 speech in Fulton, Missouri that an Iron Curtain had befallen the European continent and divided it into two halves. The speech was the apotheosis of Gorbachev's strategy to use bold vision and idealistic rhetoric to maintain the international standing that the Soviet Union had once secured through military might.

Over the course of 1988, the conviction to reduce the burdens of empire had grown within the Politburo to encompass members on both sides of the debate over the domestic course

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[474] "Gorbachev's Speech to the U.N.," December 7, 1988, https://astro.temple.edu/~rimmerma/gorbachev_speech_to_UN.htm, Accessed December 10, 2016.

of perestroika. In June, as the party prepared for the 19th All-Union Party Conference, even the conservative stalwart Andrei Gromyko had come to view exiting the arms race as a national necessity. "During Khrushchev's time we built 600 bombs (nuclear). He said then: how long are we going to do it?" But the country never stopped making them, Gromyko said, because the leadership stuck "to the principle: they are in a race and we are in a race, as in sports." Producing ever more nuclear weapons "was our mistaken position, absolutely mistaken," he concluded. "Tens of billions were spent on production of these toys." His fellow conservative, Vitaly Vorotnikov, concurred. "We did indeed let ourselves get pulled into the arms race. We found ourselves on the brink of catastrophe…. we are the ones to blame." Gorbachev capitalized on the prevailing sentiment to press his new thinking. Is the party's goal "to race the entire world regarding the levels of armaments: cannon by cannon, plane by plane?," he asked them. "Then let us introduce ration cards for food, turn the country into a military camp, and just race and race onwards." With 'the food problem' already set to be a main topic of conversation at the party conference, this was a prospect that no one in the room welcomed.[475]

As the year progressed, the tradeoff between the domestic economy and the military burden became ingrained in the Politburo's thinking. It thus directly informed Gorbachev's internal preparation for his U.N. speech. Yes, he believed in a radically new and non-violent vision of international relations, and he hoped to demonstrate that vision to the world by pulling Soviet troops out of Eastern Europe. But that is not what sold his less idealistic comrades in the Politburo on the idea. To them, the worsening domestic economy compelled military disarmament. At the Politburo meeting on November 3rd 1988, Gorbachev reasoned, "Our

[475] "Document No. 26: Notes of CC CPSU Politburo Session," June 20, 1988, in *Masterpieces of History*, p. 286-287.

military expenses are 2.5 times larger than those of the United States. No country in the world…spends more per capita on the military sector." As the budget deficit spiraled out of control and the Soviet citizenry struggled to find food and basic consumer goods, Gorbachev's claim that "We won't solve the problems of perestroika if we leave the army the way it is," resonated deeply in the chamber. If troops were not pulled out of Eastern Europe, Ryzhkov warned, then "we can forget about any increase in the standard of living. No matter what government you put in place of this one, it won't solve this problem." Sensing consensus, Gorbachev proposed to the group that he announce unilateral cuts in the armed forces in his U.N. speech. Everyone enthusiastically agreed, and Gorbachev concluded, "the main reason we're doing this is perestroika.... without reductions in the army and the military industrial complex we won't be able to deal with perestroika's tasks."[476]

Upon returning from the United Nations a month later, Gorbachev held another Politburo meeting to assess the speech and the future direction of perestroika. Yegor Ligachev, Gorbachev's preeminent opponent in the Politburo, praised the policy of unilateral disarmament on the grounds of political economy. Gorbachev had loftily spoken of common human interests in his speech, and Ligachev saw the reduction of "the huge burden of military budgets" as an important interest of both socialist and capitalist countries. "We need disarmament most of all," he said. "We took such a burden upon ourselves with relation to the military budget that it will be difficult to dramatically solve anything in the economy." He did not want to weaken the country's security, he said, but "in the final analysis, the power of the state will be determined not by military might but by a strong economy and by the political cohesion of society." Defense Minister Yazov reported that he had not heard "a single question or a provocative

[476] Chernyaev, *My Six Years*, p. 194-195.

remark" from the Soviet high command regarding Gorbachev's plan to cut back the size of the armed forces. "Everyone reacted with understanding," he said. In the spirit of glasnost, Politburo members ranging from Ligachev to Shevardnadze advocated telling the party, the country, and the world that the domestic economy had necessitated the military cutbacks. But Gorbachev, surprisingly, demurred. "We keep this secrecy for one reason," he said. "If we admit now that we cannot build a long-term economic and social policy without [unilateral cuts],…this may reduce to nothing [the effect] of the speech at the United Nations." Gorbachev knew that the idealism of the speech would lose its power if it became clear that it was driven by material considerations. "If we take this [glasnost] approach now, then people will tell us: your proposal is rubbish."[477] So long as the reasoning behind the UN proposal was secret, people were calling it revolutionary and Gorbachev visionary. If the Soviet Union was going to maintain its superpower status in an era of retrenchment, Gorbachev knew that he and the country could not afford to lose those acclamations.

Nor could they lose the regard of their allies in Eastern Europe. Since scolding the allies for 'living on credit' and lamenting the scale of Soviet oil deliveries in November 1986, Gorbachev had continuously returned to the questions of oil and indebtedness in discussions of the region. In a March 1988 Politburo meeting, he brought up former Polish leader Eduard Gierek, who had tried to spur Polish development in the 1970s by borrowing from the West. "What was it all based on?" Gorbachev said. "On credits from the West and on our cheap fuel. The same goes for Hungary." Going forward, the allies' political stability was in the Soviet Union's "vital interest" because if they collapsed "the very idea of socialism [would] be

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[477] All words above in brackets were added by the translator in "Document No. 35: Transcript of CC CPSU Politburo Session," December 27-28, 1988, in *Masterpieces*, p. 332-340.

discredited." Nevertheless, Comecon integration based in currency convertibility had to begin, Gorbachev said, "because we cannot remain a provider of cheap resources for them forever."[478]

Throughout the spring and summer of 1988, Soviet leaders held important bilateral meetings on economic relations with Hungarian, Polish, and East German leaders. These will be covered in subsequent chapters. But in the fall of 1988, as Gorbachev abandoned price reform and prepared for the Congress of People's Deputies at home, it also became apparent that a general economic crisis of the socialist bloc was fast approaching. "There are multiple signs that certain similar problems are increasingly plaguing fraternal countries," Georgy Shakhnazarov, Gorbachev's aide for Eastern Europe, wrote to him in early October. "The very similarity of the symptoms of the disease testifies to the fact that its catalyst is not some kind of malignant germ that has managed to penetrate their lower defenses, but factors rooted in the very economic and political model of socialism." In the past, "whenever any of them was in crisis, we had to come to the rescue at the cost of huge material, political and even human sacrifice." But now, "any option to 'extinguish' crises by military means must be fully excluded. Even the old leadership seems to have already realized this, at least with regard to Poland."

The current crises were financial, Shakhnazarov wrote. "We must reflect on how we will act if one or even several countries become bankrupt simultaneously," he wrote. "This is a realistic prospect for some of them on the brink of monetary insolvency (Poland, Hungary, Bulgaria, Vietnam, Cuba, GDR)." This prospect raised a number of questions that the leadership needed to address. "Could the socialist countries come out of the pre-crisis situation without Western assistance? What price will they have to pay for this assistance? To what extent should

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478 "Document No. 19: Notes of CC CPSU Politburo Session," March 10, 1988, in *Masterpieces of History*, pp. 265-267.

we encourage such a course of events or put up with it? To what degree are we interested in the continued presence of Soviet troops on the territory of a number of allied countries (excluding the GDR)?"[479]

Gorbachev's announcement at the U.N. of troop withdrawals from Eastern Europe began to answer this last question. But the monumental task of preparing the country for the Congress of People's Deputies elections prevented the leadership from addressing the other three questions for the remainder of 1988. Only at the end of January, 1989 did Gorbachev tell the Politburo, "Comrades, we are on the eve of very serious things, because we cannot give [the Eastern Europeans] more than we are giving them now." But if the Soviet Union did not provide more economic and technological support, Gorbachev said, "there will be a split and they will run away." As populations and politicians across the Eastern Bloc wondered how far they could push Moscow without inviting a harsh crackdown, Gorbachev now told his colleagues, "The peoples of those countries will ask: what about the CPSU, what kind of leash will it use to hold our countries back? They simply do not know that if they pull this leash harder, it will break." In place of the old policy of domination through economic subsidy, Gorbachev declared that it was time to transfer relations with Eastern Europe "to the market." In doing so, Gorbachev knew he "would break the old rule that we keep them attached to us only by means of energy resources."[480] To fully explore the burgeoning crisis in the bloc, Gorbachev commissioned a series of reports from the leading foreign policy institutions of the Soviet government, including

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[479] "Document 1: Georgy Shakhnazarov's Preparatory Notes for Mikhail Gorbachev for the Meeting of the Politburo," 6 October 1988, in *The End of the Cold War, Cold War International History Project Bulletin,* p. 15.
[480] Document No. 39: Report from Mikhail Gorbachev to the CC CPSU Politburo regarding His Meeting with the Trilateral Commission," Jan. 21, 1989, in *Masterpieces,* pp. 349 - 351.

the KGB, the Central Committee's International Department, the Foreign Ministry, and research institutes in Moscow (the equivalent of American think tanks).

Two of these reports have been opened to the public. The Central Committee's report, "On Strategy for Relations with the European Socialist Countries," is the most complete analysis currently available of Soviet thinking at the highest levels on the eve of Eastern Europe's revolutions. The Eastern Bloc governments suffer "from a lack of legitimacy," the authors wrote, and "*the economic factor, the ability of a country to join and to assimilate into the world economy, has moved to the top of their priorities* [all emphasis original]." The desire to join the world economy constituted "the primary national interest of the majority of the socialist countries right now, and it should be taken into account above all in our relations with them." Because the ruling parties lacked legitimacy, they could not "*rule in the old way any more, and the new 'rules of the game' – of managing the group interests…and finding a social consensus – have not yet been worked out*." Many socialist countries were likely to try to make a "smooth movement toward democratization…under the leadership of the ruling parties." This would involve "concessions" to opposition forces in society, including "a strengthening of the role of representative organs in political life." The report favored this outcome because "the chances of preserving internal political stability and alliance commitments" were high "if the initiative for democratic change originates with the ruling party." As Poland and Hungary were demonstrating, "pulling a portion of the opposition into the official structure and assigning it responsibility for constructive solutions to the problems that have accumulated could play a stabilizing role."

How should the Soviet Union seek to influence socialist countries under these precarious conditions? "Authoritarian methods and direct pressure have clearly outlived their usefulness," the authors wrote. Even if there was "a sharp deterioration in one of the countries…it is very unlikely that we would be able to employ the methods of 1956 and 1968, both as a matter of principle and because of unacceptable consequences."

In a telling misreading of the possible roads ahead for the socialist bloc, the authors wrote, "*We should not exaggerate the danger of one of the countries simply switching to the capitalist way of development*." They did not believe this would happen because it was "very unlikely that the West would be inclined to take on countries whose economies have been marked by crisis elements and heavy foreign debt." The West had so far shown no interest in "the 'marshallization' of certain socialist countries," i.e. in providing a new Marshall Plan for Eastern Europe. Gorbachev often like to talk about how the Soviet Union was stuck in the 1930s and 1940s, and this was clearly an instance of bygone thinking from that era. The Marshall Plan was the grand exception to the general rules of how the West dealt with debtor nations, as the Sovereign Debt Crisis roiling the rest of the world in the 1980s clearly demonstrated. Latin America's experience in the 1980s clearly showed that the "marshallization" of an economy was not required to pull a debtor country into the capitalist orbit. The report failed to grasp this fundamental characteristic of the global capitalist economy, and thus Soviet leaders severely underestimated the chances of the bloc's quick departure to capitalism.[481]

The report of the Institute of the Economy of the World Socialist System, written by its director Oleg Bogomolev, paralleled the Central Committee's analysis. Bogomolov plainly stated that the Soviet government faced "a dilemma:" either "thwart the evolution" toward market socialist economies and representative government in Eastern Europe "or take it in stride

[481] Document No. 41: Memorandum from CC CPSU International Deparment, "On a Strategy for Relations with the European Socialist Countries," February 1989, in *Masterpieces*, pp. 353-364

and develop the policy accepting the probability and even inevitability of this process." The academician's answer to this dilemma could not have been more clear. "Attempts to thwart emerging trends would be tantamount to fighting time itself, the objective course of history. In the long term, these kinds of steps would be doomed and in the short run would mean wasting means and resources for an obviously hopeless cause." Attempts to preserve "the status quo that has lost its objective foundations…will weigh as an excessive burden on our economy." Furthermore, "the direct use of force by the USSR…will most evidently signify the end of *perestroika* and the crumbling of trust on the part of the world community." If instead the Soviet Union permitted its Eastern Bloc allies to reform, then "the economic burden of the USSR [would] be alleviated." In conclusion, Bogomolov warned his political superiors, that "any attempt to stop this evolution by force could have the gravest consequences." Any country where the Soviet Union intervened would "inevitably acquire…quasi-dictatorial regimes which would continuously deplete the material resources of the Soviet Union and effectively exclude the prospects for renewal of socialist society in our country."[482]

For Gorbachev, these reports solidified convictions that had long been hardening. On March 3rd, 1989, he told the Soviet ambassadors to the Eastern Bloc states, "Do not impose anything on anybody!...We reject force in everything, in all our policies." Echoing the 'main line' laid down by his mentor Andropov almost a decade before, Gorbachev told the group that the leadership would now "think of our own people" instead of assuming "full responsibility" for the fate of the satellite governments in Eastern Europe. Irked by the small slights of daily life, he detailed how Soviet citizens consumed less meat than their East German counterparts, and yet

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[482] "Document 42: Memorandum from the Bogomolov Institute, 'Changes in Eastern Europe and their Impact on the USSR," February 1989, in *Masterpieces*, pp. 365-381.

the East Germans continued “to demand raw materials for special prices. This is their solidarity!” Resentfully, he continued, “They resell the specially priced resources they get from us to the West for hard currency! Such is their reciprocity! This is where I become a nationalist!”[483] These were not the words of a man who had any thoughts of saving the socialist regimes of the Eastern Bloc from their unfolding economic crises.

In July, Gorbachev eloquently couched the new Soviet national interest within a stirring internationalist call for a Common European Home in a speech to the Council of Europe in Strasbourg, France. “The social and political order in some particular countries did change in the past,” he said, “and it can change in the future as well. But this is exclusively a matter for the peoples themselves and of their choice. Any interference in internal affairs, any attempts to limit the sovereignty of states — whether of friends and allies or anybody else — are inadmissible.” His vision for a Common European Home started with dramatically reduced military expenditures and the elimination of nuclear weapons, and it extended to “the emergence of a vast economic space from the Atlantic to the Urals where [Europe’s] Eastern and Western parts would be strongly interlocked.”[484] It was a vision of the future international order that Gorbachev wanted and that the Soviet Union needed: radically peaceful in its international relations and freed from the longstanding material burden of empire.

[483] “Document No. 51: Notes of Mikhail Gorbachev’s Meeting with Soviet Ambassadors to Socialist Countries,” March 3, 1989, in *Masterpieces*, pp. 414-417.
[484] “‘Europe as a Common Home’ Address given by Mikhail Gorbachev to the Council of Europe (Strasbourg, 6 July 1989),” https://chnm.gmu.edu/1989/archive/files/gorbachev-speech-7-6-89_e3ccb87237.pdf, Accessed December 10, 2016.

In the chapters that follow, I will argue that the political transformation of Eastern Europe in the late 1980s was the result of a transnational struggle between Western banks and governments, Eastern European governments, and Eastern European peoples over who would bear the costs of economic adjustment policies. In this struggle, the Soviet leadership held power only to the extent that it was willing to provide economic assistance to its allies or to intervene militarily, which would have had its own significant economic costs. Continuing the foreign policy first set by Andropov in the Polish Crisis, Gorbachev and his Politburo were unwilling to embrace either of these options. Motivated to shed the burdens of an empire bequeathed to them by history, they watched idly as a wave of economic adjustment, masked as political revolution, washed over the nations they had once called satellites. Contrary to the historical memory that prevails today, this wave had not originated in the East with perestroika, but rather in the West with sovereign debt. By the mid-1980s, it had already washed over much of the Global South, and was cresting above the concrete walls and iron curtains that separated East from West. Soon it would wash away the division of Europe completely.

Chapter 6

The Economic History of a Political Revolution:

The Polish Roundtable

> "My relationship to economics has been reluctant….I was driven into it by the realization, by the growing realization, that most of the foreign policy problems have an economic base, and that most of the economic problems really require fundamental political decisions."
>
> Henry Kissinger, Autumn 1983[485]

It may seem odd to begin a chapter about Poland in 1989 with a quote from Henry Kissinger in 1983. And indeed, Kissinger himself had no bearing on the momentous events that unfolded in Warsaw during that year. However, the comment above came from a man with a notoriously poor relationship to the field of economics (equal parts ignorant and disdainful), and it was made at a particularly precarious time for the global economy. Over the previous year, Western governments had fended off the first forays of what would become the defining economic problem of the 1980s – variously called the Sovereign Debt, Third World, or Latin American Debt Crisis. Faced with the prospect of the most severe collapse in international trade and finance since the Great Depression and fearing the political ramifications that would result from such a development, governments had intervened as lenders of last resort in order to

[485] Henry Kissinger, "The Geopolitics of International Economic Policy," RAC Box 3, File "International Finance 10/12/83 – 11/8/83," Roger Robinson Papers, Ronald Reagan Presidential Library (RRPL), Simi Valley, CA.

prevent countries that were “too big to fail” from defaulting on their debt payments to Western banks.[486] Through the remainder of the decade and beyond, debtor nations on the brink of insolvency sat at the mercy of the International Monetary Fund (IMF), which attached conditions to its financial aid that were meant to ensure as much of the debt was repaid as possible. Debtor countries were forced to privatize state-owned industries, slash state subsidies for food, energy, and housing, and invite foreign capital to invest in their economies. It was a global economic process with profound political implications. Kissinger’s conversion to economics, therefore, serves as a clarion signal of the deepening interdependence between the global economy of the late 20th century and the political history of that era. In addition, his comment offers two postulates that historians of this period have yet to incorporate into their work, but that guide the history presented here. Political problems (both foreign and domestic) have an economic base, and economic problems require political solutions.

What, then, is the subject of the history that follows? On August 24th, 1989, Tadeusz Mazowiecki, a member of the labor union *Solidarność* (Solidarity), became the prime minister of Poland and the first democratically elected political leader in Eastern Europe since the start of the Cold War. His election helped spur the seismic political shifts that rocked the European continent in the second half of 1989 and eventually end the Cold War. How did this happen? Among scholars and the public at large, the prevailing view takes it to be something of a miracle. Padraic Kenney has written, “Descriptions of 1989 often mystify more than they reveal. Even scholars who know the region very well resort to a bit of the supernatural to explain how

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[486] For contemporary comparisons between the challenges of 1982-83 and the 1930s, see Henry Nau to William Clark, “GATT Ministerial and Williamsburg Summit Prospects,” December 1, 1982, RAC Box 3, File “ International Finance 11/17/82 – 12/31/82,” Roger Robinson Papers, RRPL.

democracy and freedom emerge from the communist bloc. In was a 'year of miracles' (or *annus mirabilis*) in which 'people power' 'lit the night'. Accounts of sudden miracles should make any historian suspicious."[487] Yet the miraculous view of popular protest lives on. Recently, Paul Wilson penned a renewal of this shorthand explanation in *The New York Review of Books*. The Polish communist party, he wrote, was "in effect, talked out of power by groups of dissidents and unofficial opposition leaders….[who] were emboldened by huge demonstrations in the streets".[488] This consensus holds a strong grip on historical memories because it appears to provide evidence of the influence that civil society can exert on totalitarian regimes. It has survived as an explanation because of the unique historical narrative to which it provides a bookend – the Cold War in East-Central Europe. Historians have long insulated the history of the Cold War in East-Central Europe from the history of economic change that swept the rest of the globe in the late 20th century. This insulation has allowed the miraculous explanation of 1989 to persist.

This chapter seeks to reincorporate Poland's history into the history of the global economy, and in doing so, provide a new explanation of Poland's political transition in 1989. By the end of the 1980s, Poland owed its international creditors an incredible $39 billion, and was subject to the same demands as other debtor countries had been throughout the decade. The quartet of Western financial institutions – the Paris Club, the London Club, the IMF, and the World Bank - demanded that the government implement a "structural adjustment" program as a

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[487] Padraic Kenney, *A Carnival of Revolution: Central Europe 1989* (Princeton, NJ, 2002), 3. Similar criticism is given in Stephen Kotkin, *Uncivil Society: 1989 and the Implosion of the Communist Establishment* (New York, 2010).
[488] Paul Wilson, "Adam Michnik: A Hero of Our Time," *New York Review of Books*, 2 April 2015, 73.

prerequisite to any debt relief.[489] The details of such a program will be described below, but it suffices now to note that it entailed a dramatic drop in living standards for the Polish population. In order to escape its economic crisis, the Polish government would have to impose austerity on its own people.

After years of unrest triggered by consumer price increases, Polish president Wojciech Jaruzelski and his leading cadre decided in 1989 that economic austerity would only be possible if it received broad support from society. They therefore moved to grant limited political concessions to their opponents in exchange for the implementation of the government's austerity plans. From this strategy, the Round Table was born. Jaruzelski hoped to thread a domestic and international needle: gain domestic agreement on austerity, then receive international relief from the country's debt burden, and only then, implement limited political liberalization. In the event, political and economic liberalization happened in reverse, and communism collapsed in Poland. In June, the country held its first relatively free elections; in August, Mazowiecki became prime minister; and only in September, did Mazowieki's Finance Minister, Leszek Balcerowicz, announce the eponymous economic plan that would radically transform the economy. In 1989, parliamentary democracy and market capitalism successively arrived in Poland not because of a miraculous popular movement for change, but because of Western capitalists' demand for

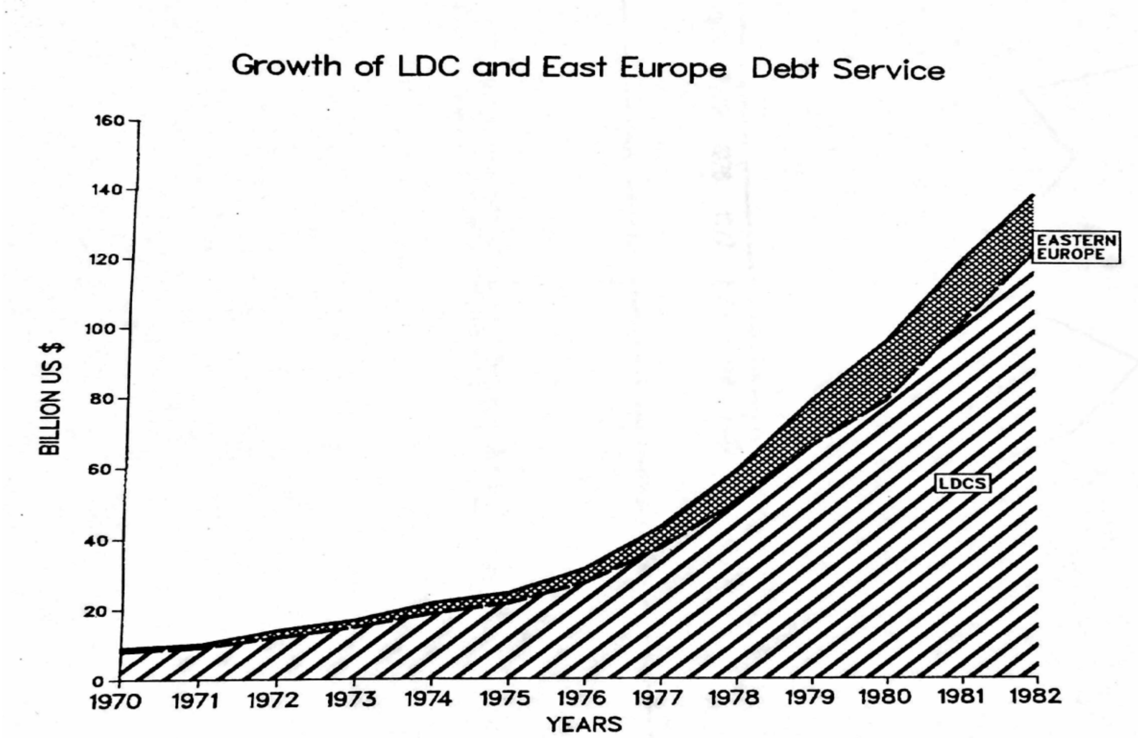
[489] Poland's Western creditors and potential creditors comprised three groups. First, Western nations who held Polish debt gathered under the auspices of what came to be known as the Paris Club. Founded in 1956 as an ad hoc forum for public creditors to discuss Argentina's debt troubles, the Paris Club grew over the next thirty years into a permanent institution for the settlement of debt reschedulings between creditor and debtor nations. Second, Western commercial banks who held Polish debt gathered under the auspices of the London Club, a forum founded in 1970 and modeled after the Paris Club. Lastly, in the late 1980s, Poland hoped to receive new loans from the International Monetary Fund and the World Bank. Poland had been a founding member of both organizations, but had withdrawn from each as part of the Stalinist exodus from international financial institutions in the 1950. In 1986, the country rejoined both organizations, but did not receive credits from either organization immediately.

austerity and a failed government strategy for survival. Seen in this light, 1989 becomes not an exceptional year that ended the Cold War, but one of many chapters in the global history of political change that travelled in the wake of sovereign debt.

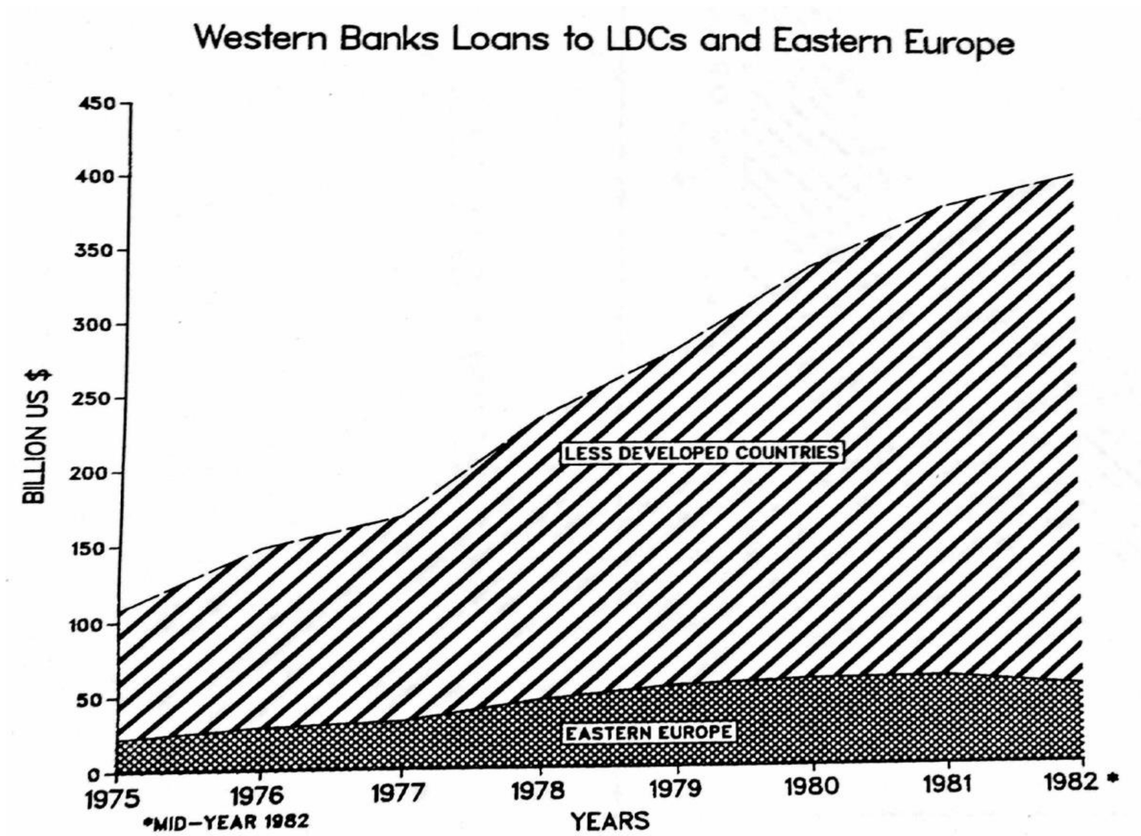
Global Debt and the IMF in the 1980s

As I discussed in the first two chapters, Poland and the countries of the Eastern Bloc partook in a global borrowing and lending binge that enveloped the global economy as governments adjusted to the two seminal economic shocks of the 1970s. First, in 1971, the United States stopped defending the fixed value of the dollar to gold, which set off a sustained devaluation of the dollar and ushered in the era of floating exchange rates. As the value of the dollar fell, the global money supply exploded, and inflation followed quickly. Then, in late 1973, the Organization of Petroleum Exporting Countries (OPEC) embargoed oil shipments to Western countries in response to the United States' and Western Europe's support for Israel in the Yom Kippur War, quadrupling the price of oil from $3 to $12 a barrel. The global economy was thrown into imbalance as oil exporting countries garnered enormous surpluses of US dollars and oil importing countries sank into balance of payments deficit as the price of their imports far outpaced the value of their exports. Economists and policymakers struggled to find a way to "recycle" the "petrodollars" now in the hands of oil producers back into the coffers of oil importers. International institutions, led by the IMF, created credit instruments to aid this adjustment process, but the vast majority of this recycling eventually took place through private Western commercial banks that accepted deposits from oil producers and then lent the money to countries around the world (including back to oil producers). Awash in liquidity, the world's financial markets became a financial Wild West in the 1970s and a cheap source of capital for governments looking to borrow money in order to pad their domestic popularity by providing cheap consumer goods, housing, and energy. While U.S. dollar inflation remained high throughout the 1970s, the real interest rate (nominal interest minus inflation) on sovereign loans hovered close to zero, further encouraging governments to avoid difficult policy choices and borrow from their future to please their present constituents. Poland began the 1970s with a negligible national debt, but after riots shook the country in 1970, state leader Edward Gierek added his country to the global glut of borrowing in the hope of "relaunching" socialism and placating domestic foes. Similar to many governments throughout the Global South, the Gierek regime used the borrowed capital to subsidize food, housing, and energy prices, raise workers' wages, and launch extravagant investments in heavy industry.

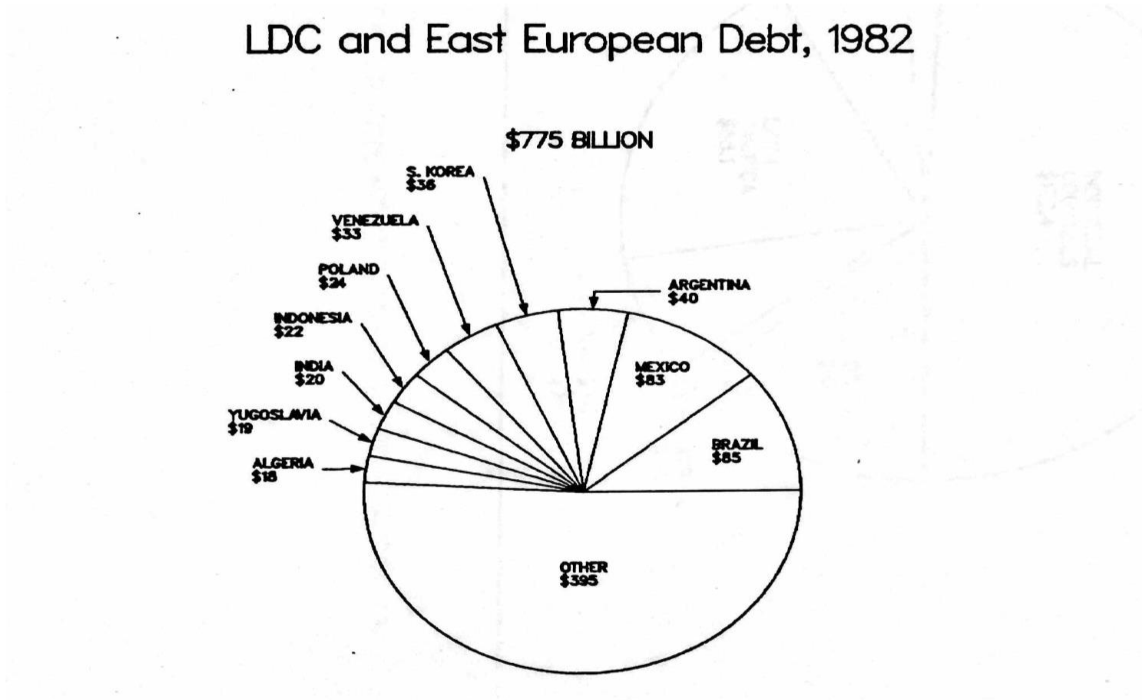
Looking back on the decade of debt in 1983, the staff of the US National Security Council graphed the growth of global debt in the following way. Less Developed Countries (LDCs) and Eastern Europe were pictured as part of the same history of the growth of sovereign debt. When combined, LDCs and the Eastern Bloc had $775 billion in total debt, and owed about $140 billion in debt service by 1982. Poland, with its $24 billion in debt, was the sixth largest debtor nation in the developing world.



Growth of LDC and East Europe Debt Service
160
140
120
100
80
60
40
20
0
BILLION US $
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
YEARS
EASTERN EUROPE
LDCS



Western Banks Loans to LDCs and Eastern Europe
450
400
350
300
250
200
150
100
50
0
BILLION US $
LESS DEVELOPED COUNTRIES
EASTERN EUROPE
1975
1976
1977
1978
1979
1980
1981
1982 *
*MID-YEAR 1982
YEARS



Figures 1-3: Graphs from the National Security Council on the global debt burden in 1982, as the Sovereign Debt Crisis began to unfold. They demonstrate that the NSC conceived of the Eastern Bloc as a special case in point of a larger global process, namely the borrowing glut that had unfolded since 1970.[490]

Bookended by economic shocks, the Roaring 70s of debt ground to a halt at the end of the decade through a tripartite jolt to the global economic system. In October 1979, US Federal Reserve Chairman Paul Volcker announced a series of policies designed to restore credibility to the Fed's commitment to lower inflation. Through two years of extremely high interest rates in the United States, Volcker's policy worked, and with it, the real interest rates on sovereign loans skyrocketed. Volcker's shock also sent the developed economies of the West into the deepest recession of the postwar period, thus eliminating the major export markets for the products of the developing world. Finally, the depressed demand in industrialized nations that accompanied the

[490] Graphs available in RAC Box 3, File "International Finance 10/12/83 – 11/8/83," Roger Robinson Papers, RRPL.

recession collapsed the high commodity prices of the 1970s upon which developing countries depended for hard currency.

The result was a perfect storm for global economic crisis. Poland was one of the first countries to reach insolvency in the aftermath. By 1981 the country's debt sat at $24 billion, and the government was unable to pay back the loans maturing that year. In the spring, it entered its first rescheduling agreements with Western governments and banks, and when General Jaruzelski declared martial law in December 1981, his government stood in de facto default on its debt obligations. Poland's inability to pay shook the confidence of Western banks in the entire process of sovereign lending, as it became clear that sovereign loans were not a riskless proposition. Banks stopped making new loans to debtors so they could "roll over" the old ones, and the debt dominoes began to fall. In 1982, the IMF and Western central banks had to bail out Hungary, Romania, and Yugoslavia, while the Soviet Union faced a temporary shortage of hard currency; and East Germany was desperate for new credits. Then in August, the full scope of the crisis emerged when Mexico, the second largest sovereign debtor in the developing world, announced that it could not make its debt payments. The two other cornerstones of the sovereign debt market, Argentina and Brazil, followed suit in the fall of 1982, and the global economy suddenly hung in the balance. The financial magazine *Bank Credit Analyst* wrote, "Gradually, piece by piece, the international financial jigsaw puzzle is coming apart, and in the process destroying the assumptions on which it was built up in the first place."[491] By 1985, US Secretary of State George Schultz estimated that $100 billion in capital had fled from Latin America alone

[491] Quoted in Norman Bailey to William Clark, "Bank Credit Analyst," April 28, 1982, RAC Box 3, File "International Finance 4/20/1982-11/16/82, RRP, RRPL.

since 1980.[492] The history of how governments, international financial institutions, and banks responded to this crisis cannot be told here. It is the implications of the collapse in sovereign lending that are most important for our purposes. As Harold James has written, the sovereign lending bust "created a 'debt trap' from which those countries that had been ensnared found escape hard and very painful."[493]

Into the breach stepped the International Monetary Fund. By the late 1970s, the IMF had developed a principle (conditionality) and a process (structural adjustment) for dealing with debtor countries. When the debtor reached insolvency and came to the Fund seeking assistance, the IMF would establish a structural adjustment program (called a standby agreement) that set out economic conditions that the debtor would have to meet before, during, and after IMF loans were dispensed. In 1979, as the number of IMF adjustment programs grew in unison with the scale of the debt problem, the Fund published its *Guidelines on Conditionality*. Noting that the Fund would "pay due regard to the domestic social and political objectives" of debtor governments, the conditionality guidelines had one primary goal, often referred to as "strengthening the country's external position" or "achieving a current account surplus." So that foreign debts could be repaid, the IMF sought to make the debtor country a net exporter of capital within a year of the implementation of a standby agreement. To achieve this singular goal, the Fund maintained a long list of policy prescriptions that affected every facet of a debtor's economy: devaluing the national currency and eliminating exchange controls, eliminating the government budget deficit through cuts in investment and public subsidies, raising domestic interest rates to encourage domestic saving and halt inflation, privatizing state-

[492] Harold James, *International Monetary Cooperation Since Bretton Woods* (New York: 1996), 358.
[493] James, *International Monetary Cooperation*, 323.

owned industry, lowering import tariffs, eliminating domestic price and wage controls, strengthening bankruptcy laws to eliminate inefficient enterprises, and eliminating barriers to foreign investment.[494] The IMF discussed these prescriptions in a language only familiar to economists. Phrases such as “implementing demand restraint,” “eliminating liquidity overhang,” and “instituting a decline in the real wage” held fundamental importance to IMF economists, but appeared as an Orwellian shield of economic jargon to the populations on the receiving end of these policies. What appeared as “eliminating market imbalances,” “introducing liberalization,” and “withstanding dislocative effects” on briefing memos in the Fund’s Washington, D.C. headquarters became crippling unemployment and price increases on the streets of Rio de Janeiro, Kingston, Manila, and eventually, Warsaw. In 1989, the Solidarity leader Bronisław Geremek would lament to American representatives that the IMF had “a special language” that the union was struggling to understand, and it was this rigid economic nomenclature to which he referred.[495] Nor was he alone. As the IMF took on a larger role in the politics of developing countries during the 1980s, it was often accused of forcing the messy reality of life on the ground in a country to conform to its jargon-laden economic models.

In addition to erecting a barrier between the Fund’s policy recommendations and their humanitarian implications, the IMF’s jargon has also obscured the political implications of structural adjustment from all but a few Cold War historians (Latin Americanist and Africanist historians, by contrast, have long examined the political implications of the IMF’s policies through their varied studies of neoliberalism). Put simply, structural adjustment toppled

[494] James, *International Monetary Cooperation*, Chapter 11 and 12 discuss the development and implementation of these policies well.
[495] Memorandum from AmEmbassy Warsaw to SecState, Sept. 5, 1989, Folder “Poland Cables January – September 1989,” Box 34, SFC, NSA.

governments. As the debt crisis swept across Latin America, governments did all they could to avoid the cost of adjustment but it ultimately caught up with them. Hal Brands has written, "The move toward economic liberalism entailed potentially severe social and political costs, and Latin American governments avoided paying this price as long as they could," often by "leaving the truly wrenching decisions to the next government." Ultimately, though, few "dictatorial regimes…survived the fallout from economic disaster" caused by IMF-mandated austerity. As one Brazilian business publication warned while the country faced economic crisis, "The dark clouds accumulating on the horizon…will only be dissipated with an authentic and democratic government."[496] Academic research since the 1980s has reinforced Brands's conclusion that "democratization was the product of debt."[497] For the nations of the Eastern Bloc, the effects of sovereign debt proved to be no different.

The Road to Reckoning

Like its dictatorial counterparts in Latin America, Poland's communist government did its best to avoid the dramatic implications of the global debt crisis for as long as possible. Cold War politics abetted their avoidance. After the declaration of martial law in 1981, the administration of US President Ronald Reagan coordinated a credit blockade of Poland with its

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[496] Hal Brands, *Latin America's Cold War* (Cambridge, MA, 2010), chapter 8. Quotes at 224, 233.

[497] Brands, 224. See James, *International Monetary Cooperation*, 386. Barbara Stallings and Robert Kaufman, eds. *Debt and Democracy in Latin America* (Boulder, CO, 1989). Karen Remmer, "Democracy and Economic Crisis: The Latin American Experience," *World Politics* 42 (1990), 315-335. Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman, OK, 1991). Peter Smith, *Democracy in Latin America: Political Change in Comparative Perspective* (New York, 2012). Kurt Weyland, "Neoliberalism and Democracy in Latin America: A Mixed Record," *Latin American Politics and Society* 46:1 (Spring 2004), 135-157.

Western European allies. Western governments refused to grant Poland new credits or negotiate to reschedule its outstanding debts until the Jaruzelski government released all Solidarity members from prison and repealed martial law. This served to both punish the Polish government (it had no access to new credits) while also relieving it of the worst consequences of debt (it did not need to pay back Western governments while they boycotted). By 1985, the government had missed over $9.5 billion in payments to Western governments, but faced no punitive action for doing so.[498] It was impossible for Western governments to do less than they were already doing. Western commercial banks, less troubled by political considerations than their government counterparts, did everything they could to get their money back. A general feeling of "acute suspicion" toward Poland's economic prospects prevailed among the banks, and most of them sought to write down their Polish loans as losses, cut their exposure to the country, and run for more profitable hills elsewhere in the global economy.[499] As an American banker put it in 1985, the banks' strategy for Poland "focuses on draining the country of as much cash as possible."[500] This strategy resulted in four rescheduling agreements with the Polish government by 1985. In each agreement, the banks rescheduled 95% of the loan principle, but received the interest payments from the government on time. In addition, to prevent the government from walking away from the negotiating table or repudiating the debt outright, the banks provided minimal credits to Poland to fund limited amounts of international trade. These

[498] Manison to Whittome, "Poland: Meeting of External Payments Obligations," Feb. 20, 1985, Box 36, File "Poland 331- Paris Club Meetings 1985-1986," Country/Country Desk Files, Central Files, IMF.
[499] "Acute suspicion" in L.A. Whittom, Memorandum for Files, "Poland," March 25, 1985, Box 36, File "Poland 330 - Meetings with Banks 1981-1989," Country/Country Desk Files, CF, IMF.
[500] Paul McCarthy, "Poland: The Long Road Back to Creditworthiness," July 21, 1986, Poland - corresp. and memos 1986 (Jan. - Sept), Box 60, EUR Country Files, IMF Archives, Washington, D.C.

credits totaled about $0.9 billion annually from 1982-1984.[501] Additionally, Western governments had guaranteed many of the banks' loans during the period of international détente in order to encourage commerce and political goodwill across the Iron Curtain. Thus, when Poland failed to pay a loan on time, a bank could simply turn the loan over to the government and receive payment in full. All tolled, the banks' strategy paid off handsomely: during the 1980s it received an average annual "take out" of $2 billion each year in interest payments.[502]

The combination of Western governments' refusal to negotiate on debt and the banks' cut and run strategy dramatically restructured the composition of Poland's debt. At the height of the Polish crisis in 1981, banks held about two-thirds of Poland's sovereign debt to the governments' one-third. By 1989, these ratios had switched, with the governments now holding two-thirds of what had grown to be $39 billion in debt.[503] This transition in the composition of Poland's creditors had one profound implication for the country's negotiating position: it transformed the debtor/creditor relationship from one of interdependence to one of dependence. In 1981, when the banks held $16 billion in exposure to Poland, they genuinely feared a Polish default because it could send them into bankruptcy. A Polish default posed a systemic risk to the Western financial system. But as more and more Polish debt moved from Western banks to Western governments, the Jaruzelski government lost the only power it had in its relationship with its creditors – the threat of mutually assured destruction. Once governments held the majority of Polish debt and banks had limited their exposure, there was no financial reason for either banks

[501] "Poland – Debt Restructuring," Undated, Box 60, File "Poland - corresp. and memos 1986 (Jan. - Sept)," EUR Country Files, IMF.
[502] Find Citation
[503] Mark Allen to Mr. Russo and Mr. Boorman, "Poland: Posture Toward the Commercial Banks," Oct. 3, 1989, Box 63, File "Poland – Mission – October 1989," EUR Country Files, IMF.

or governments to offer the country new credits. If Poland did not pay back its loans on time (as happened throughout the decade) it caused Western governments little harm. Unlike the banks' balance sheets in 1981, the balance sheets of governments could withstand Poland's failure to pay. Governments could, and did, simply wait until Poland's lack of access to global capital markets caught up with the government, and it was forced to negotiate on the terms dictated by Western states. The terms of Western financial rapprochement appeared simple: come to an agreement with the IMF, and new money could begin to flow. With the diversity of Western capitalist interests funneled into a single organization, the IMF's relationship with the Polish government came to define Poland's relationship with the West.

The extent of the banks' disengagement and the governments' disinterest in providing new credits was not at all clear to Poland's Finance Ministry. In fact, through the end of the decade, Polish officials consistently underestimated what it would take to regain the favor of both the governmental and financial communities. It was as though they believed the collapse of the sovereign debt market in the early 1980s was a temporary break in the action on the capital markets that dominated the 1970s, rather than a fundamental reordering of how international finance was conducted. The same went for government loan guarantee programs – it was only a matter of time, Polish officials believed, before Western governments would return to the policies of the 1970s. In addition, the global nature of the debt problem led the Poles to believe that eventually Western nations and banks would decide to forgive large portions of sovereign debt. The health of the global economy, it was believed, demanded it. (In this belief, the Poles were not alone – many in the developing world called for such a policy). One IMF memo noted that a segment of the Polish leadership believed the country could ignore its debt obligations "and hopefully the impatience of foreign creditors would be contained until such time as there was a global solution to the debt problem." With the money saved from debt payments, the government could increase imports "and hopefully buy the continued acquiescence of the population." At the time, the IMF concluded that this was not the predominant government policy – Polish officials had said all the right things about implementing austerity and reform.[504] But as the last years of the communist period unfolded, this is precisely the strategy the government pursued. By delaying reform and waiting for the West to renew its financial largesse, the country fell into a deeper debt trap, as every new rescheduling agreement simply compounded maturing debt payments into new future obligations. Thus, although the country's debt burden grew from $24 billion to $39 billion from 1981 to 1989, Poland received virtually no new capital from the West during this period. It was a strategy that would cost the government dearly.

The first sign of this strategy came in 1985, when Zbigniew Karcz, the Finance Ministry's international representative, began negotiations anew with Western officials after the dark years following the declaration of martial law. His expectations were wildly out of step with those of Western governments and the IMF. Karcz told Western officials he expected a "full normalization" of financial relations with the West, which he defined as not only a full debt restructuring, but also $1.3 billion in new credits. Additionally, he told his interlocutors he anticipated raising a fresh $500 million from Western banks.[505] Making matters worse, the government had little understanding of the depth of reform that would be required before new money would be made available, or how to carry it out. They did not speak the IMF's "special

[504] L.A. Whittome to The Managing Director and the Deputy Managing Director, "Poland," Jan. 27, 1987, Box 5, Poland (1987), Country Files, Office of the Managing Director Founds, Richard D. Erb, Sous-Fonds, IMF.
[505] Peter Hole to the Acting Managing Director, "Poland –Staff Visit," Feb. 27, 1985, Box 60, File "Poland – Staff Visit for Discussions on Membership," EUR Country Files, IMF.

language." After recalling a meeting where Karcz had stated that the Finance Ministry could not raise interest rates until inflation had gone down, U.S. Treasury officials lamented to the IMF, "Polish officials simply did not grasp the essentials of a stabilization-cum-reform program."[506] The Fund began accepting Polish economists to its courses for government officials because there was "a very real need to familiarize Polish officials at different levels with the theory and practice of 'indirect' methods of macroeconomic policy management."[507]

The vast difference between Poland and its Western creditors crystallized in a long-running debate between the two sides over a foundational IMF priority: the speed with which Poland would agree to move to current account surplus; or in other words, the year in which it would become a net exporter of capital. When Poland rejoined the Fund in 1986, the government was in the midst of a highly touted "second stage" of economic reform that was meant to further the first set of reforms instituted after the declaration of martial law in 1981. On paper, and thus also in government rhetoric, the second stage reforms aligned with the IMF's vision for the country: the achievement of "market equilibrium" through price increases, subsidy reductions, tighter credit policies, liquidation of inefficient and energy-intensive enterprises, and the reduction of price and foreign exchange controls. Privately, the Fund would come to deride the government's effort as "a shopping list…put together very quickly" that made no attempt at "quantification" and paid "only lip service to external sector objectives."[508] Publicly, the Fund reported that it had a "good deal of sympathy" with the goals of the second stage, but criticized

[506] Peter Hole, Memorandum for Files, "Poland," Jan. 22, 1985, Box 60, File "Poland – Staff Visit for Discussions on Membership," EUR Country Files, IMF.
[507] Peter Hole to Mr. Whitfield, "Mr. Stefan Krecisz," Nov. 7, 1986, Box 24, File 1, EUR Division Country Correspondence Files (EUR DCCF), IMF.
[508] Memorandum for Files, "Highlights from the Draft Document Outlining the 'Second Stage' of Economic Reforms (in Polish)," May 27, 1987, Box 24, File 1, EUR DCCF, IMF.

the government for devoting "much more attention to the statement of objectives than to the means of their attainment."[509] The problem was politics. In the fall of 1986, Fund economists reported after a trip to Warsaw, "there was a rather intense debate…currently in process inside the Polish government, in connection with the finalization of the Five Year Plan for 1986-90, on the further course of economic policy." The staff disappointedly reported, "the variants of the plan discussed so far appear to portend no significant current account adjustment – in fact there is a possibility of some deterioration." Fund representatives told the government this was "inappropriate and unsatisfactory."[510] Karcz responded a few weeks later. Indeed, difficulty "lay ahead in the practical application of general principles," and the government would try to reduce subsidies on "coal, milk, and foreign trade." But as an experienced Polish bureaucrat who had lived through the birth of Solidarity in the early 1980s, Karcz feared the "social tensions in response to the associated price increases."[511]

So did the West. American officials "feared an adverse social reaction in Poland to the measures which a Fund program would have to contain," and the IMF recognized that its policies needed to account for "the bounds dictated by the political and social constraints of a country."[512] In fact, the Fund viewed its challenge in Poland as a negotiation between the demands of capital and labor. Hans Schmitt, a staff member in the IMF's European department, wrote in 1986 that for structural adjustment to be "tenable in Poland it must be acceptable both to bankers abroad

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[509] Prust to Whittome, "Poland – Your Meeting and Lunch with Mr. Krowacki and Colleagues," April 28, 1987, Box 24, File 1, EUR DCCF, IMF.
[510] "Draft Statement for the Paris Culb – Tour d'Horizon Discussion on Poland," Sept. 11, 1986, Box 24, File 1, EUR DCCF, IMF.
[511] Memorandum for Files, "Poland – Meeting with Polish Delegation to Annual Meetings," Oct. 2, 1986, Box 24, File 1, EUR DCCF, IMF.
[512] "Adverse social reaction" in Prust to Whittome, "Poland – Paris Club Meeting," April 3, 1987, Box 24, File 1, EUR DCCF, IMF. "The bounds…" in Memorandum for Files, "Poland: Price Realignments – A Review of Issues for Discussion," Oct. 9, 1986, EUR DCCF, IMF.

and labor at home. At the moment the requirements of each seem to be incompatible with one another." The incompatibility stemmed from a fundamental difference in the direction that capital and labor wanted money to flow across Poland's borders. The banks (and governments), seeking to recoup their investment, wanted to establish conditions in Poland that would allow for a sustainable outflow of capital from the country. Labor, seeking to improve its plight after years of economic hardship, wanted capital to remain in the country. Schmitt noted this difference in his memorandum. "Bankers require a surplus on external current account large enough to ensure the progressive repayment of debt, and an adjustment in domestic demand (and in wages) large enough to produce it." On the other hand, "labor requires a minimum growth in wages (and in domestic demand) and a deficit on external current account large enough to finance any shortfall in GDP to support it." The IMF, he concluded, "need[s] to find where, if anywhere, the twain can meet."[513]

The Fund was acquainted with the interests of Polish labor because of its communication with Solidarity, which began in 1985**.** Solidarity leader Bronisław Geremek eventually had to remind Western officials that Solidarity was "probably the only labor union in the world" that welcomed its nation's membership in the IMF.[514] Indeed, it had. But it had done so while also registering its opposition to austerity measures that would result in a drop in Polish living standards. Through its Coordinating Office Abroad in Brussels, the Solidarity leadership informed the IMF that it would "come out strongly against measures leading to the substantial reduction of consumption, increases of prices, freezes on real wages or deterioration in social

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[513] Schmitt to Whittcome, "Poland – Negotiating a Program," June 25, 1986, Box 60, File "Poland - corresp. and memos 1986 (Jan. - Sept)," EUR Country Files, IMF Files.
[514] Memorandum from SecState to AmEmbassy Warsaw, May 23, 1989, Box 35, File "May 16-30, 1989," SFC, NSA.

care." The organization's stand against these measures came not from "a trade union bias," but instead out of the belief that such policies would "increase the danger of an uncontrolled social explosion." Despite its misgivings about austerity, Solidarity hoped that the IMF's powers of conditionality could lead to significant changes in government policy. The attachment of "political conditions" to Poland's use of IMF resources, the group wrote, was "absolutely essential." Specifically, the Solidarity leadership encouraged the IMF to embrace their long-standing policy goal of trade union pluralism – the right of workers to establish and join organizations of their own choosing. Since the declaration of martial law in December 1981, the government had outlawed Solidarity and only allowed workers to join the government-controlled unions, the All Polish Trade Unions Agreement (Polish acronym, OPZZ). The reintroduction of trade union pluralism, Solidarity wrote, would "ensure an atmosphere and mechanisms for peaceful conflict-resolution in enterprises" and avoid the bouts of labor unrest that had sporadically struck Poland throughout the postwar period.

The IMF did not normally pursue political conditionality, particularly when it would result in an increase in the bargaining power of labor, and the discrepancy between political and economic conditionality would come to play a significant role in the history of 1989. But in other areas, Solidarity documents read as though IMF officials had in fact written them. First, with regard to Poland's investment policy, the Solidarity committee declared that IMF funds should only be invested in "the manufacture of goods exportable to Western markets, because only then the real efficiency can be assessed." The communist government was intent on restarting the "programme of the 1970's, which envisaged [the] building of big, inefficient factories" that could not produce internationally competitive products.[515] If these investments continued, the Solidarity commission (and the IMF) feared that it "may lead to the petrifaction of the obsolete and inefficient structure of production" that led the country into its economic quagmire.[516] Second, both Solidarity and the IMF wanted the government to guarantee equal treatment of all sectors of the economy – the private, cooperative, and public. Third, both organizations wanted to end the state monopoly of the banking system and instead create "autonomous, self-financing commercial banks." Ultimately, to the Solidarity committee, it appeared as though its long-term goals aligned well with IMF. "Solidarity would like to see Poland in the IMF," they wrote, because "it would be more beneficial for the country to be bound with the West" than with the inefficient Soviet trade bloc, Comecon.[517]

Nevertheless, the impasse between labor and capital remained. Increasingly, capitalists in the West concluded that it would require a political solution. Specifically, it would require political legitimacy in Poland. Paul McCarthy, a Vice President of Chemical Bank in New York responsible for relations with the Eastern Bloc, wrote a prescient article in 1986 that laid out the challenges facing Poland from the perspective of an international banker. "The future actions of Western lenders are interrelated with Poland's handling of its domestic difficulties," McCarthy wrote. "New money will be unlikely until the Polish government can assure political stability. Political stability cannot be guaranteed unless the government can fundamentally overhaul the

[515] Memorandum from the Economic Comission of the Parisian Collective – Solidarite avec Solidarnosc – to Peter hall and A. Whithome. Sept. 17, 1985. Folder "Polish Trade Union 'Solidarnosc'", Box 1, Country Files, Central Files, IMF Archives, Washington, DC.
[516] "NSZZ 'Solidnarosc' Summary Position on the Issue of Poland's Membership in the International Monetary Fund," Feb. 1, 1985, Folder "Polish Trade Union 'Solidarnosc'", Box 1, Country Files, Central Files, IMF Archives, Washington, DC.
[517] Memorandum from the Economic Commission of the Paris Collective, Sept. 17, 1985, IMF Archives.

economy….The economy cannot be structurally reformed without the support of the Polish people and workforce." If he could make this logical digression, McCarthy assumed Jaruzelski could as well. And with the political implications of seeking the support of the Polish people all too clear, McCarthy feared Jaruzelski would be reluctant to undertake reform at all. This was where the IMF could play the vital role of catalyst. "The IMF has a major bargaining chip," McCarthy wrote, "in that it controls the single commodity that Poland currently needs the most and is least able to attain. The Fund can provide substantial credits, ranging to $700 million annually." Moreover, "IMF loans could begin attracting new credits from banks and governments." Only with the credibility of an IMF standby agreement could the Polish government "refocus the efforts and interests of Western commercial banks on an economic growth approach." But Western creditors would only change once Jaruzelski gained domestic legitimacy for austerity. McCarthy saw a fundamental connection between structural adjustment and political reform. "If Jaruzelski seeks reform without enfranchising the major constituencies, he risks failure. Meaningful reform will require the support of the Polish people, as further substantial cuts in living standards would be inevitable."[518]

By early 1987, the Fund was making a timid version of this point to Polish officials. In February, the Managing Director, Jacque de Larosiere, sat down to lunch with the President of the Polish National Bank, Wladysław Baka. Baka reprised the now familiar refrain of the Polish government. There "were no major differences of substance between his Government and the Fund," but Baka believed the Fund wanted Poland to move too fast to current account surplus. There were "major political and social obstacles" to austerity, and therefore "it was unrealistic to

[518] Paul McCarthy, "Poland: The Long Road Back to Creditworthiness," July 21, 1986, Poland - corresp. and memos 1986 (Jan. - Sept), Box 60, EUR Country Files, IMF Archives, Washington, D.C.

look for a reduction in consumption." Instead, Poland and the IMF should try to grow their way out of the current economic problems. The solution "had to rest on a rapid growth in exports," but this would require "a more modern capital stock and a higher level of imports," which in turn would require new credits from the West.[519] Despite Baka's assertions to the contrary, then, there were substantial differences between Poland and the Fund. Baka told Fund officials after the meeting that before the government attempted a domestic austerity program that risked a social explosion, it planned to further test the limits of Western resistance to providing new credits. Baka and the government continued to believe they could get both debt relief and new credits from the West.[520] Indeed, the growth-oriented course that Baka advocated remained precisely the opposite of the austerity-laden course favored by the Fund. De Larosiere admitted the government was in a tough position, but both Western governments and banks favored austerity, and thus it needed to be "implemented boldly (preferably in one stroke)" in order to convince them "that policies in Poland had changed radically for the better." This would not be easy, and it needed to be "acceptable to the population." Thus, "some preparation of public opinion would be necessary."[521]

Attempting Austerity without Political Legitimacy

By the summer of 1987, General Jaruzelski had begun to agree with the Fund that public opinion needed to be primed. At the end of July, he gave an interview to *The Wall Street*

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[519] [519] Memorandum for Files, "Poland – Managing Director's Lunch with Professor Baka," Feb. 26, 1987, Box 24, File 1, EUR Division Country Correspondence Files, IMF.
[520] L.A. Whittome to the Managing Director and the Deputy Managing Director, Feb. 26, 1987, Box 5, File "Poland (1987)," Country Files, Office of the Managing Director Fonds, Richard Erb Sous-Fonds, IMF.
[521] Memorandum for Files, "Poland – Managing Director's Lunch with Professor Baka," Feb. 26, 1987, Box 24, File 1, EUR Division Country Correspondence Files, IMF.

Journal in which he discussed the challenges facing his country. "As we've learned in the past," he began, "even the most beautiful and well-constructed decisions and intentions, if they do not command the support of society, they fail." Therefore, he was considering calling a national referendum on "painful but imperative" steps aimed at bringing the nation into "economic equilibrium," including price hikes, subsidy cuts, and the elimination of the present "centralistic [economic] model that hasn't passed the test of time." He cautioned the paper that the referendum was only a personal "thought" at present, not official government policy, but he stated his conviction to implement a new economic system by January 1, 1988. The general also took the opportunity to reproach the Reagan administration and the IMF for their unflinching refusal to grant the new credits that Jaruzelski believed were necessary to spur the economic growth required to pay the debt back. "The question is, can a hen that isn't fed actually lay eggs?" he asked rhetorically, "When no effort is made to meet us half way…my conclusion is that all this activity is intentional and masterminded."[522]

Notwithstanding the poultry-laced rebuke, Jaruzelski wanted the interview to signal to the IMF that public opinion preparations were underway. In a meeting with Fund representatives the day after the interview appeared, a Polish official said the referendum would "muster support for economic reform and austerity measures," and that the timing of the interview "was influenced…by hopes of a program with the Fund."[523] There were pressing domestic reasons to propose the referendum as well. In the years following martial law, the economy had modestly rebounded from its crisis low point, and the government had constructed a national narrative of economic progress to justify its repression. By 1987, the illusion of progress had faded, and a

[522] Karen Elliott House, Robert Keatley, and Barry Newman, "Jaruzelski Seeks Major Economic Reform," *Wall Street Journal*, July 30, 1987, 18.
[523] Jim Prust to Mr. Russo, "Poland," July 31, 1987, Box 24, File 1, EUR DCCF, IMF.

renewed deterioration in the economy was having a stark impact on society. An internal government report from August 1987 warned, “Generally, anxiety is rising due to the prolonged economic crisis. The opinion is spreading that the economy instead of improving is getting worse. As a result, an ever greater dissonance arises between the so-called official optimism of the authorities (‘after all, it’s better [now]’) and the feeling of society.” Furthermore, “the opinion is spreading that the government has only one ‘prescription,’ i.e. price increases. Against this background the mood of dissatisfaction is strongest among the workers.” In such a situation, the report saw Solidarity waiting to pounce. From the union’s perspective, “each action by the authorities in the economic sphere will be favorable to the opposition…a full implementation of reform…will result in a temporary decline in purchasing power, layoffs, etc.” Thus, “the adversary has come to the conclusion that it does not have to bother much – it is enough to sustain a mood of justified anger and wait and join, at the right moment, the eruption of dissatisfaction, as in 1980.”[524]

Best then to head off the dissatisfaction before the eruption. By the fall, the referendum had been officially set for the end of November. To their surprise, however, Polish officials found the IMF hesitant about the move. In a meeting with Politburo member Marian Woźniak, IMF official L.A. Whittome declared the referendum “a decision laden with heavy risk and probably unwise.” Woźniak explained that the government believed it had little choice; it could not rely on the official trade unions, the OPZZ, to support price and wage changes. In addition, “the credibility of the Party was not adequately strong nor was it easy to persuade the Party of the need to make such revolutionary changes.” The leadership therefore “faced a vacuum and

[524] “A Synthesis of the Domestic Situation and the West’s Activity,” Aug. 28, 1987, in *The End of the Cold War*, Cold War International History Project Bulletin (Fall/Winter 2001), 98-99.

chose a referendum." Looking back on the 1970s, Woźniak lamented that the government had not taken up reform earlier. "Events were too favorable and there seemed to be no need to change," he said. The easy credit of the Roaring 70s had propelled procrastination. Even at this late hour, Woźniak told Whittome of significant resistance to reform within the leadership. Whittome reported back to Washington, "The debates in the Politburo had been heated but [the leadership] had had some support from the Russians and certainly without Mr. Gorbachev's policies the [proposed] reforms could not have been so bold."[525]

To signal just how bold the reforms would be, Jaruzelski instituted a "spectacular reorganization" of the central state apparatus before the vote. This included the elimination of seven state ministries and a reduction of the country's deep ranks of deputy prime ministers to three. When referendum day came, citizens were asked two vague questions about "restoring the economy to a healthy state" and instituting "a far reaching democratization of political life." The government set a high threshold for success: a majority of all people eligible to vote, not merely those who actually voted, would be required for the referendum to pass. This made Solidarity's role as the disloyal opposition easy to play. The union simply encouraged people not to vote or vote "two times no." In the event, turnout was officially reported at 65%, with 66% of respondents favoring action on the first question and 69% favoring action on the second. After a round of national math, it became clear that the authorities had lost their bid for society's blessing by about 5%.[526]

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[525] Memorandum for Files, "Poland – Meeting with Mr. Wozniak, Politburo, October 23," Oct. 27, 1987, Box 24, File 3, EUR DCCF, IMF.
[526] Andrzej Paczkowski, *The Spring Will Be Ours: Poland and the Poles from Occupation to Freedom*, translated by Jane Cave (University Park, PA, 2003), 488-489.

In true authoritarian fashion, the government did not let defeat in referendum deter it from its reform plans. Jaruzelski told the Central Committee and the press in December that the referendum results did not indicate that the population did not want reform. Rather, he said, "a significant and important part of the society has doubts and fears" about the pace of change. Despite these societal misgivings, "reforms are a fact of life." Thus, instead of "a one-stroke radical restructuring," reform would be carried out over three years and with more attention paid to the interests of workers.[527] Instead of raising food prices by 40%, the government now planned to raise them 27% early in 1988.[528] And in a nod to that rather significant portion of society with "doubts and fears," the official trade union was allowed to negotiate a wage increase for its workers so that labor would "be fully compensated for cost-of-living increases."[529]

While the government sought domestic legitimacy at home with the referendum, its financial representatives sought debt relief abroad. In December 1987, the Finance Ministry signed a major rescheduling agreement with the Paris Club of government creditors that deferred for five years payment on roughly $10 billion in delinquent debt payments that the country had accrued since 1986.[530] Due to the nature of Paris Club agreements, the multilateral agreement signed in the French capital only took effect once a debtor signed bilateral agreements with each of its creditors. Thus, even though the agreement was signed, much work remained to be done to seal the deal. The devil, and Poland's hopes for debt relief, was in the bilateral details. Since Poland had signed its first rescheduling agreement in 1981, the government had continuously

[527] "Jaruzelski Says Reforms 'A Necessity' in Poland," Dec. 16, 1987, Box 38, File "Poland 914 - Economic reform 1987 and onwards," Country/Country Desk Files, Central Files, IMF.
[528] Jim Prust to Mr. Russo, "Poland," Jan. 22, 1988, Box 24, File 3, EUR DCCF, IMF.
[529] "Jaruzelski Says Reforms 'A Necessity' in Poland," Dec. 16, 1987.
[530] K.A. Swiderski to Mr. Russo, "Poland – Paris Club Meeting (October 29-30, 1987)," Nov. 2, 1987, Box 37, File "Poland 331 - Paris Club Meetings 1987-1988," Country/Country Desk Files, Central Files, IMF.

maintained that the interest rates charged on rescheduled debt were exploitative and had demanded rate reductions. Until 1987, this demand had come to no avail. Now, with the 1987 agreement in hand and domestic reform beginning to take shape for 1988, the government made one final stand. Reflecting the unrealistic expectations it had maintained since 1985, the Finance Ministry pressed Western states, and particularly West Germany, to soften the interest rates charged on the debt.

It proved to be a miserable failure. By March 1988, the Polish demand for rate cuts led the Paris Club to conclude that the country "was not seriously trying to reach agreement."[531] By April, the Poles had added the demand that new credits be attached to the bilateral agreements, leading to "fruitless" negotiations with West Germany, the United Kingdom, France, and Spain.[532] The problem with the Polish strategy was its disregard for Western nations' concerns about setting precedent. In debt negotiations, Poland was just one of many countries with which the West had to deal, so any concession granted to Poland would inevitably have to be granted to other debtors. On top of that, the West already considered its previous reschedulings with Poland "unusually generous debt relief."[533] This made Poland's requests nonstarters. Even Western governments favorably inclined to support reform in the Eastern Bloc, such as West Germany, quickly disposed of the Polish proposals. And yet the Poles continued to make them. As late as September 1988, no progress had been made on signing the bilateral rescheduling

[531] K. Burke Dillon to the Managing Director and the Deputy Managing Director, "Paris Club Meetings," March 31, 1988, Box 37, File "Poland 331 - Paris Club Meetings 1987-1988," Country/Country Desk Files, Central Files, IMF.
[532] Mememorandum for Files, "Poland – Meeting with Mr. von Korff," April 14, 1988, Box 37, File "Poland 331 - Paris Club Meetings 1987-1988," Country/Country Desk Files, Central Files, IMF.
[533] "Poland: Brief for the Managing Director's Visit to the United Kingdom," June 24, 1988, Box 24, File 3, EUR DCCF, IMF.

agreements because the Polish delegation continued the "same impossible refrain" of lower interest rates and new credits.[534] The Poles could tell themselves that they were the "'whipping horse' for U.S. animosity to the Soviet Union," but Western intransigence had much more to do with the desire to hold firm in relations with the developing world than it did with fighting the Cold War.[535]

The government's reform efforts at home faired little better than their search for relief abroad. Instead of bringing prices closer to market-clearing levels, the higher prices and wages implemented after the referendum set off an inflationary spiral. Sensing that prices would keep moving higher, many workers believed the wage increases were not enough. So in late April and early May, strikes ripped through the country. By June 1988, prices and wages were expected to rise 55% and 60%, respectively, for the year. This meant that far from declining, as the government hoped and the IMF demanded, the real wage of Polish workers was actually rising by about 5%.[536] Fund officials noted "a deep resistance to change" among the population and doubted that the government could withstand "the transitional costs" of economic reform.[537]

Thus, over the summer of 1988, IMF officials changed their tune. Instead of simply encouraging the government to "prepare public opinion," Fund officials started to suggest, and indeed demand, that the government build a "social consensus" around reform. On June 27, 1988, the Managing Director, now Michel Camdessus, suggested to the visiting Polish Deputy

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534 A.R. Boote, Memorandum for Files, "Poland: Negotiations with the Paris Club," Sept. 7, 1988, Box 37, File "Poland 331 - Paris Club Meetings 1987-1988," Country/Country Desk Files, Central Files, IMF.
535 A.R. Boote to Mr. Russo, "Poland: Professor Sadowski's Visit to London," June 24, 1988, Box 24, File 3, EUR DCCF, IMF.
536 Massimo Russo to Mr. Whittome, "Poland," June 24, 1988, Box 24, File 3, EUR DCCF, IMF.
537 L.A. Whittome to Mr. Russo, "Poland – Visit of Professor Sadowski," June 20, 1988, Box 61, File "Poland - corresp. + memos June - Sept 1988," EUR Country Files, IMF.

Prime Minister, Zdzislaw Sadowski, that "increased popular participation in political decision-making might…reconcile the population to the sacrifices required for economic stabilization."[538] Sadowski equivocated in response, but IMF officials persisted throughout the summer months. After the staff got wind of Polish "discussions of the linkages of economic and political reforms" in July,[539] the Deputy Managing Director told the Polish foreign minister that "socio-political issues" could become a concern of the IMF Executive Board "if they were seen to impinge on the viability of the proposed economic program."[540] At the country's annual meeting with the Executive Board in September, directors of the Fund pressed the government to build a "social consensus" around a decline in real wages for Polish workers.[541]

Polish workers had other ideas. On August 15th, miners at the Manifest Lipcowy coal mine went on strike, and soon, work halted at many other mines and ports across the country. Fearing that it was losing control of the country, the government reached out to Solidarity on August 20th to begin exploratory talks on how the two sides could begin a dialogue. By August 27th, the Interior Minister Czesław Kiszczak announced the authorities' willingness to engage "representatives of a variety of social and occupational groups." On August 31st, the eight-year anniversary of the Gdańsk Agreement that had orignally legalized Solidarity, Kiszczak sat down with Lech Wałęnsa. After Wałęnsa committed to halting the strikes currently underway, he and

538 Memorandum for Files, "Poland: MD's Lunch with Mr. Sadowski," June 27, 1988, Box 24, File 3, EUR DCCF, IMF.
539 Eugenio Lari to Mr. Barber B. Conable, "Poland – Visit of Foreign Minister Tadeusz Olechowski," July 25, 1988, Box 61, File "Poland - corresp. + memos June - Sept 1988," EUR Country Files, IMF.
540 Memorandum for Files, "Poland – Visit of Foreign Minister Olechowski with Deputy Managing Director," July 27, 1988, Box 61, File "Poland - corresp. + memos June - Sept 1988," EUR Country Files, IMF.
541 Memorandum for Files, "Poland: 1988 Article IV Consultation Board Discussion on September 14, 1988," Sept. 14, 1988, Box 61, File "Poland - corresp. + memos June - Sept 1988," EUR Country Files, IMF.

Kiszczak set about planning a collaborative process of political and economic reform. The roundtable was born.[542]

Trading Austerity for Democracy, but Forgetting the Austerity

In the early 1990s, General Jaruzelski reviewed the course of events that had led to his personal downfall and the end of communist rule in Poland. He concluded, "the economic failures of 1987-1989 convinced us that our methods were ineffective. Without letting into the power system the so-called constructive opposition, we were unable to overcome social resistance to necessary economic reforms. With this realization a rapid process was launched which led us to the round table."[543] From the government's standpoint, the logic of the roundtable was simple. As the Finance Minister told the IMF, "the main purpose of the round table talks is to offer a <u>political</u> concession so as to facilitate the implementation of the authorities' <u>economic</u> plans" (underlining original).[544] The new strategy envisioned simultaneous progress on both the domestic and international levels, and called for economic austerity to precede political change. Domestically, the government would co-opt the opposition into supporting austerity, and only then offer political concessions. The American ambassador in Warsaw wrote in January, "The authorities, facing seemingly intractable problems and in desperate need for broad social support, want to rope the opposition into accepting

[542] Paczkowski, *The Spring Will Be Ours*, 490.
[543] Jaruzelski quoted in Wiktor Osiatynski, "The Roundtable Talks in Poland," in Jon Ester, ed. *The Roundtable Talks and the Breakdown of Communism* (Chicago: The University of Chicago Press, 1996), 62-63, n 7.
[544] Jim Prust to Massimo Russo, "Poland – Missions and Visits," Feb. 2, 1989, Box 61, EUR Country Files, IMF Archives.

coresponsibility for the painful measures required. They do not want to govern alone."[545] The problem, as party member Aleksander Kwasniewski put it, was that "economic change requires many years, while political reforms are faster and easier to implement."[546] It was a problem the government would spectacularly fail to solve.

Internationally, Polish officials updated their excessive optimism about financial relations with the West to fit the new circumstances: with the roundtable underway, surely the West would finally offer new credits and debt relief in support of the evident political progress. Here was the government's final, critical error in dealing with the West. Despite the decades of Cold War rhetoric about human rights, political freedom, and democracy, Western purse strings were not responsive to political changes. Money moved when economic conditionality was met. Simply holding elections or legalizing opposition groups would not change Western policy. Polish officials from both the government and Solidarity misunderstood the true nature of Western priorities, and were therefore dumbfounded when Solidarity's legalization and parliamentary elections did not deliver them from the West's financial straightjacket. For this mistake, however, they cannot be faulted – as will be shown below, even State Department officials could not understand why Western governments did not embrace Poland's political transformation.

As 1988 turned to 1989, Solidarity was reluctant to play ball with the government's attempt to co-opt their position in society. The leadership hesitated to participate in the political process because it understood the challenges that would accompany economic reform. In January 1989, as the country prepared for the roundtable, Solidarity members often expressed a desire to suppress the movement's political ambitions and focus on protecting the interests of

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545 Memorandum AmEmbassy Warsaw to SecState, Jan 30, 1989, Box 35, File "January 1989," SFC, NSA.
546 Quoted in Osiatynski, "The Roundtable Talks in Poland," 42.

Polish workers under austerity. Zbigniew Romaszewski, a member of the national leadership commission, told a crowd in Poznan in early 1989, "political pluralism can wait, and in any case it is better pursued by others." The union, Romaszewski believed, should focus on achieving economic justice in the workplace as the country transitioned to "early capitalism" and softening the blow of the inevitable disruptions that would accompany the economic restructuring that lay ahead. In contrast to the union's previous focus on strikes to improve their workers' plight, Romanszewski now envisioned Solidarity programs emblematic of the startling labor mobility that would arise under capitalism: skill retraining, employment counseling, reimbursing relocation expenses, and administering small loans for the temporarily unemployed.[547] Bronisław Geremek agreed that Solidarity's focus should remain on its trade union activity, but also noted that political participation in reform was the "price they must pay" for the government's decision to legalize the union. Andrzej Stelmachowski believed it was necessary to "rebuild the social fabric" of the nation through the construction of a new political culture of clubs, associations, and political parties before the arrival of political pluralism. The American embassy in Warsaw noted the irony of having "a totalitarian regime begging for opposition participation in governing the country, while the opposition resists pressure to become involved."[548]

Before begging Solidarity, Jaruzelski first had to beg the Central Committee to go along with the roundtable. Wałęnsa had agreed to undertake the roundtable process on the condition that Solidarity, which had been officially outlawed since the martial law declaration in 1981,

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[547] Memorandum AmConsul Poznan to SecState, Feb. 2, 1989, Folder "Feb. 1-17 1989," Box 35, Soviet Flashpoints Collection, National Security Archive, Washington, D.C.
[548] Memorandum AmEmbassy Warsaw to SecState, Jan 30, 1989, Box 35, File "January 1989," SFC, NSA.

could retake its position in society. In practice, this meant legalizing (or relegalizing) the trade union.[549] Much of the Central Committee, the vast majority of the party rank-in-file, and particularly the state-sponored unions stridently resisted this prospect. After many heated debates at the January meeting of the Central Committee, Jaruzelski and three of his top advisors offered their resignations if the committee did not want to move ahead with legalization. After a vote, Jaruzelski prevailed, and plans for legalizing Solidarity after the roundtable was completed moved ahead.[550]

The roundtable opened with a large plenary session on February 6, 1989, but the substantive negotiations were immediately divided into three working groups: one to debate the specifics of trade union pluralism; one to negotiate political reforms; and one to discuss social and economic policy. Wałęnsa and Kiszczak had decided on two foundational points of agreement that would guide the discussion in the Trade Union and Political Reform Tables for the first month of negotiations. First, Solidarity would be legalized, not relegalized, so that the government did not have to admit that martial law was a mistake. And second, partially free elections would be held for the Sejm to ensure that the party retained control of the chamber but that Solidarity received a substantial minority. Difficult and important negotiations took place at the Trade Union and Political Reform Tables to finalize these two points, but they will not be discussed in detail here, except as they pertain to the economic reform discussions. No similar agreement was reached between the two leaders with regard to the economy. Given the

[549] For both Solidarity and the government, there was an important difference between legalizing and relegalizing the trade union. One implied that the union had never been legal in the first place, the other implied that the government had cracked down on a legitimate social movement when it declared martial law. In the end, Solidarity conceded its point, and the union was officially legalized after the roundtable.

[550] Osiatynski, "The Roundtable Talks in Poland," 64, n 17.

difficulty of reforming the economy, this was no surprise. Nevertheless, as the Economic Reform Table opened, it had none of the momentum that underlay the budding progress in trade union and political reform.

Despite their recognition and acceptance of the austerity that would necessarily come in the future, Solidarity officials pursued a policy at the roundtable meant to maintain their credibility with Polish labor. Their credibility was in question because Alfred Miodowicz, the irascible leader of the OPZZ, had begun to position the state-sponsored unions as the only remaining bastion of resistance in Polish society to the imposition of international capitalist exploitation. In this role, Miodowicz posed an equal threat to the PZPR and Solidarity. The State Department reported on the eve of the roundtable, Miodowicz "can represent himself as the only true defender of workers' rights against a cabal seeking to introduce free enterprise and impose wage restraints."[551] In the Economic Reform Table discussions to come, representatives from the PZPR and Solidarity would have to be ever mindful of the ironic prospect that the state-sponsored OPZZ, which had long appeared to be a naked tool of government manipulation, might actually win the hearts and minds of Polish workers.

Thus, as the three major parties in the negotiations – the PZPR, Solidarity, and the OPZZ – sat down to negotiate economic reforms, all three had scant interest in making concessions. Wladysław Baka, the former head of the national bank and now the party's representative at the Economic Reform Table, opened the discussion by inviting "innovative proposals on the economy" and proposed that the group be split into two subcommittees - one to address price and wage policy and another to address the country's foreign debt problem. Solidarity's

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[551] Memorandum AmEmbassy Warsaw to SecState, Jan 30, 1989, Folder "January 1989," Box 35, Soviet Flashpoints Collection, National Security Archive, Washington, D.C.

representative, Witold Trzeciakowski, protested initially that the foreign debt was the government's problem, and instead focused his proposal on demonopolizing the market, strengthening worker self-management, cutting the defense and internal security budget, and eliminating the *nomenklatura* system of preferential job placement for members of the communist party. He also introduced the issue that would come to define the debate in the committee: indexing wages across the country to the rate of inflation. Wage indexation was Solidarity's answer to the chronic problem of strikes. If wages could be guaranteed to move in tune with prices, the union believed it could both reinforce its credentials as a protector of labor and head off a "pay race" between different sectors of the economy.[552]

It was not to be. According to government figures, there were 173 strikes in January 1989. Just as the Economic Reform Table was convening in Warsaw on February 8th, coal miners in Belchatow went on strike for higher wages, and management caved to their demands two days later. Because it coincided with the opening of the roundtable economic discussions, the strike served as a warning to all parties involved that workers would not let their interests be negotiated away behind closed doors. By February 15th, there were roughly a dozen strikes going on across the country.[553] Both Solidarity and the PZPR attempted to minimize the significance of the strikes to their ongoing economic work at the roundtable, with the union going so far as to actively and vocally discourage workers from striking. Speaking to reporters in Gdańsk, Walesa told the nation, "every Pole has good reasons to strike," but warned, "Europe and the world are racing forward. If we start to get involved in the melees, in hustling strikes

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552 Memorandum from AmEmbassy to SecState, Feb. 9, 1989, Folder "Feb. 1-17 1989", Box 35, NSA.

553 Memorandum from AmEmbassy to SecState, Feb. 16, 1989, Folder "Feb 1-17 1989", Box 35, NSA. "Pay race" in Memorandum from AmEmbassy to SecState, Feb. 15, 1989, Folder "Feb 1-17 1989, Box 35, NSA.

along….we risk becoming Europe's and the world's backyard."[554] Sensing further opportunity to position himself and the OPZZ as the true defender of Polish labor, Miodowicz expressed no such qualms about the consequences of strikes, and actively encouraged the perception that the OPZZ stood behind much of the labor resistance during the roundtable negotiations.

With unrest swirling around them, the negotiators in the Economic Reform Table set to work. With Solidarity refusing to become involved in the foreign debt problems of the government, the discussion at the second meeting of the group focused on Solidarity's proposal to index wages to inflation. Against the backdrop of strikes across the nation and ever-increasing inflation, neither the government nor the OPZZ was in a position to directly oppose indexation. Thus, the discussion hinged on the level at which wages would be indexed. As the parties continued to negotiate, they slowly moved toward agreement on indexing wages at 80% of the inflation rate.[555]

Negotiations on prices were another matter entirely. At the second meeting of the working group, Deputy Prime Minster Kazimierz Olesiak called on classic tropes on liberal economic theory when introducing a proposal to free the retail price of food and the price for farm industry inputs, such as machinery and fertilizer. "Freeing up the prices of farm produce," he told a gathering of the press after the meeting, "will provoke competition and, as a result, production and supply of food will grow." For Solidarity, resisting price increases and demanding wage increases were two sides of the same coin in its quest to maintain legitimacy in the eyes of Polish labor. They therefore balked at the government's proposal, and a

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[554] Memorandum from AmEmbassy to SecState, Feb. 17, 1989, Folder "February 1-17 1989," Box 35, NSA.
[555] Memorandum from AmEmbassy to SecState, Feb. 15, 1989, Folder "February 1-17 1989," Box 35, SFC, NSA.

representative later told the American embassy that "taking responsibility for the food price issue" made the Solidarity leadership "very nervous." Nevertheless, they also knew that prices would have to be liberalized in any final economic agreement, and this liberalization would inevitably mean higher living costs for Polish citizens. Thus, in response to the government promotion of the benign effects of competition under market capitalism, Solidarity turned to the rationale that underlay the modern welfare state – the use of government spending to accommodate the unemployment and poverty inflicted by market dynamism. "Food stamps," the Solidarity negotiating team told the working group, should accompany any price liberalization.[556]

Similar dynamics affected the working group's negotiations over housing policy. Housing in Poland had long been a national disaster, and it grew worse with each passing year. By the late 1980s, Poles had to wait twenty years to move into an apartment of their own. Twenty-year waitlists constituted a problem that transcended political differences, so everyone at the working group table agreed that radical reform was necessary. Because of heavy government subsidy, housing prices had long ago stopped reflecting the social value and economic cost of the property. There was thus little incentive for construction firms to build new housing at a faster pace. To everyone at the roundtable, the solution was both obvious and painful – raise the price of housing. As with so many other areas of the economy, however, this solution would hurt millions of Polish citizens and force Solidarity to abandon its traditional labor interests. Aleksander Paszynski, the Solidarity negotiator in charge of housing policy, noted the contradictions of reform. Solidarity would have to "brutally" tell society that the era of cheap

[556] Memorandum from AmEmbassy to SecState, Feb. 15, 1989, Folder "February 1-17 1989," Box 35, SFC, NSA.

housing was over, and instead work to provide a social "safety net." He lamented the apparent trade off between "equity and efficiency," and told American officials, "as trade unionists, Solidarity leaders support higher wages and maintaining standards of living, but as supporters of economic reform, they find themselves backing higher prices and higher rents, even if this leads to greater income disparities." Solidarity, he concluded, would have to gamble that "more roofs" might offset dissatisfaction with "higher rents." [557]

Without concrete proposals to discuss, however, the gambles of the working group were made without real money and real commitments. One party at the roundtable needed to take the initiative of committing concrete proposals to paper and introducing them for discussion. At the third session of the working group, Baka took such a leap. Amidst proposed changes in wages, prices, and housing, Baka's draft contained one glaring flaw in the eyes of Solidarity's representatives, a flaw that signaled the ultimate overlap between the economic and political negotiations taking place during the roundtable process. The proposal contained no way for Solidarity to participate in the implementation of the agreement, but instead left control in the hands of the government. "If we are to sign a social accord," Trzeciakowski said, "We must control its implementation." The Economic Reform Table, Trzeciakowski reminded his tablemates, was not isolated from the work of the trade union and political working groups. The three were instead deeply intertwined. "A fundamental condition of [an agreement] is participation by society in decision-making."[558] This point of contention would outlive the

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[557] Memorandum from AmEmbassy Warsaw to SecState, Feb. 17, 1989, Folder "February 17-28 1989," Box 35, SFC, NSA.
[558] Memorandum AmEmbassy Warsaw to SecState, Feb. 21, 1989, Folder "February 17-28 1989", Box 35, SFC, NSA.

roundtable negotiations. Ultimately, Solidarity would not agree to any substantive economic plan until it had control of the government.

By the end of February, the list of complicated interwoven issues had grown so long that Trzeciakowski facetiously told the American economic counselor that he was "ready to quit." With the leadership of the OPZZ warning the public of a Solidarity-PZPR pact to sell out socialism and impose austerity, government and Solidarity officials had agreed to the 80% wage indexation even as they worried it would only increase inflationary pressure. Their economic judgment cautioned against such a move, but their precarious political credibility demanded it. Beyond wage indexation, however, neither side showed a willingness to sacrifice its core interests: Solidarity continued to resist freeing agricultural prices, while the government continued to resist cuts in military and investment spending and a reform of the *nomenklatura* system of party favoritism. Moreover, the government continued to spurn Solidarity's demand for a consultative Economic Coordinating Council to implement the accord. This left Trzeciakowski fearing that no agreement would emerge from the economic committee to match the agreements that had begun to emerge from the trade union and political committees.[559] Indeed, had it not been for the progress being made at the trade union and political roundtables, the Solidarity economic team likely would have walked out of the Economic Reform Table after a few weeks.[560]

In the best tradition of diplomatic negotiation, the solution to stalemate was to place hope in the remedial powers of subcommittees. The Economic Reform Table formed five: economic

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[559] Memorandum from AmEmbassy to SecState, Feb. 27, 1989, Box 35, Folder "February 17-28 1989," SFC, NSA.

[560] Memorandum from AmEmbassy to SecState, March 1, 1989, Box 35, Folder "March 1-15 1989," SFC, NSA.

policy, wage indexation, property rights, cooperation in the implementation of the accord, and strategies for foreign debt. Solidarity entered the roundtable negotiations with a firm belief that the country's foreign debt was the government's problem, but it had discovered along the way that the debt was its "carrot" in the negotiations. The government wanted Solidarity's support internationally, and this gave the union leverage at the roundtable. Furthermore, their economic discussions in the first month of the roundtable had made clear that domestic reform was doomed to failure without debt relief. And so, in an astonishing turn, the union threw its support behind strategy that would have seemed unthinkable just months earlier: making a joint appeal with the government for debt relief from the West.[561] Taking his cues from the Finance Ministry, Andrzej Topinski, a leading Solidarity economist participating in the talks, told the American embassy that "there would be no progress on Poland's foreign debt unless Western governments took the initiative" to ease repayment terms.[562]

With the roundtable unfinished, however, officials in Washington at both the IMF and the State Department did not let the newly united front distract them from the continued lack of austerity. US Undersecretary of State Tom Simons told a visiting Polish finance official, that the main problem in the roundtable appeared to be "the concern over the amount of responsibility for austerity the opposition would have to accept and whether the opposition would be allowed a place in the political system commensurate with that responsibility." Until the level of austerity, and the parties' commitment to it, had been worked out, the United States could not ease

[561] Memorandum from AmEmbassy Warsaw to Sec State, March 1, 1989, Box 35, Folder "March 1-15, 1989," SFC, NSA.
[562] Memorandum from AmEmbassy Warsaw to SecState, March 1, 1989, Box 35, Folder "March 1-15, 1989," SFC, NSA.

Poland's financial pressure, Simons said. Instead he renewed a familiar refrain, encouraging the Poles to come to terms with the IMF.[563]

Fund officials remained deeply unsatisfied with the state of the economy, and worried that the rising inflation caused by the 1988 wage and price increases would bury the hopes of anything but the most radical reform. During a staff trip to Poland in the midst of the roundtable discussions in March, IMF economist Jim Prust once again encouraged government officials to tighten credit, hold wage increases "significantly" below prices increases, and further depreciate the exchange rate in order "to establish the basis for an attempt to finalize agreement on a stand-by agreement." But he feared pressing too hard at a moment of such political fragility. There was a distinct possibility, he told officials in Washington, that an IMF demand for "an 'x' percent reduction in real incomes" could lead "to the breakdown of the roundtable."[564] He, and the Polish authorities, resigned to wait. "The authorities recorded no significant disagreement with the thrust of the mission's suggestions," he told Washington, "but appeared resigned to the continuation of a high level of inflation for some time yet."

In discussions with Trzeckiakowski, Prust also learned of the 80% wage indexation agreement emerging from the Economic Reform Table. Far from impressed, he predicted this would only exacerbate the inflationary issues. The indexation merely established "a floor for real wages," he told Camdessus, and any agreement that emerged from the economic group "would have as much symbolic as substantive importance." Trzeckiakowski told the mission that the working group was fighting for survival against extremist challenges from within the

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[563] Memorandum from SecState to AmEmbassy Warsaw, March 2, 1989, Box 35, Folder "March 1-15, 1989, SFC, NSA.
[564] Jim Prust to Mr. Russo, "Poland: ETR's Comments on Draft Briefing Paper," March 6, 1989, Box 61, File "Poland - corresp. + memos Jan. - May 1989," EUR Country Files, IMF.

government, the party, and Solidarity. Agreement, even if it was symbolic, was "essential to restore social peace and to contain pressures from extreme groups on both sides." Looking for real reductions in real wages rather than symbolic reductions in nominal ones, Prust could do nothing for the Poles except send them to the next stop on the creditor carousel, the Paris Club.[565]

The Finance Ministry needed little encouragement, as it had already reached out to the Club to see if the opening of the roundtable would finally bring the long-sought interest rate cuts and new credits. An agreement on rate cuts, they hoped, would relieve the country of the immediate need to repay maturing debts, reduce the overall debt burden, and encourage the idea domestically that the post-roundtable communist government would be able to win concessions from the West. In a letter to the Club, Vice Minister Janusz Sawicki told the members that the recent reforms aimed to give the country "a free market character," but they depended on "real, extended cooperation with Creditor Countries."[566] With bilateral settlements of the 1987 rescheduling agreement still unsigned, however, the creditor countries showed little inclination to leniency. The West German representative at the Club told IMF officials that once the 1987 agreement had been settled, his country might "be prepared to give sympathetic consideration to a request for rescheduling of 1989 maturities on generous terms." But "a multiyear rescheduling operation," the official continued, "was out of the question at present."[567]

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565 Jim Prust to the Managing Director and the Deputy Managing Director, March 28, 1989, Box 61, Folder "Poland – corresp + memos Jan. – May 1989," EUR Country Files, IMF.
566 Memorandum for Files, "Poland – Letter to Paris Club Secretariat," April 4, 1989, Box 61, Folder "Poland – corresp + memos Jan. – May 1989," EUR Country Files, IMF.
567 Memorandum for Files, "Poland," April 5, 1989, Box 61, Folder "Poland – corresp + memos Jan. – May 1989," EUR Country Files, IMF.

There was one other foreign creditor to which the Poles could turn – the Soviet Union. But watching the roundtable process unfold from Moscow, Soviet Premier Mikhail Gorbachev knew his country did not have enough money to apply its own conditionality to the course of Polish events. As he told his Politburo colleagues, Poland "is crawling away from us….And what can we do? Poland has a $56 billion debt. Can we take Poland on our balance sheet in our current economic situation? No. And if we cannot – then we have no influence."[568]

Thus, the roundtable would have to be completed without the cover of foreign relief. On March 2nd, Wałęnsa and Kiszczak met again to break the deadlock building up in the three working groups. The Political Reform Table had become hung up on the government's proposal to create a strong office of the presidency. Having offered Solidarity an element of political diversity in the Sejm, the party wanted to use a strong president to retain ultimate control of the country. Such a president, whom everyone agreed would be Jaruzelski, would have the power to dissolve parliament, retain control over the nation's security forces, and fill the roll of head of state. Solidarity found this bargain unacceptable, so the decision was postponed until Wałęnsa and Kiszczak could meet. When they did, they arrived at a decision that would define the shape of the final roundtable agreement and set the course for Poland's transition to post-communism. In exchange for Solidarity's support of a strong presidency, Kiszczak offered the creation of a wholly new chamber of parliament, the Senate, whose 100 members would be freely chosen in

[568] It is not clear how Gorbachev arrived at the $56 billion figure. All Western estimates of the country's debt put the number at roughly $39 billion. Surely, though, the discrepancy between $54 and $39 billion was not driving Gorbachev's pessimism. Even had he known the accurate number, the Soviet Union would still have been in no position to bail out Poland. Gorbachev comment recalled by Anatoly Chernayev as quoted in Vladislav M. Zubok, "New Evidence on 'The Soviet Factor' in the Peaceful Revolutions of 1989," in *New Evidence on the End of the Cold War*, Cold War International History Project Bulletin, Issue 12/13, Fall/Winter 2001.

open elections. Although the power to introduce legislation would remain in the Sejm, where the party would maintain control, the Senate would be given a "blocking" power on economic, social, and environmental matters. More to the point, it would give Solidarity the ability to engage in politics without being co-opted into government programs with which it disagreed. The new chamber was a momentous concession that met the union's most important demands. For his part, Trzeciakowski believed that the new Senate would fulfill his demand in the Economic Reform Table for a coordinating council to exert "social control" over the implementation of the economic agreement.[569] With few prospects for agreement on other serious issues facing the Economic Reform Table, Trzeciakowski decided to back away from pursuing real reform in the roundtable and wait until after the June elections.

The roundtable negotiations continued through the end of March and were not officially signed until the April 5th, but the basic structure of the final agreement did not change. Elections would be held in June, and the PZPR would control the Sejm because 65% of the seats would go to the party and its allies. The other 35% would be freely elected. The Senate would also be freely elected, and the president would be elected by a majority vote from the two houses of parliament combined. Because the Sejm was much bigger than the Senate, this would ensure that Jaruzelski would become president. This, at least, was how the elections were supposed to unfold.

As the parties scrambled to get ready for the elections, they renewed their united front internationally. When Wałęsa met with a group of American congressmen in April, he implored

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[569] Memorandum from AmEmbassy Warsaw to SecState, March 3, 1989, Box 35, Folder "March 1 -15, 1989," SFC, NSA.

them to remove the "necktie" of indebtedness that was strangling his country.[570] When the Solidarity leader Jacek Kuroń met with US Deputy Secretary Simons in early May, he suggested that the West should reschedule Poland's official debt and "capitaliz[e] Poland's overdue interest in order to reduce the…unsustainable debt-service burden." In addition, the United States should "reduce the mandatory reserve requirement" for new commercial lending to Poland. The Solidarity leader's technical vocabulary surprised Simon, and he remarked that Kuroń sounded an awful lot like Polish government officials. Kuroń admitted that the communist Finance Minister had briefed him on the debt issue the day before. But, he concluded, "The reds deserve some reward for the roundtable."[571]

Doomed to the Market

The supposed rewards came in a speech by US President George H.W. Bush on April 17th. Proposing policies to help Poland transition to parliamentary elections and restart its economy, the President did his best to sell the initiatives as worthy of the dramatic change unfolding behind the Iron Curtain. The United States, he said, would "facilitate cooperation and direct contacts between U.S. firms and Poland's private business sector," pursue "imaginative exchange, educational, cultural, and training programs," and encourage the implementation of "creative" solutions to Poland's debt problem, such as debt-for-equity and debt-for-nature swaps. His administration would not, however, press the IMF for leniency. "A stand-by agreement should be subject to the usual IMF standards," because "IMF conditionality can help Poland

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[570] AmEmbassy Warsaw to Sect State, April 28, 1989, Box 35, File "April 16-30 1989," SFC, NSA.
[571] SecState to AmEmbassy Warsaw, "Department Meeting with Solidarity Advisor Jacek Kuroń," May 3, 1989, Box 35, File "May 1-15, 1989," SFC, NSA.

pursue needed economic reforms."[572] In this conviction, Bush was not alone domestically or internationally. The AFL-CIO, Solidarity's long-standing labor ally in the West, believed Western aid needed to be "conditioned," because only conditional aid could "assure that Western loans...are not squandered by a corrupt and inefficient communist oligarchy."[573] The West German government hoped the IMF would move quickly to come to terms with Poland, but it did not want it to sacrifice the Fund's standards in the process. Once again, precedent was at issue. West German officials told the U.S. embassy in Bonn they were "very satisfied" with the firm American position on the IMF standby agreement because "overly easy terms for Poland [would] set a precedent for Brazil and Mexico."[574]

For PZPR officials who had heard endlessly of the importance of human rights and democracy to the West, the tepid financial reaction to the roundtable came as a genuine shock. Rather inexplicably, Party Secretary Josef Czyrek told *The Washington Post* that the leadership had expected "more trust" from the Americans "as far as our willingness to undertake reform. We did not expect it to be so conditional."[575] After the State Department took offense to Czyrek's comments, a Polish official responded, "the West" had for years urged the Polish government "to take exactly those steps the roundtable represented." Now that the roundtable was complete, the official said the government had expected "more support and less conditionality."[576] Privately, Czyrek told Deputy Secretary Lawrence Eagleburger that the

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[572] SecState to AmEmbassy Warsaw, April 17, 1989, Box 35, Folder "April 16-30," SFC, NSA.
[573] Memorandum from SecState to Labor Collective, "AFL-CIO Executive Council Salutes Solidarnosc's Relegalization," May 5, 1989, Box 35, File "May 1-15 1989," SFC, NSA.
[574] AmEmbassy Bonn to SecState, April 19, 1989, Box 35, File "April 16-30 1989," SFC, NSA.
[575] Don Oberdorfer, "Polish Official Faults Bush's Aid Program," May 17, 1989, *The Washington Post,* A16.
[576] Sec State to AmEmbassy Warsaw, May 18, 1989, Box 35, Folder "May 16-30 1989," SFC, NSA.

government wanted to move ahead with the IMF, but "was very concerned by the effect IMF programs had had in Venezuela and other countries."[577]

The Unites States' own ambassador in Warsaw, John Davis, was "very disappointed" with the paucity of his government's response to the roundtable. He wanted a "major reinforcement to what [he] perceived as a huge change in Eastern Europe. It was something [the United States] had tried to achieve for forty years and here it is and now we can't respond to it? That is unbelievable."[578] Opinions such as Davis's have led to the historiographic consensus that George Bush's slow reaction to change in Eastern Europe meant that events in that region during 1989 happened in spite of, not because of, his actions. Greg Domber has written that Bush's economic plan for Poland after the roundtable "fulfilled the PZPR's long-term goals. The opposition was left wanting much more."[579] From the history presented here, we can draw a much different conclusion. Had the West dropped its economic conditionality and come forth with an enormous financial aid and debt restructuring package at any point before Solidarity took control of the government in August, it is very likely that the PZPR would have been able to successfully form a government after the June elections. Poland would have survived as the partially reformed, partially democratic, but communist dominated state that the PZPR intended it to be when they launched the roundtable in the first place. The unwavering pursuit of austerity led to more extreme outcomes in Poland, both politically and economically. Although the IMF and the U.S. government did not consciously pursue austerity in Poland as a means of installing a Solidarity-led government, this is precisely what the pursuit of austerity resulted in.

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[577] SecState to AmEmbassy Warsaw, May 17, 1989, Box 35, File "May 16 -30 1989," SFC, NSA.
[578] Cited in Greg Domber, *Empowering Revolution* (Chapel Hill, NC, 2014), 228.
[579] Ibid, 232.

As Bush was calling for "creative" solutions to the debt issue, the American financier George Soros announced just such a plan.[580] The Soros Plan envisioned a startling reorganization of the economy, and it represented the interests of foreign capital *par excellence*. Soros began, "The problem is that the interests of capital are not properly represented. Communist systems treat capital as a free good and the function that in a capitalist system is performed by the owner is left unfulfilled." Economic reform had consistently failed in Poland because "owners are missing." Therefore, Soros proposed, that "enterprises owned by the Polish state" be traded for debt reduction. This was called a "debt/equity swap," and it was a concept that had been discussed for years as a potential solution to the global debt problem. In Soros's version, state-owned companies would be put under the control of "an independent Agency," which would be charged with "selecting and supervising management," reorganizing "state enterprises into joint stock companies," and finding domestic or foreign "final owners for their capital." The Agency could employ foreigners in an "advisory role," but it would not "infringe on Polish sovereignty" because its creation would be subject to the approval of the Sejm. Nevertheless, once created, the Agency would be isolated from "domestic political pressures" by the fact that foreign lenders could reject the debt/equity exchange offer if they were not satisfied with the terms. Additionally, price controls and subsidies would be removed all at once in a "big bang," and the zloty would be devalued. Soros projected tight monetary policy and "tough decision taken by the Agency" would cause "a temporary reduction in living standards," but they would "rise rapidly from the initial low point."

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[580] Soros has made a habit out of proposing debt-restructuring plans in times of crisis. For the most recent, on Ukraine, see http://www.nybooks.com/articles/archives/2015/feb/05/new-policy-rescue-ukraine/.

In exchange for this domestic reordering, the Soros Plan foresaw a three-year moratorium on Paris Club debt payments. After three years, if the Club were "satisfied with the performance of the Agency," it would exchange its debt for preferred shares or bonds in the companies created by the Agency. Western commercial banks would continue receiving interest payments from the Polish government, but would have to loan half of these payments back to the Agency. After 3-5 years, the banks would be asked to give the Agency the option to buy out Poland's debt obligations at 50 cents on the dollar. If his plan was implemented, Soros anticipated Poland's debt payments would drop by about $1 billion a year, which when combined with $700 million a year from the IMF and World Bank, would give the country a dramatically different hard currency position. Together, the measures would create "upward momentum in the economy."[581]

Perhaps because it was operating in a vacuum of financial inaction, the Soros Plan momentarily captured the Polish debt agenda. Claiming that he had already discussed the plan with the U.S. National Security Council and the British Foreign Office, Soros traveled to Warsaw in late April and presented the plan to the Polish Finance Ministry, the Solidarity leadership, and the American ambassador, John Davis. Ironically, Solidarity initially reacted with "keen interest," while it was the communist Finance Minister, Andrzej Wroblewski, who was "somewhat skeptical" because "the scheme was essentially anti-democratic in character, taking control of the economy out of the hands of the newly elected parliament." For his part, Davis believed the country should give the plan very serious consideration because the new Agency would bring "an expertise…stature and independence" otherwise unavailable in Polish

[581] George Soros, "A Plan to Solve the Economic Crisis in Poland," May 1, 1989, Box 62, File "Poland - corresp. + memos June - July 1989," EUR Country Files, IMF.

society, and the three year moratorium on interest payments was far more than the government could currently get from the Paris Club.[582] Wroblewski followed up with Soros in writing in May to inform him that the plan was "convergent, in many respects" with the solutions "being adopted by the Polish government." But he reminded Soros that, under Polish law, "the transfer of control of an enterprise...or the sale of its equity capital" required the "acceptance of its employee self-management."[583] He repeated his concerns about the anti-democratic nature of the plan. Would the Agency be subject to Polish law, and what kind of role would the Polish government play in economic decision-making once the Agency had been created? Despite his lingering questions, Wroblewski declared the government ready to take part in the discussions.

After years of experience with Polish resistance, IMF officials believed the plan would not be acceptable to Polish labor. Jim Prust wrote that Soros was "presentationally neat" but "his characterization of Poland as a basket case so hopeless that the population will accept any alternative to the present mess (including the 'big bang') is overdrawn." He wished the financier well, but told him that the Fund could not be officially involved in a private initiative.[584]

The Soros Plan, however, was doomed to failure not because of Polish labor, but because of Western governments. A three-year moratorium on debt payments, particularly while the banks continued to get paid, was too generous for Washington, Bonn, and Paris. Governments kept their focus on the procedures of the Paris Club and the IMF. Here the economic news from Poland, and thus the prospects for relief, remained bleak. In April 1989, prices rose 73% while

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582 AmEmbassy Warsaw to SecState, "Soros Plan to Resolve Polish Debt Problem," April 27, 1989, Box 35, File "April 16-30 1989," SFC, NSA.
583 Wroblewski to Soros, May 22, 1989, Box 62, File "Poland - corresp. + memos June - July 1989," EUR Country Files, IMF.
584 Memorandum for Files, "Poland – Mr George Soros's 'Pland to Solve the Economic Crisis in Poland," May 25, 1989, Box 62, File "Poland - corresp. + memos June - July 1989," EUR Country Files, IMF.

incomes rose 110%, creating what the IMF termed an "excessive infusion of purchasing power." In a June visit to Warsaw, the staff continued to counsel a "severe tightening of financial and income policies," but recognized that policy changes were impossible until after the elections.[585]

When the first round of elections came on June 4, their results surprised everyone and injected a new level of uncertainty into the country's immediate political and economic future. Foreign and domestic observers (with the exception of U.S. ambassador Davis) entered the elections with genuine uncertainty about their results. Solidarity held the momentum and the enthusiasm, it was believed, but the PZPR maintained a vast organization upon which it could rely. In the event, Solidarity won a landslide in the Senate (99 or 100 seats), while in the Sejm, the government candidates, who needed 50% of the eligible voting population to avoid competing in the second round of elections, failed to achieve their threshold even though they ran unopposed. As the second round of elections approached on June 18th, there was now a real possibility that Solidarity might achieve 38% of the seats in the Sejm because if the government candidates still could not win in the second round, their seats would go unfilled. For Solidarity, the government, and the West, this was an unwelcome prospect. As Davis explained, "While the regime needs Solidarity, so, at present, does Solidarity need the regime; it does not want to be the government, saddled with more responsibility than authority."[586]

After the second round of elections, the PZPR and the allied United Peasant Party achieved enough support to form a government. By the end of June, however, their alliance had broken down as the Peasant Party leadership broke ranks with their communist masters. By July,

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585 "Statement for Paris Club Tour d'Horizon Discussions on Poland on Wednesday, June 21, 1989," June 16, 1989, Box 37, File, "Poland 331-C - Paris Club Meetings 1989," Country/Country Desk Files, Central Files, IMF.
586 Quoted in Domber, *Empowering Revolution*, 235.

Kiszczak, who had moved from Interior Minister to become head of the party after Jaruzelski became president, struggled to form a government with only PZPR and United Peasant Party votes. This presented Solidarity with a choice – either join a coalition government with Kiszczak at its head or gamble on forming its own government. On July 3rd, Adam Michnik opened this debate by publishing an article titled "Your President, Our Prime Minister," in which he proposed that Solidarity be allowed to form its own government in exchange for electing Jaruzelski president.

In this seminal debate, the prospect of Western financial assistance and debt relief played a crucial role. "We are in the age of legends…don't be surprised at whatever you hear," Solidarity activist Wojciech Lamentowicz warned Davis in Warsaw. The warning was required because leading Solidarity and government circles were caught up in the rumor the West was preparing a new Marshall Plan for Poland. Davis reported that the rumor entailed "two Western governments – presumably the U.S. and Britain" offering Poland a "Marshall Plan" of $10 billion on the condition that Solidarity be given the Presidency and the Prime Minister's job in the new government. "This trade off is somehow connected with George Soros's plan," he added. Both "well connected and knowledgeable activists" in the opposition and "some in the regime leadership" took the rumor seriously, Davis told Washington.[587]

Even after the Marshall/Soros Plan rumor had been debunked, Solidarity officials calculated their political strategy in economic terms. This calculus cut two ways. First, as Davis reported, "one of the main arguments for the [Michnik] Plan…is the rampant expectation that a Solidarity government would be better placed to secure vital economic assistance from the

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[587] AmEmbassy Warsaw to SecState, "Tall Tales About U.S. 'Marshall Plan,'" June 20, 1989, Box 34, File "Poland Cables January - September 1989," SFC, NSA.

West." Although Davis had done his "best to dispel those rumors, the general perception of linkage persists." Gemerek, in particular, had "been persuaded that significant economic aid" was "a possibility to be won with the right combination of moves." If those who supported Michnik's plan did so on economic grounds, so too did those who opposed it. The Solidarity spokesman Janusz Onyszkiewicz told Davis "with considerable vigor and evident anxiety" that Michnik's plan was detrimental to the union's interests because "Solidarity would be 'trapped' into accepting responsibility for a deteriorating economic situation and the social volatility it entailed."[588]

Even as they continued to resist the formation of a communist government under Kiszczak at the late hour of August 1st, the union leadership remained divided over the issue of whether a Soldarity-led government should be formed. Tadeusz Mazowiecki told his colleagues that he was opposed to Michnick's idea because "the opposition-Solidarity side has no [economic] program and within three months that would become dramatically clear." His colleague Andrzej Stelmachowski concurred, "If the economic diagnosis is bad, it would be folly to take over the government until such a time as the 'Solidarity' is the only way out. If we are expecting a deterioration [of the situation], we should not assume responsibility for it." But Michnik was of a different mindset, and defended his original call for a Solidarity premiership in the Sejm on the ground that the country sat at a historic crossroads. "We have such an international constellation, a historical moment, when we can catch something. We should not

588 AmEmbassy Warsaw to SecState, "Continuing Controvery on the 'Michnik Plan,'" July 6, 1989, Box 34, File "Poland Cables January - September 1989," SFC, NSA.

use an argument that there is no program – as no one in the world has that recipe," he told the meeting. "We are doomed for one [program] – a sharp, sudden entrance into the market."[589]

Revolution in Poland: The Balcerowicz Plan

The Michnik Plan eventually carried the day, and on August 24th, Mazowiecki became the prime minister of Poland. During his inaugural address to the parliament, the new prime minister fainted and left the building momentarily to receive medical attention. Upon his return, he joked with the chamber, "Excuse me, but I have reached the same state as the Polish economy. But I have recovered, and I hope the economy will recover too."[590] Despite the political transformation, it had not. In fact, it had gotten worse. During conversations with the Finance Ministry in July and August, the IMF recorded that open and repressed inflation was accelerating, output was stagnating, and the budget and current account deficits were ballooning. By late August, "an atmosphere of deep concern and, occasionally, gloom" hung over Warsaw as annual inflation sat at about 105% over the summer.[591] In Mazowiecki, the IMF saw a cautious man who understood the need for "economic liberalization and reform to proceed" but had yet to take a position on the "essentially political issue of the pace of such processes." The pace of reform would dictate the scale of the IMF's support. If the new government felt "prudence required a 'phased' approach to liberalization," then the IMF could offer a one-year standby agreement worth about $300 million. If, on the other hand, Mazowiecki chose to implement

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[589] Minutes of the Meeting of the Presidium of the Citizens' Parlimentary Club, August 1, 1989, in *CWIHP*, 120-121. The additions in brackets are from the original translated text in the CWIHP bulletin.
[590] Kotkin, *Uncivil Society*, 131.
[591] H. Flickenschild and R.J. Ossowski to Mr. Hole, "Poland – Staff Visit (August 30-September 7, 1989)," Sept. 12, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.

"genuinely radical and comprehensive reform," the IMF would provide a substantially larger credit.[592]

The new government began to signal its intention with the appointment of its cabinet on September 7th. Leszek Balcerowicz, a Solidarity economist who had been a chief architect of the union's economic platform before martial law, became Finance Minister, while Wladysław Baka, the erstwhile PZPR finance leader, returned to the head of the National Bank of Poland, which he had left in 1988 to join the Politburo. IMF officials noted, "the proposed cabinet may imply compromise and gradualism." Additionally, the two publicly circulating Solidarity economic plans, written by economists Ryszard Bugaj and Aleksander Pasyznski, called for a "short-run holding operation to control inflation" and "long-run proposals involving a time consuming consensus building process."[593]

But then there was Jeffery Sachs. IMF officials noted, "the presence of Mr. Sachs in Warsaw, and his proposals for a shock liberalization plan, received wide publicity in the Polish media."[594] In meetings with the Mazowieki, Balcerowicz, Baka, and Kuroń (now Minister of Labor and Social Policy), the leader of the IMF delegation, Massimo Russo, told his Polish colleagues not to couch their requests for Western support in "political terms" as Sachs encouraged them to do. "Governments did not need to be reminded of the global political

[592] Massimo Russo to the Managing Director, "Poland," August 30, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.
[593] H. Flickenschild and R.J. Ossowski to Mr. Hole, "Poland – Staff Visit (August 30-September 7, 1989)," Sept. 12, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.
[594] Ibid.

ramifications of Polish reform," he told them, "but Ministers of Finance, who controlled the purse strings, did need to be convinced that assistance would not be wasted."[595]

Both in public and behind the scenes, the young American economist Sachs had begun to influence the terms of the economic debate in Poland with his doctrine of "shock therapy." On September 14th, he and his colleague David Lipton sent Balcerowicz "a draft proposal to suggest the kind of document that you could circulate to the Western governments, the IMF, and the World Bank." In the proposal, Lipton and Sachs (writing from the perspective of the Polish government) wrote that the government would implement a three part reform program comprising monetary and price stabilization, structural adjustment, and foreign economic assistance. With regard to monetary and price stabilization, the government would institute within the next 90 days a sharp reduction in domestic subsidies, a rise in interest rates to positive real levels, a sharp cutback in investment spending, a rise in housing rental rates. The government would also commit to keeping wages below price increases. In the realm of structural adjustment, the government would end restrictions on the development of private firms, privatize "much of the existing state enterprise sector" within one to three years, and shift investment from heavy industry to services and construction. The model for privatizing state enterprise would be the United Kingdom, where auctions had been held for shares of the enterprise, "with special purchase rights reserved for those directly affected by privatization, i.e. workers and managers." With only 10% of the non-farm economy in private hands in 1989, the government would aim to increase that number to 25% by 1991 and 50% by 1993. To help the government implement this domestic move toward a market economy, Sachs and Lipton had the

595 Massimo Russo to the Managing Director and Deputy Managing Director, "Poland," Sept. 22, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.

government ask the IMF "to recognize the significance of the historical challenge facing Poland" and to apply its conditionality "firmly but also imaginatively." The government (Lipton and Sachs) hoped agreement could be reached within a month. Once the IMF program was in place, it also hoped the Paris Club would complete "a definitive reduction of Poland's debt burden" and commercial banks would follow suit with a comparable agreement.[596]

So much for the IMF's concern that Poland's pleas relied too heavily on political appeals. The Sachs-Lipton Plan proposed a radical transformation of the Polish economy in much the same terms as Soros's previous scheme (minus the ominous authoritarian Agency). On September 22nd, the Mazowiecki government sent Western governments, the IMF, and the World Bank an almost verbatim copy of the Sachs-Lipton Plan to announce its economic plans. When Russo received the document, he told the Managing Director that it represented "a good basis for us to work with the authorities."[597]

Much work remained before the newly titled Balcerowicz Plan could be implemented, but a foundational understanding between Poland and its international creditors had finally been reached. Throughout the fall, negotiations continued between the Mazowiecki government, the IMF, and the Paris Club, and by the end of the year a series of domestic and international steps had been agreed to. On December 28th, the Sejm (in which the communist party still had a majority) voted on a package of ten laws intended to fulfill the aims of the Balcerowicz Plan and bring a market economy to Poland. On January 2, 1990, Western nations established a $1 billion

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596 Jeffrey Sachs and David Lipton to Leszek Balcerowicz, "Preparation of a Document for International Circulation," Sept. 14, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.
597 Massimo Russo to The Managing Director and the Deputy Managing Director, "Poland," Sept. 25, 1989, Box 62, File "Poland - corresp. + memos August - Sept 1989," EUR Country Files, IMF.

fund to support the National Bank's hard currency transactions and maintain the value of the zloty.[598] On February 16th, the Paris Club signed an unprecedented rescheduling agreement on Poland's debt that stretched repayment out over 14 years, more than twice its normal repayment schedule.[599] 1990 was also the year that austerity arrived in Poland, as gross national product dropped 8%, real wages declined 25%, and unemployment, which had previously been nonexistent, reached 6%.[600] It took some time to reach agreements on debt reduction, but in 1991 the Paris Club forgave roughly 50% of Poland's debt obligations and commercial banks agreed to a reduction package in 1994.[601]

In 1992, the Polish historical sociologist Jan Gross sat down to assess the course of events in his native land over the previous three years. He wrote, "What is the essential point of reference, the short hand designation, the symbol associated today with the Polish revolution?...It is…the Balcerowicz Plan." With the end of communism in Poland, he wrote, "economics revealed itself with a vengeance to be the key determinant of the political realm."[602]

Out of a desire to correct the Reaganite narrative that the United States "won" the Cold War, scholars have tried to argue that the West in fact played little or no role in events of 1989. Greg Domber has recently written with regard to Poland, "Generally, Washington had little control over or impact on moves made on the ground in Warsaw."[603] A focus on the financial

598 Hobart Rowen, "Poland Gets $1 Billion Fund," Jan. 3, 1990, *The Washington Post*, C1.
599 Steve Greenhouse, "Poland's Foreign Lenders Accept Unusual Extension of Payments," Feb. 17, 1990, *The New York Times*, 1.
600 Cited in Paczkowski, *The Spring Will Be Ours*, 512.
601 Letter to Michel Camdessus, Aug. 27, 1993, Box 1, File "Fund Relations with Commercial Banks," Country Files, Central Files, IMF. Letter to Michel Camdessus, March 25, 1994, Box 1, File "Fund Relations with Commercial Banks," Country Files, Central Files, IMF.
602 Quoted in James, *International Monetary Cooperation*, 568-569.
603 Domber, *Empowering Revolution*, 254.

history of the end of the Cold War brings a starkly different and more accurate picture into view: Washington exerted enormous power over the course of events in Warsaw, but it did so through the power of omission rather than the power of commission. Washington, along with New York, London, Paris, Bonn, and Frankfurt, withheld money until events conformed to its demands. In so doing, it brought an end to communism in Poland.

Ultimately a financial history of the end of the Cold War helps answer three central questions about 1989: how and why did it happen at that moment? Why did it happen peacefully? And what did the world gain and lose from the events of that year? Examining Poland's history in the manner presented in this chapter makes the seemingly surprising and unprecedented events of 1989 comparable to other times and other places. As the history presented here hopefully demonstrates, the political transformations of 1989 make more sense when placed within the global historical trajectory of the sovereign debt crisis of the 1980s, rather than the historical trajectory of the Cold War. If one views 1989 as the conclusion of a political and ideological contest begun in 1946, then the speed of political change, and its peaceful nature, are bewildering. If, on the other hand, one views 1989 as part of a economic history begun in the early 1970s and affecting countries throughout the developing world over the course of the 1980s, then the political change of that year becomes not only comprehensible, but perhaps even unexceptional. General Jaruzelski found himself facing the familiar challenge of anti-democratic leaders subject to the demands of the IMF: to legitimize austerity in a political system that had no legitimacy. As he later concluded, the "necessary social support" for economic reform could "be granted only in a system of parliamentary democracy." Only such a system, he said, could "carry the burden of unpopular decisions."[604]

[604] Jaruzelski quoted in Wiktor Osiatynski, "The Roundtable Talks in Poland," in Jon Ester, ed. *The Roundtable Talks and the Breakdown of Communism* (Chicago: The University of Chicago Press, 1996), 62-63, n 7.

Chapter 7

The Coercion of Creditworthiness:

Hungary's Road to Democracy

On April 10, 1987, the staff of *PlanEcon*, the most authoritative Western publication on the communist economies of the Eastern Bloc, told its readers in the world of finance, "We may sound very cynical, but it is not far from the truth to say that <u>Hungarian economic fortunes in the near future do not depend on anything done in Budapest, but will be determined in Tokyo.</u> We doubt very much that Mr. Kadar yet understands this and the implications of such a situation for Hungarian economic sovereignty [underlining in the original]." Over the previous two years, the journal noted, Japanese banks flush with the surplus capital from the booming Japanese economy had indiscriminately financed the Kádár government's plush domestic economic policy. But time was running out. *PlanEcon* went on, "<u>If and when Western banks finally realize…what Hungary is up to, they are likely to bring their lending activities to a screeching halt and cause [a] severe economic crisis in Hungary</u>."[605]

Almost three years to the day after *PlanEcon* published its stinging analysis, Hungary held its first multiparty democratic elections since the start of the Cold War. This chapter explores the history of those years and argues that the financial pressures described in the dire warnings of a financial trade publication in 1987 were intimately connected to the momentous political changes that shook Hungary, Europe, and ultimately the world in 1989. In the summer

[605] PlanEcon Report, April 10, 1987, Vol 3, 14-15, pp. 3, 5.

of 1987, banks finally did realize that Hungary's debt was unsustainable, and the country lost its creditworthiness on global capital markets. To restore its standing in the eyes of the financial world, the Kádár government was forced to come to terms with the International Monetary Fund (IMF) on an economic stabilization and reform plan. Leading members of the Hungary's communist party, the Hungarian Socialist Workers' Party (Hungarian acronym, MSZMP), knew that such a plan would involve a sharp drop in the living standards of the Hungarian population, and they consequently feared that the party would lose legitimacy because of the austerity measures. Therefore, in order to build a "social consensus" around austerity, the party launched a process to democratize the state.

Scholars of Hungary's democratic transition and the end of the Cold War have yet to sufficiently draw this connection between austerity and democracy. Important Hungarian-language scholarship has appeared on the growth of the nation's foreign debt under János Kádár. In *Az Eladósodás Politikatörténete* ("The Political History of Indebtedness"), György Földes provides a wealth of empirical evidence from key actors in the Hungarian Politburo, Planning Commission, and the Hungarian National Bank (HNB) about the growth of the debt from 1957 to 1986. However, the author purposefully stops short of analyzing the 1986-1990 period because his research question centers on whether the Kádár regime could have solved the debt problem on its own, without giving up political power. In *Kádár Hitele* ("Kadar Credits"), the journalist Attila Mong does interrogate the relationship between sovereign debt and the political transition of the late 1980s, as well as the effects that the debt of the Kadar era still has on Hungarian society to the present day. Mong's book is extremely well researched and builds off of Földes's work by including further research from the Hungarian National Archives (including the State Security Service), memoirs, and published accounts from the Hungarian policymakers who managed the country's debt during the communist period. Despite all of this Hungarian language research, however, Mong concludes that his most important source base for his monograph was in fact the IMF archives, and he cites IMF sources extensively. Indeed, Mong concludes that researching in the IMF archive was an "astonishing experience" that provided "priceless documents," while sources at the National Archives on Hungary's debt are "particularly sparse" and "filled with jargon, nebulous, rigid, and humorless."[606] This chapter shares Mong's reliance on IMF sources, and in fact expands on *Kádár Hitele*'s use of IMF documents, particularly in the 1988-1990 period. This allows me to draw a stronger and more direct connection between the Hungarian government's austerity policies and democratization. Mong concludes, "The Hungarian payments crisis only became apparent at the end of 1987 when the country had to turn again to the International Monetary Fund and finally adopted the framework of a new agreement of a broad reform program, which - at least partially - led to the 1989-90 regime change" [original Hungarian to come, for some reason I do not have the

[606] Mong writes, *"Az anyaggyűjtés során a legnagyobb izgalmat az okozta, hogy kivételes lehetőséget kaptam a Nemzetközi Valutaalap archívumában való kutatásra Washington D. C.-ben, ahol Magyarországgal kapcsolatban több ezer oldalnyi iratanyagot volt alkalmam átnézni, és ezekről fotómásolatot készíteni. Döbbenetes volt megtapasztalni, hogy az IMF archívumában a korszak magyar történelmének felbecsülhetetlen értékű iratanyaga szabadon kutatható, miközben a hazai levéltárakban egészen más a helyzet. Az adóssággal, a Nemzetközi Valutaalappal, a Világbankkal kapcsolatos iratanyag Magyarországon rendkívül gyér. Egyrészt mert nyilvánvalóan manipulációk és lopások tépázták meg a gyűjteményt, másrészt mert a dokumentumok egy része érthetetlen módon még most is minősített, szigorúan titkos vagy szolgálati titok besorolású, a kutatók előtt is zárt, és eredmény nélkül kértem ezen minősítések feloldását. Washingtonban ezzel szemben szabadon elolvashatok a Budapestre látogató szakemberek feljegyzései, egymás közötti levelei, a magyar tárgyalópartnerekkel folytatott megbeszélések részletes jegyzőkönyvei, sokszor még a szállodafoglalás nehézségeiről szóló beszámolók vagy költségelszámolások is. Az IMF rendkívül alapos szakemberei mindenről mindent feljegyeztek, mindent dokumentáltak, és ezért nem lehetünk eléggé hálásak nekik. A korszak magyar pártdokumentumainak bikkfanyelvével, ködösítésével, merevségével és humortalanságával szemben ezek az iratok többnyire kendőzetlen őszinteséggel és nem kevés humorral beszélnek a magyar tapasztalatokról"*, p. 10.

original].[607] This chapter strengthens this claim. Instead of "partially" explaining the political transition of 1989-90, Hungary's international financial difficulties at the end of 1987 and country's subsequent IMF program were the primary causes of the government's move to democratization and the ultimate arrival of multi-party democracy. Surely Hungary's international financial relations were not the only cause of this transition, but they deserve to be viewed as the primary factor driving political change.

There has not been a great deal of English-language scholarship on Hungary's democratic transition, and the work that has been done was primarily conducted by political scientists in the immediate post-Cold War period. Nevertheless, this chapter changes the debate of the scholarship that does exist. Unlike the scholarship surrounding 1989 in Poland or East Germany, where many scholars focus on the role of civil society and mass demonstrations in the political transitions of that year, all scholars of the Hungarian transition agree that it was coordinated by elites within the MSZMP. In perhaps the leading English language work on Hungary's democratic transition, Rudolf Tőkés titled the transition a "negotiated revolution" that "was managed and brought to fruition by both the outgoing and the incoming political elites in Hungary."[608] Even with this understanding of the "negotiated" and purposeful elements of the transition, Tőkés does not draw out the direct connection between the economic crisis of the late 1980s and political reform. Scholars who have drawn this connection, such as András Sajó, have usually misunderstood the connection between Hungary's economic crisis and political reform. Sajó wrote, "In order to solve the economic crisis and the resulting social crisis, [the Hungarian leadership] tried to gain Western financial and moral (diplomatic) support. To obtain that

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607 Mong, 225.
608 Rudolf Tőkés , *Hungary's Negotiated Revolution*, 34.

support, they had to meet the human rights criteria set by the West."[609] This argument exhibits perhaps the most common misunderstanding about the role of the West in the Eastern Bloc's democratic transitions – that Western nations set "human rights criteria," which communist regimes needed to meet before they would qualify for Western aid. To a certain extent, this was true, and certainly Western leaders publicly spoke a great deal about tying their aid to the governments' respect for human rights. But the human rights conditions were not the criteria that drove the Hungarian regime (or any other Eastern Bloc government) toward reform.

Instead, through a process I have called "the coercion of creditworthiness," Western nations and banks established a stringent set of economic criteria that the regime needed to meet in order to maintain its access to Western credit markets or receive IMF loans.[610] Because Hungarian officials relied on Western banks to issue Hungarian bonds and attract capital to the country, they had little choice but to meet the banks' demand and work with the IMF. The IMF established a set of criteria that the government would have to implement in order to qualify for Fund financing, and these criteria ensured that Hungarian society would experience a drop in living standards over a period of 3-4 years. Thus, in order to meet these criteria, the reform communists and eventually the regime as a whole launched a process of democratization in order to build social support for economic austerity. Ultimately, this chapter provides evidence of one of the overarching arguments of this dissertation: when the end of the Cold War came in 1989, it

[609] András Sajó, "The Roundtable Talks in Hungary," in *The Roundtable Talks and the Breakdown of Communism*, 69.

[610] This is an old concept within the field of International Political Economy, although I do not know of anyone who has used the phrase "the coercion of creditworthiness." Professor Katzenstein, perhaps you could steer me toward the relevant literature, but representative studies include, Timothy Sinclair, *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness* (Ithaca, NY: Cornell University Press, 2005). Bartholomew Paudyn, *Credit Ratings and Sovereign Debt: The Political Economy of Creditworthiness Through Risk and Uncertainty* (London: Palgrave MacMillan, 2014).

was the result not only of communism's loss of legitimacy among the peoples of Eastern Europe, but its loss of creditworthiness on global capital markets.

Liar's Poker and Goulash Communism

By the spring of 1984, János Kádár's patience with the austerity of the 1979-1983 period had worn thin, and he believed the party's restrictions on the domestic economy had become politically dangerous for his regime. At the April 17, 1984 Central Committee meeting, he told his colleagues, “"Believe me, comrades, the two main slogans we cite and reference most often ‘the international economic environment’ and ‘to preserve the results achieved in the standard of living’ can no longer be retained.” He continued, “Five years ago, we stood before the people and said…the current program is meant to ensure a balance between the economy…and preserving the quality of life. But that was five years ago! Do we think…that it is now also possible for this same program to find acceptance among the people? No! That's not enough! A new program must do more than this." Kádár believed that “the deteriorating standard of living” had eroded the political support of the people, and the new economic program needed to restore public confidence. “The current slogans are not enough. Believe me, 0.5% growth in national income cannot continue to exist, and it cannot win the support of the masses.” Instead, Kádár set the benchmark for the economy's performance at 2.5-3% growth in the standard of living, and told the Planning Office and the National Bank to use whatever means necessary to achieve that goal.[611]

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[611] Central Committee meeting quoted on Mong, 238. *[„Higgyék el, elvtársak, az a két sokszor hangoztatott fő jelszó és hivatkozás, hogy "nemzetközigazdasági körülmények" és az "életszínvonal elért eredményeinek megőrzése", nem tartható…" - érvelt Kádár János 1984. április 17-én a Központi Bizottság ülésén, majd így folytatta:„öt évvel ezelőtt odaálltunk a nép elé, és ezt mondtuk: [...] most az a program, hogy biztosítsuk a népgazdaság [...] egyensúlyát,*

Lucky for Kádár, global economic and financial changes that were completely out of his control brought his thoughts of renewed expansion to fruition. After the collapse of the sovereign lending market in the early 1980s, Western banks were no longer willing to put their own capital on the line to fund loans to sovereign borrowers, so they changed the way they issued debt from loans (directly from the bank) to bonds, which could be sold to any type or class of investor. For Western banks, there was one group of customers for these bonds that stood above the rest: Japanese investors. Japan was the economic and financial juggernaut of the 1980s, and its investors fueled global capital markets as a result. From their perches at Tokyo commercial and investment banks, Japanese bankers invested in anything and everything – most famously in the United States, government bonds and Rockefeller Center. But Japanese companies made so much money exporting their products to the rest of the world that not even the massive United States economy could absorb all of their surplus capital. Therefore, their banks needed to look beyond the US for investment opportunities. "The Japanese were the Arabs of the 1980s,' Michael Lewis wrote in his famous Wall Street memoir, *Liar's Poker*, "Japan's trade surplus left it gorged with dollars it had either to sell or to invest."[612]

From 1984 to 1987, Kádár's Hungary was a favored destination of Japanese capital. After a trip to Wall Street in 1986, Helen Junz reported back to the IMF on this phenomenon.

[...] és meg kell őrizni az életszínvonalat. De hát ez öt évvel ezelőtt volt! Gondolják, hogy ez [...] most is program lehet, és hogy hitelt találna a népnél? Nem! Ez kevés! Más kell, ennél több kell." Kádár szerint „az életszínvonal kopik, olvad"78, vele együtt a nép politikai támogatása is, márpedig a bizalom helyreállításához új program kell, „az eddigi jelszavaink nem elegendőek. [...] Higgyék el, hogy a 0,5 százalékos nemzetijövedelem-növe- kedéssel [...] nem lehet létezni, és nem lehet vele a tömegek támogatását elnyerni. [...] Vagy hiszünkaszocialista rendszerben, abban, hogy többnek kell lennie benne, [...] vagy nem hiszünk benne" - mondta Kádár, és ki is tűzte, hogy évi 2,5-3 százalékos gazdasági növekedést kell betervezni, vagyis többet kell kihozni a rendszerből. Bármi áron.]

612 Michael Lewis, *Liar's Poker*, 181.

"On the whole, the business that was being done was more of a funneling nature," Junz wrote, "with banks issuing Hungarian paper [i.e. bonds] not intending to hold it in their own portfolios. So far, little if any resistance was being encountered in placing these assets in the market (mainly to Japanese and Arab addresses)." New York banks particularly welcomed Hungarian business because Budapest officials were "willing to pay relatively high up-front fees" in order to satisfy "their desire to show very fine spreads," and thus maintain the appearance of a Western European level of creditworthiness.[613]

János Fekete, the Vice Chairman of the National Bank of Hungry (NBH), knew how to play this game, and knew how to play it well. Although investors in New York and London continued to shun Hungarian bonds, the country regained its creditworthiness in Japan by the spring of 1984. Fekete planned to use Tokyo's favor to meet Kádár's policy demands. He would later write, "Since the events of 1981-1982 warned us against borrowing on short term if possible, the main goal was to get long term loans. We could only expect long term loans from countries with current balance surplus such as Japan…We could not get any [US dollar] loans for 10 years."[614] The Japanese bond market – where, in an unwitting demonstration that Orientalism was alive and well in the 1980s, the bonds were known in the Western press as "Samurai Bonds" – served Hungary's financing needs quite well. In 1985, Fekete told the IMF "he was not concerned about the balance of payments" because "Hungary had at present no difficulty in getting medium and long-term funds."[615]

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[613] Memorandum for Files, "Hungary," Sept. 23, 1986, Box 159, File 1, EURAI CF, IMF.
[614] Quoted in Mong, 266. This is Mong's translation (edited for length) sent to the author via email.
[615] Memorandum for Files, "Meeting with Mr. J. Fekete, Senior Vice President, National Bank of Hungary," March 27, 1985, Box 32, File 2, EURAI CF, IMF.

Not everyone in the NBH agreed with Fekete's strategy, however. "Fekete indulges. Are we going to build a plan on sand again?" Bank President, Mátyás Tímár, wrote in his diary in May 1984.[616] Edo Bakó, the Managing Director of the NBH and a skeptic of renewed economic expansion, criticized Fekete for his "excessive optimism," and told Fund officials there were "two different lines among policy makers. For the first group the financial crisis was over and one could safely accelerate growth. For the second group,…demand management should be strengthened…[and the country] should wait before shifting to a more expansionary policy stance."[617]

But with Kádár and Fekete leading the group in favor of an immediate rise in living standards and markets readily obliging, the bureaucracy quickly fell in line. In late 1984, the Planning Office formulated a plan called "The Conditions and Possibilities of Spurring Hungarian Economic Growth." Although the authors of the document warned that the country's debt would continue to rise unless the structure of the economy was changed, they nevertheless projected a path toward 3% economic growth. An official in the Ministry of Finance recalled later, the planners "said that especially in the last two years, 3 percent growth can be achieved, and it would do something to improve living conditions. The planners did not make this choice spontaneously, but instead because the country was already at the limit of what it would tolerate." For Havasi, social pressure on the party made this policy a no-brainer. "How were we to allow a reduction in living standards? Instead, the plan stressed the need to improve them. The country's leadership was under pressure from society. The Congress could not take place on

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616 Quoted in Mong, 241. *[„Fekete engedékeny. Megint homokra építünk tervet?"*].
617 "excessive optimism" in Memoranum for Files, "Hungary," April 16, 1985, Box 32, File 2, EURAI CF, IMF. Other quote from Memorandum for Files, "Meeting with Mr. E. Bakó, Managing Director, National Bank of Hungary," March 27, 1985, Box 32, File 2, EURAI CF, IMF.

the prospect that five years from now living conditions might improve. In politics, this was simply inconceivable."[618]

Like Fekete, Havasi sought to use the benign international financial environment to bolster the party's domestic legitimacy. He told the Politburo in December 1984, "The external economic equilibrium situation is improving, and we have a good international credit reputation. International payments are not a daily problem.…1985 will be the year of the XIII Party Congress, elections, and the 40th anniversary of the country's liberation. The economy has the honorable task of making sure that these major political events go off without a hitch."[619] When the XIII Party Congress arrived in March, the party endorsed a renewed effort to raise the living standards of the population. Mátyás Tímár would later explain the dynamics of the congress to the IMF. "As in the West," he said, the elections that took place at the Congress were

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[618] Quoted in Mong, 242. [*„Nekünk Faluvégi Lajos az akkori OT vezetésével esküdött, hogy a tervben ez benne van. [...] A VII. ötéves terv két variációban készült. Azt mondták, hogy főképpen az utolsó két évben a 3 százalékos növekedést el lehet érni, és akkor lehet valamit javítani az életkörülményeken. Ezt a tervezők nem jószántukból csinálták, hanem akkor az ország tele volt már azzal, hogy a tűrőképesség határán vagyunk. Mikor hagyjuk már abba az életszínvonal csökkentését? Emelni, javítani kell. Társadalmi nyomás volt az ország vezetésén. Egy kongresszuson nem lehet azt kilátásba helyezni, hogy öt év múlva majd javulhatnak a viszonyok. Ezt egyszerűen a politika nem tudta elképzelni"99 - emlékezett egyik interjújában Havasi Ferenc.*]

[619] Ibid, 242. [*„Külgazdasági egyensúlyi helyzetünk javul, hitelképességünk nemzetközi megítélése jó. [...] Fizetési kötelezettségeink teljesítése már nem napi gondként jelentkezik. [...] Nem sok hozzánk hasonló ország mondhatja el magáról, hogy fizetőképességét úgy őrizte meg, hogy [...] a belső felhasználásban elkerülte a drasztikus, a társadalmi megrázkódtatást okozó visszaesést" - sorolta az eredményeket a KB gazdaságpolitikai titkára a testület 1984. decemberi ülésén, majd Havasi azt is nyilvánvalóvá tette, hogy 1985-nek már nem a megszorításokról, a nehézségekről kell szólnia. ‚Jlz 1985. év a XIII. kongresszus, a választások és a felszabadulás 40. évfordulójának éve. A gazdaságra az a megtisztelő feladat hárul, hogy elősegítse a jelentős politikai események eredményes lezajlását"101 – mondta.*]

"accompanied by promises. The party congress wanted to paint an optimistic picture and promised more investment and better living standards."[620]

But red flags abounded, both within Hungary and across the Atlantic Ocean. Bakó encouraged the IMF's Managing Director, Jacques de Larosière, to "exert an important influence in encouraging the authorities to accelerate the process of reform and in underscoring that from the external standpoint the economy remained far from a safe harbor."[621] *PlanEcon* eventually found more biting words:

> "Knowing full well that Hungary cannot go on indefinitely supporting high domestic consumption by sliding deeply into debt, [economic] advisors – notably individuals responsible for Hungarian external borrowing – have reassured Mr. Kadar that there is no problem in supporting his policies and they can raise all the money that is necessary. They have discovered a new source of funds with an insatiable appetite for lending at the finest possible terms – Japanese commercial banks. Because the Japanese financial institutions are so flush with surplus funds (reflecting Japan's huge trade surplus) and already over-exposed in their holdings of U.S. government securities and debt instruments, they are eager to find alternative sovereign borrowers and are not overly concerned with understanding the purposes for which they [*sic*] money is to be used. In order to please Mr. Kadar, Hungarian bankers are supporting unsustainable economic policies and deliberately bringing the country ever closer to an external payments crisis….The most disturbing aspect of this is that they know very well what they are doing and what the consequences might be, while Mr. Kadar may have considerable difficulty in understanding the consequences of his own policies."

If Kádár was unaware, the IMF Managing Director's visit to Hungary in the spring of 1985 should have dispelled his ignorance. In order to bolster their international standing, Hungarian officials had been hoping de Larosière would visit Budapest since the country was first admitted to the institution in 1982. When the visit came three years later, it occurred at a palpable moment of transition in the Eastern Bloc, and the Fund saw it as an important

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[620] Minutes of Meeting, "Meeting with the President of the NBH," Aug. 17, 1987, Box 32, File 3, EURAI CF, IMF.
[621] Memorandum for Files, "Hungary," April 26, 1985, Box 32, File 2, EURAI CF, IMF.

opportunity. With Mikhail Gorbachev coming to power in the Soviet Union, a briefing memo noted, "the reform-minded people…and the conservatives…are closely watching the signals from Moscow. Therefore, there is at present a certain air of uncertainty and anxiety as to the course the 'big brother' will take." The memo concluded, "A successful visit by the Managing Director would give a significant boost to the prestige of the reformers."[622]

The visit was undoubtedly a personal success, and appeared at first glance to be a professional success as well. In a thank you note to Tímár after the visit, the MD thanked the bank president for his "weekend visit with you and your wife to Lake Balaton, which combined the pleasures of good company, delicious food and wine, excellent fishing, a beautiful Mass, and superb scenery."[623] Professionally, de Larosière later recalled the "deep and thoughtful discussions" he had with Kádár,[624] and declared himself "immensely impressed by the detailed knowledge of the economic problem facing Hungary displayed all the way up to the highest levels of the Hungarian leadership."[625]

And yet nothing changed. As 1985 unfolded, the Kádár regime released the reigns on imports from the West, borrowed Japanese capital to pay for them, and rapidly deteriorated the country's current account (net capital flow). The reason for this resistance to reform, however, was not what the IMF had anticipated. The conservatives in Hungary were empowered not by signals from their "big brother" in Moscow. On the contrary, Gorbachev almost immediately made clear to the Eastern Bloc and the world at large that he was intent on reforming the command economic system. And the conservatives were not empowered by some failure on the

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[622] Gyorgy Szapary to Mr. Whittom, "Hungary," May 2, 1985, Box 32, File 2, EURAI CF, IMF.
[623] J. de Larosière to Matyas Tímár, Letter, May 30, 1985, Box 32, File 2, EURAI CF, IMF.
[624] Letter from de Larosière to Kadar, Nov. 27, 1985, Box 32, File 2, EURAI CF, IMF.
[625] J. de Larosière to Matyas Tímár, Letter, May 30, 1985, Box 32, File 2, EURAI CF, IMF.

part of de Larosière to strongly make the case for reform to Hungarian officials. On the contrary, Tímár recorded in his diary that the MD "strongly emphasized the role that reducing debt would play in determining Hungary's perception in the marketplace."[626] Instead, the possibilities of markets trumped the prudence of sound financial policy. Until markets told Budapest to change, there would be no reform in Hungary.

By the time IMF officials were preparing to meet Fekete at the Annual Meetings in October, the head of the European Office, L.A. Whittome, wrote to de Larosière, "As you know Fekete talks rather than listens but I have been trying to get home to him the risks he is running with renewed heavy borrowing…whilst letting the current account slip into deficit. Unfortunately memories in Hungary seem to be very short."[627] In one-on-one conversations with Whittome, Fekete defended his practices with the strategies of a Ponzi scheme, noting that debt "maturities falling due in 1986 were particularly heavy some $1.9 billion but he had already made an advance repayment of $500 million from the proceeds of the medium-term loans" he had just taken out. Because Hungary had gone through a difficult winter in 1984-85 and world prices for agricultural exports were depressed (which together increased Hungary's energy use and hurt the value of its exports), Fekete believed that taking out new medium term loans to repay old debts was just part of the job description of a central banker in his circumstances. Despite Whittome's insistence on "the foolishness of building up a debt exposure," Fekete told him that he "felt under no pressure."[628]

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[626] Quoted in Mong, 256. [*„erősen hangsúlyozta, hogy hitelpiaci megítélésünkben szerepe lesz annak, a továbbiakban tudunk-e csökkentést elérni az adósságaink terén"*]
[627] L.A. Whittome to the Managing Director, "Hungary," Oct. 9, 1985, Box 32, File 2, EURAI CF, IMF.
[628] Memorandum for Files, "Hungary," Oct. 10, 1986, Box 32, File 2, EURAI CF, IMF.

By late November the situation had become so worrisome that Whittome convinced de Larosière to write a personal letter directly to Kádár. Noting the serious and informed nature of the discussions they had while in Budapest the previous May, the Managing Director wrote that he was "particularly concerned to hear that instead of a surplus on the external current account in convertible currencies, a deficit is likely to be recorded." He continued, "I single out this question because it was the achievement of a current account surplus over the two preceding years that, more than any other consideration, underpinned the restoration of Hungary's access to international financial markets."[629] Edo Bakó told Fund officials that the letter was "well done" because it "highlighted the most negative aspects of the Hungarian economy."[630] Bakó's persistent effort to work with the IMF to influence his own government reinforces an impression that a frustrated Helen Junz shared with her IMF colleagues during one of many visits to Budapest, "I feel like we are basically message brokers, because these people cannot effectively speak with one another."[631] As long as markets looked kindly on Hungary, the IMF could indeed only be a message broker. As soon as markets lost confidence, however, the IMF would become a power broker, defining the terms on which Hungary could regain the markets' favor.

But those moments of crisis lay in the future. As the economy continued to falter in the early months of 1986, increasing numbers of Hungarian officials joined Bakó in the skeptics' camp. Resző Nyers, the economist known as the father of the country's "New Economic Model" in 1968, said the country's deterioriating economic performance proved "this system and this method have been...exhausted." And the Secretary of the Planning Office, János Hoos, publicly

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629 Letter from de Lariosère to Kádár, Nov. 27, 1985, Box 32, File 2, EURAI CF, IMF.
630 Alan Tait to Mr. Whittome, "Hungary: Discussions with the National Bank of Hungary," Dec. 23, 1985, Box 32, File 2, EURAI CF, IMF.
631 Quote in Mong, 230.

stated that planned increases in the standard of living would have to be reviewed if economic performance did not meet the targets set for 1986. [632] Whittome told the Managing Director in April, "the atmosphere in the National Bank seems to be poisonous," and a Hungarian official disclosed in June that, "at neither the technical nor the political level were the authorities happy."[633]

The man at the top, however, remained steadfast in the face of looming economic crisis. Kádár told the Politburo in June, "I say, comrades, we cannot change the decision of the Congress, the five-year plan, or the annual plan …. Those decisions pointed us in the right direction. Several speakers said that they believe the plan will not be completed this year. I say, comrades, we must not stop our work …. The plan must be kept."[634] And to the surprise of financial policymakers in both the NBH and the IMF, markets continued to fund Kádár's unsustainable dreams through the summer of 1986. Whittome declared himself dumfounded. "It is amazing that the banks are prepared to go on lending at very fine terms to Hungary in this situation."[635]

In September 1986, dissent continued to ripple through Hungarian financial and political circles. Károly Grósz, a Politburo member and the man many expected to succeed Kádár,

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[632] Nyers quote and Hoos statement in Mong, 258. [Nyers - *„ebben a rendszerben és ebben a módszerben [...] kimerült".*]
[633] L.A. Whittome to the Managing Director, "Hungary," April 8, 1986, and Memorandum for Files, "Hungary," June 2, 1986, both in Box 159, File 1, EURAI CF, IMF.
[634] Quotes in Mong, 258. [*Kadar - „Én azt mondom, elvtársak, hogy sem a kongresszusi határozathoz, sem az ötéves tervhez, sem az éves tervhez nem nyúlhatunk. Akármennyit is gondolkodik az ember, úgy tűnik, hogy abban a helyzetben, amikor ezek a határozatok születtek, helyesek voltak. [...] Az irány, amit ezek a határozatok jeleztek, helyes. Több felszólaló elmondta, hogy meggyőződése szerint az idei terv nem teljesíthető. Én azt mondom, elvtársak, így mi ne álljunk hozzá a munkához. [...] Ezek a tervek valójában mind politikai, gazdasági, harci célkitűzések. [...] A tervet tartanunk kell."*]
[635] L.A. Whittome to the Managing Director, April 8, 1986, Box 32, File 3, EURAI CF, IMF.

signaled a change in his own thinking in an interview with a small Hungarian publication, *Siker*. Hungary has made "terribly slow progress in today's fast developing world, against a background of accelerating technological revolution," he said. "Unless we change our present conditions, the economic-technological challenge of the world will impose increasingly heavy burdens on us." Since launching the New Economic Mechanism in 1968, the party had been unable "to modernize the structure of our economy." And these eighteen years of persistent problems had demonstrated that "it is not just a technical problem…it is a political problem." Reform was a political issue because it necessarily would lead to greater inequality. "If we place greater value on bigger and better performance, then some workers will earn more than others. And if we penalize performances which are below average, then some other workers will get considerably less money than the average worker. In other words, the differences in earnings will increase considerably, a condition which our society still barely tolerates." For Grósz, this aversion to inequality was a real and important impediment to reform, but it was born of a misreading of the very socialist doctrine the country professed to follow. "Marxism has never accepted egalitarianism, but rather the postulate of equal opportunity. This postulate takes into account, in all respects, the possibility of considerable inequality…Equality has never been and cannot be a feature of socialism. Its great advantage consists precisely in its ability to automatically grant greater opportunity to everyone than does capitalism."[636]

It was an astonishing reinterpretation of Marxist doctrine, but it was one that fit the times. Grósz was not alone. At the same moment, Imre Poszgay, a headstrong cadre who had been banished from the top leadership of the party in 1982 to become leader of the party's umbrella

[636] "Our Problems and Possibilities: An Interview with Karoly Grósz," Translated and added to Memorandum for Files, "Hungary – Interview with Mr. Karoly Grosz," Dec. 4, 1986, Box 159, File 1, EURAI CF, IMF.

social organization, the Patriotic People's Front (PPF), commissioned a report from a group of fifty economists and social scientists within the Ministry of Finance and various economic research institutions on the causes of the economic crisis and avenues toward reform. The 220 page document they collectively produced, titled "Turnaround and Reform," outlined the leading reformist economic thinking at the time and marked the first step in the MSZMP's strategy to develop social and political pluralism as a means of implementing economic reforms. "The 1980s, and particularly the experiences of 1985-86," the report began, "indicate that the Hungarian economy is in a serious crisis."[637] According to the authors, the country's continued reliance on extensive growth wasted resources and prevented Hungarian goods from competing in the world economy. Reliance on the stilted trading and financing systems of Comecon, the inconvertibility of the forint (the national currency), and significant government restrictions on imports had all sheltered Hungarian industries from the competition of the global economy and allowed most of the country's major industries to become globally uncompetitive. If the country was to recover, the authors wrote, the party and the government would have to close inefficient enterprises, make the Hungarian forint (Ft) convertible, liberalize imports, cut corporate taxes and subsidies, adopt a restrictive monetary policy, and allow for a greater degree of wage differentiation between workers based on productivity. Over time, the system of state ownership needed to be reformed as well, so that the economy encouraged firms to focus on building up

[637] Quoted in Tibor Kovácsy, "Politikai reformtervek Magyarországon - „FORDULAT ÉS REFORM," [Poltical Reform Agenda in Hungary – Turnaround and Reform] [*A 80-as évek — különösen az 1985—86-os évek tapasztalatai — azt mutatják, hogy a magyar gazdaság súlyos helyzetben van.*]

their long-term wealth, instead of just maximizing annual revenues.[638] In short, the authors believed their country needed to be exposed to the competitive pressures of the world economy.

But this process of structural adjustment – a term the report itself used (*szerkezeti alkalmazkodási*) – would not be quick, popular, or produce immediate results. "Transformation of the structure of the global economic adjustment clearly involves victims of the reform policies that can be mitigated, and the distribution of burdens must be made socially acceptable. A sincere and realistic reform policy cannot promise rapid economic growth and rising standards of living in the short term. In fact, it should be openly said that it might even temporarily bring economic losses as well."[639] Therefore, the economists believed it needed to be accompanied by social and political reforms to build social support for change. The reform program should not be "limited to the economy in the narrow sense of the term. Because the program's implementation in society depends on actions embedded in people's behavior, it should cover other areas of social relations, including the political conditions." Succinctly, the authors concluded, "Economic reform and social reform go hand in hand."[640]

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638 This point is emphasized in Ivan Szelenyi, "Eastern Europe in an Epoch of Transition: Toward a Socialist Mixed Economy?" in Victor Nee and David Stark, eds., *Remaking the Economic Institutions of Socialism: China and Eastern Europe* (Stanford University Press, 1989), 228.

639 [*A szerkezet átalakítása, a világgazdasági alkalmazkodás nyilvánvalóan áldozatokkal jár, amit a reformpolitika mérsékelhet, illetve a terhek elosztását társadalmilag elfogadhatóbbá teheti. Az őszinte és reális reformpolitika rövid távon nem ígérhet gyors gazdasági növekedést, emelkedő életszínvonalat, sőt, nyíltan meg kell mondani, hogy átmenetileg még gazdasági veszteségekkel is jár.*]

640 [*A reformprogram nem korlátozható a szűkén értelmezett gazdaságra. Mivel megvalósulása a társadalomba és nem csak annak gazdasági szférájába beágyazott emberek magatartásán, cselekvésén múlik, ki kell terjednie a társadalmi viszonyok egyéb területeire, ezen belül a politikai viszonyokra. A gazdasági reform és egy társadalmi reform a legszorosabb összefüggésben áll egymással. (...)"*]

In its vision for reforming the economy, "Turnaround and Reform" sounded as though the IMF itself had written it. Unsurprisingly, then, IMF officials were pleased and impressed when they learned of its economic contents. What did surprise Fund officials, however, were the political, social, and legal changes also called for in the document. In a summary of the report circulated in the European office, Fund economist George Kopits called it "a remarkable document" that presented "daring solutions" because "the reform process is interpreted as both a government program as well as a social and political movement." After summarizing the economic program, Kopits noted that the report "suggests a new division of responsibilities among the Party, the government, the courts, and interest groups. In such a system, the government would operate effectively and responsibly,…[and be] subject to public scrutiny." Importantly, "interest groups, as well as individuals, would participate openly and democratically in the debate on, and thus identify with, the reforms."[641]

This vision of politics – as a societal forum for interest groups and individuals to express their competing interests and arrive at consensus – defined Imre Poszgay's vision for Hungarian reform. In a theoretical article published in 1987 titled, "Political Institutions and Social Development," Poszgay sought to diagnose "why, despite our earlier initiatives and an economic reform launched nearly 20 years ago, we are still coping with problems similar to the ones in countries that have not changed meaningfully their…systems of economic management." To develop an answer, he wrote, "it is necessary to investigate…our political system." The failings were numerous – "voluntary public and political organizations lack sufficient weight," "the representation of interests is very unstable," and the "failure up to now to define economic self-

[641] George Kopits, Memorandum for Files, "Hungary – Overview of Change and Reform," March 26, 1987, Box 32, File 3, EURAI CF, IMF.

management and self-government" so that they "ensure local independence and initiative." Ultimately, Poszgay wrote, "the reform of economic management has produced…the realization that the interest relations cannot be explored, and sound and necessary policy decisions cannot be made, without openly letting the interests surface, clash and be represented." This meant, "an essential feature of socialist democracy is…the development of a system for the representation of interests, based on the variety and division of interests." This was not, it must be made clear, advocacy for a transition to a "Western-style" (a term often used in reformist circles as a point of comparison) multi-party democracy. That would come later. In Poszgay's vision of reform, the MSZMP retained its leading role in society. But what Poszgay did argue, was that the communist party could no longer assume or impose social consensus on society, as had been done under the Stalinist model. Instead, consensus had to be arrived at through the open recognition and representation of society's competing interests.[642]

While ideas of political reform expanded under the watchful eye of Poszgay and the PPF, financial officials within the NBH rebelled against Fekete's borrowing strategy. In October 1986, the head of the credit policy department at the NBH wrote to Tímár in October, "We do not agree with an economic policy that assumes the continuation of the external debt…. The increase in debt that occurred in 1985, 1986 and is expected for 1987 has not led to a technological renewal…. If the Hungarian economy…does not show appreciable improvement in 1987, a deterioration in the international perception of our creditworthiness may be inevitable. This could lead to severe consequences."[643] György Zdeborsky, the head of the foreign

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[642] Imr Pozsgay, "Political Insittutions and Social Development," Tarsadalmi Szemle No 3, 1987, translated in Joint Publication Research Search – Eastern Europe (JPRS-EER) – 87-060.
[643] Quoted in Mong, 259. [*„Nem érthetünk egyet olyan gazdaságpolitikával, amely a külső adósság további folytatását feltételezi. [...] Az 1985-ben, 1986-ban és várhatóan 1987-ben bekövetkező adósságnövekedés ugyanúgy nem vezetett technikai megújuláshoz…[...] Ha a*

exchange department at the time, later recalled, “Serious discussion…broke out for the first time in September 1986 when it became clear that the balance of payments in 1986 would not be in accordance with the plan…. Then the foreign exchange management department went through a serious spiritual crisis.”[644]

In November, the Central Committee held an emergency two-day meeting to discuss paths out of the economic crisis. The CC resolution published after the meeting euphemistically called for “stabilizing the 1985-86 standard of living” and “selective” industrial development. Behind the evasive language were clear signals that wage differentiation would increase, social subsidies would be cut, and loss-making enterprises would no longer be supported by the state budget. In an interview after the meeting, János Hoos, the chairman of the Planning Commission, said economic reform had “become a life or death issue,” but it was dependent on “the existence of a society-wide consensus that supports this type of conflict-ridden economic policy.” Therefore, he said, the Central Committee had decided to increase the role of party organs and social organizations in economic life, because the party’s “main task” in the crisis was to “establish political conditions in which the economic policy can be realized.”[645]

As these voices of reform coalesced at home, Fekete returned to the international financial scene, where he remained admired as “an old soldier” of global finance known for his “astuteness and acerbic wit.” At the IMF Annual Meetings, he lectured audiences of capitalists

magyar gazdaság [...] 1987-bensem tud érzékelhető mértékű javulást felmutatni, nemzetközi hitelképességünk megítélésének romlása elkerülhetetlen, és ennek konzekvenciái súlyosak lehetnek.]

644 Quoted in Mong, 264. [„*Komoly vita [...] 1986 szeptemberében tört ki először, amikor már világos volt, hogy az 1986-os fizetési mérleg messze nem a terveknek megfelelően fog alakulni*] [„*Akkor a devizagazdálkodási főosztály komoly lelki válságon esett át…*]

645 “After the Resolution: Interview with Janos Hoos,” *Otlet*, Dec. 4, 1986; translated in JPRS-EEC-87-024, pp. 20-26.

about their mistaken abandonment of the Bretton Woods system in 1971. Before the early 1970s, he said, capitalist countries "enjoyed more or less steady economic growth, relatively stable prices, nearly full employment, and flourishing world trade, causing much embarrassment and headache to all of us believers in the cyclical crisis theory of capitalism." Since then, however, the chaos of the post-Bretton Woods system had hurt both the industrialized nations of the West and the developing nations of the Second and Third World. Particularly since the onset of the global debt crisis in the early 1980s, Fekete told the assembled financial elite, global capital had been flowing in the wrong direction – from the poor to the rich; from the developing back to the developed. "We are today witnessing a reverse blood transfusion whereby the healthy get blood from the sick," he declared.[646]

In a speech a few weeks later at a meeting of global financial elites in New York aimed at solving the problem of global debt, Fekete further developed these themes, and made common cause with the nations of the Global South. "The economies of the indebted developing countries – virtually the majority of the world – are damaged by low raw material prices, high real interest rates, high debt servicing burdens, as well as slow economic growth and increasing protectionism in the developed countries." In a later speech, he would cite important and startling numbers, "While during 1972-1982, $147 billion of long-term capital entered the developing countries, the tendency reversed during 1983-1987, when $85 billion flowed out of these countries."[647] Finance ministers, politicians, and populations of countries across the Global South shared Fekete's sense of injustice, and indeed a Mexican, Nigerian, or Filipino official

[646] Unknown financial periodical article, "Bad Blood," Nov. 1986, in Box 159, File 1, EURAI CF, IMF.
[647] János Fekete, "Statement by the Hon. Janos Fekete," Sept. 28, 1988, Box 33, File 3, EURAI CF, IMF.

could have delivered the same exact lines. For all of these countries, Fekete said, "Severe adjustment programs undermine their potential for future growth…[and] the balance of trade surpluses attained by so heavy sacrifices are used to service debts." Fekete believed the populations suffering under these conditions had reached their breaking point. "For borrower countries it becomes politically more and more difficult to sustain severe adjustment programs if they do not see the proverbial light at the end of the tunnel. What we need today is a comprehensive program for world economic recovery centered on solving the debt crisis."[648]

For the historian, this moment in late 1986 is full of irony and explanatory power. Fekete was at once right in the policy he prescribed internationally and wrong in the policy he endorsed domestically. Political leaders of all stripes – including US President Ronald Reagan and his Treasury Secretary James Baker, who in 1985 launched his own failed effort to solve the global debt problem – agreed with or at least paid lip service to the basic points of his analysis. But nothing changed, and developing countries did not attain meaningful debt relief until the spring of 1989, when Baker's successor at the Treasury Department, Nicholas Brady, launched his own debt relief plan that succeeded in actually lowering the debt burden of some developing countries. At that point, of course, Hungary was in the throws of political and economic change – change it likely would have avoided had Western nations, and particularly the United States, "solved" the problem of global debt sooner. Because Western nations did not implement a successful debt relief plan, and - to use Fekete's image - the healthy kept getting blood from the sick, Hungary was forced to reckon with its debt burden beginning in 1987.

[648] János Fekete, "Proposal for the Solution of the Debt Crisis: A Program for World Economic Recovery," Dec. 4-5, 1986, Box 159, File 1, EURAI CF, IMF.

Despite his justified critique of the international financial system, Fekete endorsed a policy at home that shored up the party's short-term popularity at the expense of the country's long-term economic well-being. Building up debt from 1984-1986 delayed the implementation of domestic structural adjustment. In 1987, markets finally began to coerce Fekete, Kádár, and the reluctant bureaucracies of the Hungarian state into instituting these reforms. From that point onward, Hungary would implement the very adjustment policies that Fekete criticized, all in the hope of becoming economically competitive in the global marketplace. And to do so, the Hungarian Socialist Workers' Party would jettison the political system and ideological foundation that had guided the state for over forty years.

The Coercion of Creditworthiness

In what he termed the "24th hour for decision-making in Hungary," Fekete took up the reformist cause in February 1987 because markets were losing confidence in his country. He now approached the IMF with a request for a three year Fund program to support Hungary's effort at fundamental structural transformation. Whittome welcomed Fekete's and the government's newfound interest in undertaking reform, but he told the Vice Chairman that three year programs were no longer part of Fund practice, and in any case the conditions that Hungary would have to meet for such funding would be too severe for the country's current conditions. More appropriate, Whittome thought, would be a one-year stand by agreement that would provide the country with some financing, but more importantly, would signal to the marketplace that the government was getting serious about reform. Fekete countered that "the Government would not be impressed with a stand-by for a modest amount of say, US $300 million." Instead, he believed that a three-year arrangement involving $900 million in new financing would be “more saleable.” The two sides agreed to defer their differences until an IMF team travelled to Budapest in April.[649]

When the Fund team’s visit began on April 13th, Hungarian officials believed they were instituting reform and austerity measures as fast as possible without inviting a destabilizing social reaction. In March, the government had devalued the forint by 8% against a basket of Western currencies, which made Hungarian exports cheaper but increased the price of the country’s imports. As part of the World Bank’s package of structural adjustment loans, which Hungary had been receiving since 1982, the government was also working to establish a system of commercial banks that would operate independently of the NBH, but getting the new banks off the ground was difficult and added to societal uncertainty. Finally, and most significantly, the government had also announced the introduction of a national personal income tax and value-added tax that would take effect on January 1st, 1988 and dramatically overhaul how individuals and companies were taxed. There was a great deal of uncertainty and discussion in society about the effects of the tax reform on Hungarian standards of living, but the government minister for price control projected the tax changes would result in a 3.5-4% price increase and that the general price level would rise 12% in 1988.[650] While the Fund delegation was in Budapest, the leadership committed to holding the current account deficit for 1987 to $700 million, which was down from $1.4 billion in 1986, and the state budget deficit to Ft 30 billion, which had originally

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[649] Memorandum for Files, “Hungary- Meeting with Mr. J. Fekete,” March 3, 1987, Box 32, File 3, EURAI CF, IMF.

[650] “Interview with Bela Szikszay, State Secretary and President of the Office of Matieral and Price Control,” *Figyelő,* July 2, 1987, translated in JPRS-EER-87-145, p. 69.

projected to be Ft 47 billion.[651] Thus, in April Hungarian officials felt they were already reaching the limit of what they could safely ask society to accept before tensions boiled over.

The IMF demanded more. In his first meeting with the IMF delegation, Tímár told the delegation, "There [is] no big difference between the International Monetary Fund and [the] Hungarian leadership as to what should be done, the difference being largely with regard to timing. Political stability in Hungary was a very important issue." Tímár was concerned that although "the population accepted the effects of these measures to a certain degree, one had to guard against overloading." But Helen Junz, the leader of the delegation, told Tímár she was disappointed "inefficient industries were still receiving budgetary subsidies" and "the policies did not seem to go far enough in reducing the budget deficit." Instead of a deficit of Ft 30 billion, Junz wanted to see a deficit of Ft 20 billion. If Tímár was concerned about placating the domestic population, Junz reminded him that he needed to placate the market too. She reminded him that based on current projections Hungary would have to borrow $3.5 billion on international credit markets in 1987 and 1988 just to stay financially afloat. "The market," she said, "would only be willing to support such needs if economic policies were perceived to be effectively channeling resources into productive uses." Just to reinforce the point, she noted that "two recent issues of Hungarian debt on international markets had encountered some placement problems."[652]

Far from resisting these calls for greater reform, some Hungarian officials actively sought to use the IMF and the threat of a loss of market confidence to further the reform

[651] Minutes of Meeting No.17, "Hungary- Staff Visit," April 18, 1987, Box 32, File 3, EURAI CF, IMF. 1986 current account deficit and initial budget deficit projection from "Briefing Paper- Use of Fund Resources," Nov. 20, 1987, Box 33, File 1, EURAI CF, IMF.
[652] Minutes of Meeting No. 2, "Hungary – Staff Visit," April 13, 1987, Box 32, File 3, EURAI CF, IMF.

movement. Finance Minister Peter Medgyessy advocated reform at a conference of business leaders on the grounds that "Hungary's international financial rating largely depends on significant near term accomplishments in structural transformation and the subsequent rate of decrease in budgetary deficits."[653] In her letter to Hungarian officials at the end of the April visit, Junz warned that "the progressive erosion of ease of access" to capital markets "must be counted [as] a clear and present danger."[654] But after seeing an advance copy of the document, Deputy Prime Minister József Marjai told Junz it was "insufficiently critical of the Hungarian economic situation and the Government's policies." Marjai believed "the political and economic leadership needed to be confronted with a sense of urgency before they would take action." "The Fund," he told Junz, "could help in producing such a climate among the Hungarian authorities."[655]

There was a fine line, however, between creating a sense of urgency and dictating conditions. Some Hungarian officials, such as Marjai, wanted the IMF to do the first, but no Hungarian officials wanted the IMF to appear to be doing the second. Therefore, the IMF's interlocutors in the NBH, the Finance Ministry, and the Planning Office detailed a careful two stage negotiating process with the Fund for a stand-by agreement in order to "make the whole process politically more palatable" and "minimize the appearance of outside pressure." First, the Hungarian officials would use the June Central Committee meeting to gain adoption of a more stringent economic and financial plan for the remainder of 1987. Then, they would hold initial

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[653] "Dialogue on Tax Reform," *Heti Vilaggazdasag*, May 16, 1987, translated in JPRS-EER-87-111, p. 98.
[654] Helen Junz to Mr. J. Marjai and Mr. J. Fekete, "Staff Visit to Hungary, April 12-18, 1987," April 17, 1987, Box 32, File 3, EURAI CF, IMF.
[655] Minutes of Meeting No. 16, "Hungary- Staff Visit," April 18, 1987, Box 32, File 3, EURAI CF, IMF.

negotiations with the Fund in July, where Fund officials could "comment on the authorities' policy plan" and the two sides could work out an unofficial framework of a stand-by agreement. But negotiations to finalize the agreement would not be held until October to "allow possible needed changes to the policy program to be agree internally and possible preconditions [of the stand-by] to be put in place." If all went according to plan, the government could begin receiving the stand-by funds at the very end of 1987 "in order to help bridge the import needs associated with the implementation of the structural reform measures [the income and value added taxes] foreseen for January 1988."[656]

Having coordinated their actions externally with the IMF, NBH officials now turned inward to convince the government of the necessity of taking action at the June 3rd Politburo meeting. Now fully convinced of the urgency of reform, Fekete told his subordinates at the bank, "The end of May has created a seriously threatening situation, and it is our duty to share our opinion with officials and committed party members. We believe it is essential for the leadership to be aware of [the nation's] financial position." In conjunction with Miklós Németh, the party's new reformist economic secretary, the NBH prepared a bleak report for the Central Committee detailing the troubles on the horizon. "We believe that the [projected] 1987 deficit of more than $1 billion cannot be financed in 1988," the report stated. "There is acute danger, the time to take decisive action is growing short." To escape the crisis, the document declared "[we] must reach agreement with the IMF on an appropriate stand-by credit and create the political and economic conditions" necessary to implement it in 1987.[657]

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[656] Helen Junz to the Managing Director and the Deputy Managing Director, "Hungary- Back-to-Office Report – April 12-18, 1987," April 28, 1987, Box 32, File 3, EURAI CF, IMF.
[657] These are from a document given to Mong by a current policymaker in Hungary who asked not to be identified. Thus, the document remains in Mong's personal possession. Quoted on p. 269. [*Az egyre növekvő fizetésimérleg-hiány miatt 1987. nyár elejére olyan aggasztó jelzéseket*

János Kádár accepted the eventuality of reform, but remained reluctant to embrace its urgency. He complicated the adoption of the new reform package at the June Central Committee meeting when he criticized the language in the reform proposal. “I do not think that we were [are?] close to insolvency status. Much of this is a dramatization. Nor would I say that the situation is worse today than it was three years ago."[658] With the General Secretary dawdling, the Central Committee could not agree on a package of reform and austerity measures, and Marjai told Fund officials afterwards that their “old line of warning that the banks would lose confidence and cease to be net lenders no longer had credibility.”[659] To give a jolt to the debates going on in Budapest, Fund officials decided they needed to threaten to suspend negotiations on a stand-by and to cancel the trip to Budapest scheduled for July. Upon hearing of Marjai’s message, Junz “posed the question” within the European Office of “whether we would not gain

kapott a politikai vezetés az MNB-ből, amely azt mutatta, hogy a Fekete által idézett 24. órának is az utolsó percei peregnek. „A május végével kialakult súlyos veszélyekkel fenyegető helyzetben, minta kérdéssel foglalkozó szakemberek és elkötelezett párttagok, kötelességünk véleményünket elmondani. Elengedhetetlennek tartjuk, hogy álláspontunkról a legfelső gazdasági vezetés tudomást szerezzen" - írták Fekete János első elnökhelyettesnek a saját beosztottai az MNB-ben 1987. június 3-án. Ebben az engedélyét kérték, hogy az általuk elkészített, és a fizetésképtelenség rémével fenyegető helyzet leírását tartalmazó jelentést eljuttathassák amegfelelő helyre, legfőképpen Németh Miklósnak, az MSZMP KB gazdaságpolitikai titkárának. (Az iratot a szerző az egyik korabeli döntéshozótól kapta meg, aki személyét nem kívánta felfedni.) A dokumentum valóban drámai képet mutat: „úgygondoljuk, hogy 1 milliárd dollárt meghaladó 1987. évi deficit mellett 1988 nem finanszírozható. [...] A veszély akut, a rendelkezésre álló idő egyre kevesebb, parancsolószükségszerűségként jelentkezik a határozott cselekvés” - írták, és világossá tették, hogy még 1987-ben „megállapodásra kell jutni az IMF-fel a megfelelő készenléti hitel nyújtásáról, s ennek politikai és gazdasági feltételeit meg kell teremteni"]

658 Quoted in Mong, 267 [*„Nem írnám azt, hogy közel kerültünk a fizetésképtelenség állapotához. Sok az ilyen dramatizálás. Azt sem írnám, hogy ma rosszabb a helyzet, mint három évvel ezelőtt volt" - - bírálta méltatlankodva Kádár János a Politikai Bizottság 1987. június 3-ai ülése elé került tervezet megfogalmazásait, amely a gazdasági-társadalmi kibontakozáscselekvési programja címet viselte.*]

659 L.A. Whittome to Mr. Rose, “Hungary,” June 8, 1987, Box 32, File 3, EURAI CF, IMF.

in leverage by questioning the need for a visit under current circumstances."[660] Two days later, she wrote to Fekete, "We believe that, if your authorities have not been able to formulate their policy program beyond the general outlines known last April, a visit might not be very productive. In fact, it could be counterproductive…. [T]he markets might react negatively if it became known that we had begun talks without any positive outcome."[661] Although the letter was addressed to Fekete, its message surely was meant not for him, but instead for the authorities wrestling over the fate of the country above him. It was yet another instance of Hungarian and IMF officials collaborating to use the weight of the IMF and the nebulous, but all-important, "opinion of the market" to influence the course of domestic Hungarian debates.

And their collective efforts worked. In late June, Károly Grósz formed a new government as prime minister, and the reformers in the NBH and the Ministry of Finance received a limited mandate to cut back state subsidies to the economy. On July 21st, Fekete wrote to the Fund to inform them that the government had adopted a new package of policies that would cut Ft 5 billion in state spending. The government cut subsidies to four major commodity groups with centrally planned prices. The price of motor oil and gasoline increased 2 forints per liter, the price of household energy went up by an average of 20 percent, the price of tobacco products went up 20 percent, and the average price of flour and bakery products went up 19 percent. Fekete told the Fund that the government would take compensatory measures to protect pensioners and families in "justified cases." The total cost to the budget of these measures would be roughly Ft 1 billion, so the net savings to the budget would be Ft 4 billion.[662]

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[660] Helen Junz to Mr. Whittome, "Hungary," June 10, 1987, Box 32, File 3, EURAI CF, IMF.
[661] Helen Junz to János Fekete, June 12, 1987, Box 32, File 3, EURAI CF, IMF.
[662] János Fekete to Massimo Russo, Patrick de Fontenay, and Helen Junz, July 21, 1987, Box 32, File 3, EURAI CF, IMF.

Although it was delayed until mid-August, the IMF staff's visit to Budapest went ahead after the announced policy changes. But having raised prices significantly, the reformist coalition now believed society needed time to digest the austerity measures. Thus, Fund officials found themselves in the familiar position of advocating more aggressive action, but this time to a new audience – the reformers themselves. In the delegation's first meeting, Fekete laid out the authorities fears. The government "needed to be careful and avoid…the limits of social tolerance," he said. If too many loss-making enterprises were liquidated all at once, "there was a risk of a confrontation at the political level."[663] Tímár expected "200,000 lay-offs" over the next two years.[664] Finance Minister Medgyessy worried that reform would lead to too much "redundant labor" and that "tensions might become extreme in some places."[665] Miklós Németh agreed that action was necessary, but the reform plan had to receive Parliament's endorsement, which could come no earlier than September, and "the population had to be convinced that there was no other option."[666]

Government officials also needed to be convinced that there were no other options, because Fekete still counted the world's capital markets as his strategic reserve. In discussions with Fund officials on how he was funding the current account deficit, Fekete sounded like an inveterate gambler looking for his next stake. He paid "one eighth a percent more" on the last syndicated loan from 39 banks so that it would include "more than just Japanese banks." The

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[663] Minutes of Meeting No. 1, "Hungary- Staff Visit," Aug. 17, 1987, Box 32, File 3, EURAI CF, IMF.
[664] Minutes of Meeting No. 2, "Hungary- Staff Visit," Aug. 17, 1987, Box 32, File 3, EURAI CF, IMF.
[665] Minutes of Meeting No. 8, "Hungary- Staff Visit," Aug. 19, 1987, Box 32, File 3, EURAI CF, IMF.
[666] Minutes of Meeting No. 10, "Hungary – Staff Visit," Aug. 19, 1987, Box 32, File 3, EURAI CF, IMF.

World Bank had just approved a loan for $150 million, the Japanese had just agreed to issue a Samurai bond for $270 million, "bilateral deals" would yield another $10 million, and "the Austrian banks continued to help." British, French, and Italian banks had recently reduced their exposure to Hungary, so they "could probably be tapped next year." In any case, the way he had structured the debt meant that payments would not really start to bite until 1991. All in all, he told the Fund, there was "no financing problem" as long as "there was a perception" that the government was committed to reform.[667]

Junz returned to Washington beset by pessimism. "Whereas policy goals are clearly defined and unexceptional," she wrote to the new Managing Director, Michel Camdessus, "policy actions are lagging and lacking in coherence and consistency." The authorities have, she continued, "a basic reluctance to face off with the vest interests in implementing proposed reform measures, [which] is leading to piecemeal implementation with an attendant loss of effectiveness and credibility." All she could do was hope that the market would eventually coerce the government into action, and here there was reason for optimism. Hungarian authorities, she calculated, would need to borrow $6.5 billion in 1988 and 1989 to fund the state on its current trajectory, and Junz saw no way this could happen "in the absence of support from the multilateral institutions."[668]

Hungarian officials remained interested in the IMF's money, if not the pace of its policy suggestions, so in September they pushed through Parliament a "Program for Stabilization and Evolution." In a letter to Camdessus, Deputy Prime Minister József Marjai sold the merits of the

[667] Minutes of Meeting No. 5, "Hungary – Staff Visit, Aug. 17, 1987, Box 32, File 3, EURAI CF, IMF.
[668] Helen Junz to the Managing Director, "Hungary—Back-to-Office Report, August 16-20, 1987," Aug. 31, 1987, Box 32, File 3, EURAI CF, IMF.

plan as "complying with the demand of the foreign markets."[669] Markets were indeed getting demanding. On his way to Budapest in October, Fund economist Patrick de Fontenay heard pessimistic outlooks on Hungarian prospects from the New York and London banking communities. On Wall Street, bankers at Manufacturers Hanover told him that they were "very gloomy" on Hungary and thought the country was headed for a rescheduling. The last Hungarian syndicated loan "had been very difficult and required some arm-twisting," because banks were generally trying to reduce their exposure to the country. Making matters worse, the Hungarian reliance on Japanese banks was dangerous because Japanese bankers were "known to have a herd psychology and could precipitate a crisis if they were all to revise their views" at once. In London, de Fontenay heard tell that the Japanese moment of reconsideration may have already arrived. "Hungarian paper was not selling easily in the markets," bankers told him, because "the Japanese were beginning to reconsider their position."[670] It was no accident, then, that Fekete changed his previously confident tune by the end of September and readily admitted that the government was "more interested in the effect of a Fund arrangement on financial markets' confidence in Hungary than in the money" provided under a stand-by agreement.[671]

If Hungary was in it for the money, the Western governments that backed the IMF and controlled the approval of stand-by agreements were in it for the reform. By waiting until the market's confidence had evaporated and the IMF remained as the only option, Fekete and the Hungarian government exposed itself to the conditions that Western governments could tie to any IMF loan. By the fall of 1987, the two most important IMF shareholders for loans to the

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[669] József Marjai to Michel Camdessus, Sept. 24, 1987, Box 32, File 3, EURAI CF, IMF.
[670] P. de Fontenay, Memorandum for Files, "Hungary," Oct. 9, 1987, Box 32, File 3, EURAI CF, IMF.
[671] P. de Fontenay to the Deputy Managing Director, "Meeting with Hungarian Delegation," Sept. 29, 1987, Box 32, File 3, EURAI CF, IMF.

European region – West Germany and the United States – both maintained a strong interest in using the prospective standby agreement to demand reform in Hungary. After meeting with US and West German financial leaders at the IMF Annual Meetings in September 1987, Patrick de Fontenay noted, "We should warn [the Hungarians] that any program will be reform-oriented, that prior actions will be required and that reform measures…will probably have to be made performance criteria [A/N: conditions of the loan]." "The U.S. seems particularly insistent on this," he wrote.[672] Massimo Russo later wrote to the Managing Director, "The United States is keen on a conditionality largely based on structural measures and Germany on front-loading of adjustment measures."[673] What did this mean? In a reflection of their historical interests, the Americans wanted more capitalism, and the Germans wanted more austerity. Neither was what Hungarian officials, already fearful of the social consequences of reform, wanted to hear. But with dwindling options on global capital markets, they would have little economic leverage in the negotiations. The leverage they did possess, and indeed used quite well, was political: the specter of a conservative (or Soviet) resurgence if the reform movement failed. An internal memo from de Fontenay in February 1988 exemplifies the effect that this prospect had on Western discussions of Hungarian reform: "political support for the reform movement is still fragile…. [W]hat is needed is continuous and gradual progress rather than abrupt changes that would risk a backlash against reform."[674]

[672] P. de Fontenay to Mr. Russo, "Hungary," Sept. 24, 1987, Box 32, File 3, EURAI CF, IMF.
[673] Massimo Russo to the Managing Director, "Hungary- Brief for Article IV Consultation Discussions," Box 11, File "Hungary 1987," Country Files, Office of the Managing Director Fonds Michel Camdessus Sous-Fonds.
[674] P. de Fontenay to Mr. Boorman, "Hungary – Stand-by Arrangement," Feb. 11, 1988, Box 33, File 1, EURAI CF, IMF.

It is also important to note here that the leverage Western countries sought to exert and the conditions they sought to impose on Hungary through the IMF were economic, and not moral or political. The human rights historiography that argues for a "Helsinki Effect" on the end of the Cold War is very well developed at this point.[675] In the literature on the end of communism in Hungary, this argument has its proponents as well. As noted in the introduction, András Sajó argued, "In order to solve the economic crisis and the resulting social crisis, [the Hungarian leadership] tried to gain Western financial and moral (diplomatic) support. To obtain that support, they had to meet the human rights criteria set by the West."[676] There is no doubt that the Hungarian government had to meet Western criteria, but these criteria were of an economic and financial nature. In order to meet these criteria, however, the communist party undertook a series of political reforms that looked very much like they were aimed at meeting Western standards of democracy and human rights. In fact, they were meant to build a social consensus around the disruptions of economic reform.

Bringing the Politics 'Round

While financial officials in Budapest and abroad progressed through their summer of discontent in 1987, Imre Poszgay was busy building on his vision of democratizing society and the state in the service of economic transformation. After the PPF-commissioned "Turnaround and Reform" report was completed in the fall of 1986, it was published in a Hungarian economic

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[675] Daniel C. Thomas, *The Helsinki Effect: International Norms, Human Rights, and the Demise of Communism* (Princeton, NJ: Princeton University Press, 2001); Sarah Snyder, *Human Rights Activism and the End of the Cold War: A Transnational History of the Helsinki Network* (New York: Cambridge Unversity Press, 2011).
[676] András Sajó, "The Roundtable Talks in Hungary," in *The Roundtable Talks and the Breakdown of Communism*, 69.

journal in June 1987. In March of that year, academicians and party ideological leaders held a theoretical conference in Szeged to discuss the relationship between political pluralism and economic reform, and Central Committee member Tamas Kolosi said afterward, "Every shred of historical experience suggests that if we strive for an exclusive line of thought…as the self-proclaimed representative of the public interest…exclusivity sooner or later will produce unbearable social tensions." In contrast, "Pluralism in the fields of interest representation and forms of property ownership…are indispensible in a society…that aims for social consensus."[677]

On March 15, 1987, Poszgay spoke at a rally of nascent opposition groups commemorating the nation's revolution against Austria in 1848 - the first opposition rally ever legalized by the Hungarian authorities. In front of a crowd made up of members of both the PPF and the nascent opposition movement, he declared that the nation faced the task of "reforming, democratizing, and renewing" its political institutions, and the "tasks lying ahead that can only be accomplished through joint social and national collaborative effort."[678] After the government reorganization in June that brought Károly Grósz into the premiership but did not bring Poszgay into the Politburo, the *Frankfurter Allgemeine Zeitung* noted that his absence from the Politburo "could be interpreted to the effect that some institutions of the country consciously are to be pushed away from the party to achieve a relative importance of their own."[679]

Parliament was one such institution. So even as Fekete, Németh, and Medygessy sought to gain a rubber stamp on their economic reform package, those promoting political pluralism

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[677] Interview with Kalman Kulscar and Tamas Kolosi, *Otlet*, March 5, 1987, translated in JPRS-EER-87-078, pp. 15-21.
[678] "Our Wished Can Be Realized on the Basis of National Consensus," *Magyar Nemzet*, Mar 16, 1987, translated in JPRS-EER-87-077.
[679] Grosz New Head of Government? First Signs of Pluralism," *Frankfurter Allgemeine Zeitung*, June 25, 1987, translated in JPRS-EER-87-125.

looked to build up Parliament as an independent voice from the party. The first issue on which members of Parliament struck out on their own was the budget deficit. They criticized a system in which "Parliament must accept responsibility for the deficit, while decisional processes that lead to the deficit circumvent the legislative process." Had they known the extent of the influence of the IMF officials shuttling in and out of Budapest, they could have added the processes that would soon aim to reduce the budget deficit to the list of legislative circumventions. Even without this knowledge, they called for rules allowing Parliament to set limits on state spending.[680]

In the summer of 1987, the push for pluralism still did not mean a push for multi-party democracy or an abandonment of the leading role of the communist party in society. But it did mean raising these questions at the highest levels. In an essay published in the Hungarian press, the party's new ideological chief and one of two prospective candidates to replace Kádár (along with Grósz), János Berecz asked "could our single-party political mechanism…enable, generalize and demand the surfacing interests[?]…Would the single party system be capable of transforming the recognized diversity of interests into joint societal action in the interest of achieving societal goals?"[681] At that point, Berecz's answer was essentially "yes," but raising the question in the first place signaled a changing mentality within the party. And within opposition circles the logic of reform could mean only one thing, as Gyorgy Gado, editor of the samizdat *Magyar Zsido* said 1987. "There is no economic reform without political reform which

[680] "Committee Debate on Actual Closing Budget Figures," *Heti Vilaggazdasag*, June 27, 1987, translated in JPRS-EER-87-140, pp. 11-13.
[681] János Berecz, Untitled article, *Tarsadalmi Szemle*, No 7, 1987, translated in JPRS-EER-87-142, p. 11.

points in the direction of real democracy, and which limits and promises the total liquidation of party dictatorship."[682]

In September, the PPF published an "action program" aimed at supporting the Program of Stabilization and Evolution that the Ministry of Finance and NBH were trying to get through Parliament. The preface to the plan said that, "as the institution for societal dialogue," the PPF was "prepared to serve as a forum for the broadest possible political activity that is necessary…. [T]he PPF wishes to provide a degree of openness for the preparatory, decision-making, as well as implementation processes…. This way the PPF contributes to the fulfillment of a community need to permit greater societal control over these processes." This broadening of the political role of the PPF was required because "there is a need to establish a consensus."[683] In pursuit of these goals, Poszgay gave the introductory lecture a meeting of 150 writers and intellectuals in Lakitelek to discuss ways out of the crisis in the fall of 1987. As the ideology chief Berecz later said, "Pozsgay went there in all good faith to try to put together a consensus, or to create a situation of mutual understanding." Although this group would go on to become the Hungarian Democratic Forum (known by its Hungarian acronym, MDF, *Magyar Demokrata Fórum*), which was the political party that won the 1990 democratic elections, in the fall of 1987 it was a group of intellectuals with an inchoate vision of reform and little support among the population. With Poszgay's endorsement, the group issued "the Lakitelek proclamation" at the end of the meeting

[682] Gado quoted in "Reform and Hungary," *Szazadveg*, No 4-5, 1987, translated in JPRS-EER-88-042, p 10.
[683] "Taking a Stance," *Magyar Nemzet*, Sept. 26, 1987, translated in JPRS-EER-87-151, quotes on pp 1-2.

calling on the government to open a dialogue with society, which was published in the party newspaper *Magyar Nemzet* in November.[684]

Although the reformers' belief in the power of pluralism to bring about social consensus was sincere, there was also a more cynical strand of thought that underlay their interest in democratization. It can be thought of as the "if not bread, then circuses" principle: to compensate for the unpopularity of austerity, the authorities embraced liberalization as means of padding their standing among the populace. This is the explanation for liberalization that Hungarian officials most often gave to IMF officials in Washington. As one example, Miklós Nemeth told IMF officials in 1988, "there was no room for any increase in the standard of living for the next three to four years and….the authorities wanted to compensate [for] the pressure in the economic field by 'increasing freedom of choice in the political field.'"[685] After hearing this explanation consistently from his Hungarian counterparts, Partick de Fontenay briefed the Acting Managing Director at the end of 1988 along the following lines. "Political liberalization…which was initially aimed at making relative austerity more easily tolerated, has brought to the surface demands by various groups and interests, which the government is finding it difficult to resist as it seeks popular support."[686]

Perhaps the best example of the power and problems of this strategy came with the government's decision to ease foreign travel restrictions for Hungarian citizens in the fall 1987.

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[684] See "Chronology," in *Political Transition in Hungary, 1989-1990: A Compendium of Declassified Documents and Chronology of Events*, available for download on the website of the Cold War International History Project, https://www.wilsoncenter.org/publication/political-transition-hungary-1989-1990, Access Sept. 2, 2015.
[685] Memorandum for Files, "Hungary—Meetings with Mr. Németh, Secretary of the MSZMP Central Committee," June 17, 1988, File 2, Box 33, EURAI Country Files, IMF Archives.
[686] P. de Fontenay to the Acting Managing Director, "Hungary- Staff Visit," Dec. 15, 1988, Box 11, File "Hungary 1988," Country Files, Office of the Managing Director Fonds Michel Camdessus Sous-Fonds, IMF.

One member of the press wrote of the change, “This recent decision has been explained various ways by different people. There are those who see the spirit of ‘glasnost’ behind it; others see it as a result of the relaxation of the international situation…. The most commonly voicedsupposition, however, is that the leadership wants to divert attention from other unpopular measures.” The author held out little hope that the government’s gambit would work. “It would be naïve to believe that the new passport regulation will cause millions to forget their concerns about the standard of living.”[687] Although it would not be clear until a year later, the implications of the passport regulation for Hungary’s financial position suggested that the belief was not so naïve after all. Attempting to justify the country’s continued financial precariousness, an NBH official told the IMF a central problem was “the spread of information about shopping conditions in Vienna (including during post-Christmas sales)” that had occurred as more Hungarians travelled abroad.[688] Like the Americans and West Europeans before them, Hungarians were not immune to the allure of consumerism. The pleasure and excitement of Christmas shopping, it would seem, transcended the rising tensions of austerity. Even with the government literally raising the price on a loaf of bread, there would continue to be circuses.

Striking the Balance

But IMF officials kept demanding even higher prices for bread (and energy, housing, and every other facet of the Hungarian economy) in their never-ending negotiation of a standby agreement. While Hungarian citizens were rediscovering the joys of Christmas in Vienna, Fund

[687] Sandor Novobaczky, “Crumbling Barriers – Passport Regulations to Undergo Major Changes: “We Have Come a Long Way…,” *Magyarorszag*, Oct. 9. 1987, translated in JPRS-EER-87-162.
[688] Minutes of Meeting No. 2, “Hungary – May 1989 Use of Fund Resources,” May 24, 1989, Box 34, File 2, EURAI CF, IMF.

officials were in Budapest keeping the pressure on Fekete, Marjai, and Medgyessy to turn ideas of reform into action. Action was precisely the problem. Marjai told de Fontenay, "the Hungarian authorities had come to realize that implementation was more difficult than the formulation of the task to be undertaken." The hot button issue that December was raising the government-determined interest rate on housing loans, an issue that has the ring of boring minutia to the contemporary ear, but augured political revolt in the minds Hungarian officials. Time and again, Fund officials told their interlocutors that the rates needed to be raised, and time and again their Hungarian counterparts agreed in principle, but refused a change in practice. "Too politically sensitive" was the common refrain. Miklós Németh informed the Fund, "the average price for a home in Hungary (Ft 900,000) required 15 years average income. For comparison, in Western Europe, only 5-6 years income was required and in the United States 3-4 years income."[689] Also demurring action, Minister of Finance Medgyessy said, "that the price of a square meter for an apartment in Budapest was Ft 20,000 and that few people could afford it without receiving financing help."[690]

In was in this context that officials in both Western embassies and the IMF began to sense that the reform movement was grinding to a halt. The British ambassador lamented in early 1988, "a loss of momentum for the reform movement…The political situation was uncertain…The Politburo was split…The Government was worried by the reaction of the population to the measures taken….Fear of workers' protest marches was a major factor.

[689] Memorandum for Files, "Reform of Housing and Housing Finance," Dec. 28, 1987, Box 33, File 1, EURAI CF, IMF.
[690] Memorandum for Files, "Meeting with the Minister of Finance, Mr. Medgyessy and with Mr. Patko," Dec. 8, 1987, Box 33, File 1, EURAI CF, IMF.

Generally, the Government was view as weak."[691] Trying to negotiate with a government in such a position was difficult, and de Fontenay relayed to Washington that the Hungarians were "wearing us down."[692] In the new year, Marjai told the Fund again "the Government could not afford to lose the support of the population,"[693] and Prime Minister Grósz feared, "the country may collapse under its burdens." Despite the government's efforts to use the press "to prepare public opinion," Grósz said, "the changes taking place were considerable and the population had not been sufficiently prepared for them."[694]

The key to escaping this trap between creditors' demands for adjustment and the population's resistance to austerity lay in the IMF's bank account. At a meeting with the Ministry of Finance, Hungarian officials told the IMF "the higher the amount [of money for the standby] the better this would be for the creditworthiness of Hungary" and the easier it would be "for the Hungarian negotiators to justify to the politicians the measures they had agree to."[695] After further negotiation and internal debate within the Fund, more money is precisely what the IMF used to achieve its goals. At the end of January, the two sides finally reached agreement on the basic outline of a stand by, and de Fontenay credited the Fund's willingness to increase the stand-by amount with breaking Hungarian resistance to the IMF package of reforms.[696] And quite a list of reforms it was: freeing 50% of prices to be determined by the market, a

[691] Memorandum for Files, "Meeting with the British Ambassador, Mr. Applegate," Jan. 7, 1988, Box 33, File 1, EURAI CF, IMF.
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[693] Memorandum for Files, "Meeting with the Deputy Prime Minister Mr. Marjai," Jan. 8, 1988, Box 33, File 1, EURAI CF, IMF.
[694] Memorandum for Files, "Hungary – Meeting with the Prime Minister, Mr. Grosz," Jan. 11, 1988, Box 33, File, 1 EURAI CF, IMF.
[695] Memorandum for Files, "Hungary- Meeting State Development Institution and Interest Rate Trigger," Jan. 12, 1988, Box 33, File, 1 EURAI CF, IMF.
[696] P. de Fontenay to the Acting Managing Director, "Hungary- Stand-By Arrangement," Jan. 25, 1988, Box 33, File, 1 EURAI CF, IMF.

commitment to reform the wage system and legalize joint stock companies through Parliament in 1988, limits on domestic credit issued by the NBH, a ceiling on the budget deficit, quarterly increases on bank deposit interest rates. In addition, Hungary committed to undertaking a 5% devaluation of the forint before the IMF board approved the agreement in May. As de Fontenay wrote to a colleague who believed the Fund should have gotten more, "it seems difficult to argue that a cut in the budget deficit equivalent to 2 percent of GDP, a marked reduction in credit expansion, and a consequent reduction in the current account deficit of half a billion dollars represent weak adjustment."[697] In return, Hungary received roughly $350 million in IMF loans and held on to its access to international credit markets by its shoestrings.[698]

Strong adjustment ensured difficult politics. Hungarian authorities again realized the difference between committing to a policy on paper and implementing in practice. By April, they were struggling to gain the support in the Central Committee for the 5% devaluation of the forint. Fontenay returned to Budapest, where he was "kept incognito by the authorities," to negotiate a set of policies in other areas that could "compensate" for not going through with the devaluation.[699] By the IMF's calculation, the authorities would have to remove Ft 5 billion from household disposable income to offset their lack of action on the exchange rate.[700] The two sides went through a reprise of a now familiar cycle: Hungarian authorities resisting such measures;

[697] P. de Fontenay to Mr. Boorman, "Hungary-Stand-by Arrangement," Feb. 11, 1988, Box 33, File, 1 EURAI CF, IMF.
[698] The stand-by agreement was valued at 265 million SDRs (Special Drawing Rights), a mixed basket of the world's most important currencies that was used by the IMF to hedge its holdings and loans against fluctuations in exchange rates. Mong estimates this as $350 million, *Kadar Hitele*, 272.
[699] Memorandum for Files, "Hungary- Conversation with Patrick de Fontenay," March 29, 1988, Box 33, File, 1 EURAI CF, IMF.
[700] Memorandum for Files, "Hungary-Note on Compensatory Interest Rate Action," March 30, 1988, Box 33, File, 1 EURAI CF, IMF.

IMF officials debating how far they could push the country without killing the reform movement altogether; Fekete realizing he needed to reach agreement with the Fund in order to shore up the confidence of banks advancing him a loan; and as a result, Hungarian officials eventually agreeing to “very significant” compensation for not raising the exchange rate in the form of removing liquidity from the economy by substantially raising interest rates on all bank deposits.[701] It was another episode in the long running tension that animated the Hungarian-IMF relationship: the Hungarians wanted to move as slowly in reform as possible without actually falling over the cliff into bankruptcy, and the IMF wanted to push Hungary as far as it would go without extinguishing the light of reform all together.

This proved to be a productive tension. As financial officials raced to come up with compensation for the lack of exchange rate action, the Hungarian communist party prepared for an exceptional party conference from May 20-22 that would seek to consolidate the reformers hold on the party. This conference that is often marked in the historiography as the beginning of the transition period that culminated in the multi-party elections of April 1990 because it removed János Kádár as General Secretary of the party and replaced him with Károly Grósz. It is at the very least a suggestive historical coincidence that the IMF Executive Board approved Hungary’s stand by agreement on the same day that Kádár submitted his resignation to the Politburo, May 19, 1987. This is not to say that the two events were related in some form of quid pro quo (they certainly were not), but the coincidence does suggest the following questions. What effect did the IMF and the coercion of creditworthiness have on this leadership change?

[701] Documents on this mini-sage are Massimo Russo to the Managing Director, “Hungary- Staff Visit,” May 5, 1988, Box 33, File 2, EURAI CF, IMF.; Memorandum for Files, “Opening Meeting with the Hungarian Delegation at the National Bank of Hungary,” April 29, 1988, Box 33, File 2, EURAI CF, IMF.

Was it the IMF's pressure on the Hungarian government or its patience with the slow pace of reform that allowed the reformists to succeed? Answers to these questions look different depending on which side of the Iron Curtain you approach them from. Kádár's understanding of the power of the IMF is perhaps best revealed by how he described his predicament to Soviet General Secretary Mikhail Gorbachev, who later recalled these views to East German Chancellor Egon Krenz. Gorbachev said, "In 1987 Comrade Kádár was given an ultimatum by the IMF; in case of non-compliance with the numerous demands a suspension of the loans was threatened."[702] In contrast, de Fontenay defended the program after the May removal of Kádár by writing, "by averting a possible backlash against reform, which a more ambitious program might have produced, [the program] may have facilitated the recent leadership change."[703] As is often the case in international diplomacy, what looked to one side like an ultimatum looked to the other like a series of concessions. Attila Mong concludes in his book that the IMF displayed consistent "flexibility" and played an important role in "'financing' the peaceful transition."[704]

The conclusion that fits best with the evidence presented here is that it was neither pressure nor accommodation alone that influenced reform in Hungary, but instead the productive tension between the two. For the rest of 1988 and 1989, Hungarian and IMF officials went through more cycles such as the one described above: a period of ambitious plans for reform, followed by the failure to implement them until market confidence once again became

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702 Memorandum of Conversation Between Egon Krenz and Mikhail Gorbachev, Nov. 1, 1989, in "The End of the Cold War," *Cold War International History Bulletin*, Issue 12/13, Fall/Winter 2001, p. 145.

703 P. de Fontenay, "Hungary- Briefing Paper for the Review Mission, June 29, 1988, Box 33, File 2, EURAI CF, IMF.

704 Mong, 278-280. Quotes on 278. [*…a nemzetközi pénzügyi szervezetekre, amelyek az 1988-1990 közötti időszakban fontos szerepet játszottak a békés átmenet „finanszírozásában….Az IMF rugalmassága…*]

precarious, followed by the IMF flexibly changing it performance criteria to prevent Hungary from falling out of favor with the markets and the reform movement from crumbling, followed by the introduction of different or more limited reform than previously planned, followed by momentary restoration of market confidence in response to the new IMF endorsement, followed by a repeat of the process until the next crisis developed. For considerations of space, these cycles will not be recounted here. It suffices to say that for three years from 1987 to 1990, Hungary teetered on the cusp of insolvency without ever actually falling into it. In the historian's evaluation of the international forces that affected Hungary's democratic transition, it is this condition – not human rights discourses, the thaw in superpower relations, or a simpler process of the West merely "dictating" conditions that need to be met in order to receive its assistance – that affected the Hungarian transition more than any other.

From Democratization to Multi-party Democracy

In the historiography of Hungary's democratic transition, 1989 is primarily viewed through the prism of the communist party's negotiations with the Opposition Roundtable and the development of a myriad of political parties that went on to compete in the national elections of 1990. Scholars normally understand the importance of this year and the roundtable process to be that it ensured that the "democratized" one-party system, which the MSZMP wanted to preserve, did not survive and that a multi-party democratic system took its place. The predominant historiographic narrative contends that because of Hungarians demonstrations in the streets and the Opposition Roundtable's steadfast refusal to compromise with the MSZMP on the freedom of any future political system, Hungary achieved a fully democratic system. Key events and people drive this narrative. Foremost among them are Imre Pozsgay's reevaluation of the events of 1956 as a national uprising, not a counterrevolution in January 1989; the opposition's decision to coordinate their positions through the formation of the Opposition Roundtable in March 1989; the popular demonstrations on March 15 and in conjunction with the reburial of Imre Nagy in June; the opposition's ability to maintain its unity in the face of many MSZMP attempts to divide it; popular demonstrations against the building of the Bös-Nagymaros Dam; and the eventual conclusion of the National Roundtable talks and announcement of multi-party elections in August.[705] All of these were important factors, and they had the cumulative effect of changing the 1990 parliamentary elections from ones which had been meant to, as Imre Poszgay put it, "maintain party hegemony under party pluralism," into real free elections which the communist party could actually lose. At the level of politics, this was an important difference.

But a historical inquiry based in the perspective of debt uncovers new causes and consequences of the political transition of that year. Just like the communist party's democratization efforts in late 1986, the party's halting embrace of multi-party elections in 1989 served the ultimate purposes of legitimizing austerity and allowing the party to escape blame for unpopular economic measures. It is primarily these two causes that brought electoral democracy to Hungary in 1990. The history of the transition from the perspective of debt also shows that regardless of the election's outcome at the political level (which parties won, which lost), the election's social, economic, and financial consequences were determined long before a single vote was cast.

[705] Timothy Garton Ash's *The Magic Lantern*, the classic work of historical journalism that is still used as an introduction to the events of 1989, stresses these people and events. See aslo "Chronology," in *Political Transition in Hungary, 1989-1990: A Compendium of Declassified Documents and Chronology of Events*, available for download on the website of the Cold War International History Project, https://www.wilsoncenter.org/publication/political-transition-hungary-1989-1990, Access Sept. 2, 2015.

The most important MSZMP meeting on the issue of multi-party democracy occurred on February 7, 1989. It was at this meeting that the leading reform communists discussed their visions for the years ahead. With cold political calculation, Károly Grósz set the terms of the discussion by stating, "I can picture the transition period in two phases. The first phase would come to its end…at the end of 1990…The second phase would be the period between '90 and '95." He continued, "The first phase…is going to be around the elections of 1990. The real test comes after the elections and not before them." This was because Grósz believed it would take some time for the population to weigh the merits of each political party. "The [economic] crisis period would be '92-'93 when everyone is going to be weighed, and put in their places in the political structure, and that is when the MSZMP will be weighed as well – does it have a solution to the crisis, does it have a program to put an end to the crisis, and so on and so forth." The first transition period through 1990, Grósz said, "will not be a solution to the crisis in itself." Rezső Nyers interjected, "It will only change the players in the crisis." Grósz agreed, and continued, "The big question is whether a change of government…would mean a change of social structures as well. A change of social structures would result in a civil war in Hungary. And it is very difficult for me to imagine that there is any considerable force in Hungary today that would intend to set such a civil war as a goal."

Imre Poszgay then acceded to the introduction of a multi-party system because the party had "not managed to create pluralism along with the single-party system" as they had envisioned at the May 1988 Central Committee meeting where they removed Kádár from power. Nyers attributed this inability to the fact that the economic crisis had been more severe than they previously thought. "I think in May we had been optimistic concerning the time and the manner of resolving the crisis. It can be seen that [the crisis] is deeper. I agree with comrade Grósz that…it will probably be by ’95 or the beginning of the ‘90s that this crisis can be resolved, until then we are going to be a society managing crisis, an economic crisis." For this reason, Nyers believed elections needed to come soon. The political crisis, he said, "must not last as long as the economic crisis, because that would cause a collapse." Building on the idea of Grósz’s two phases of transition, Nyers said that after the first phase was complete, "economic crisis management would go on."

At this point, the party leadership’s vision for the elections was still not a completely free competition of political parties. Poszgay said, "we should aim at a hegemonic position…it should be guaranteed in the first round through some kind of…compromise and we should face open competition only in the second round."[706] After much more debate, the Political Committee of the MSZMP privately agreed on this strategy to achieve a hegemonic position and publicly endorsed multi-party elections.

Clearly, with the MDF winning the 1990 election, this vision of a hegemonic position within a multi-party system was never realized. Therefore, the political events and opposition efforts that took place between February 1989 and March 1990 can be understood as a successful struggle to move the "open competition" elections from 1995 up to 1990. This was by no means a meaningless difference – popular protest and the National Roundtable held significance in this regard – but the struggle that transpired during that year was over the question of when, not whether, fully free elections would happen. As Grósz told Gorbachev in a meeting in Moscow,

[706] All of the previous quotes from February 7, 1989 meeting come from Document 9, "Meeting of the MSZMP Political Committee. Verbatim Record of Minutes," Feb. 7, 1989 in CWIHP Reader, 1988- June 1989, pp. 63-94.

“events in Hungary have lately accelerated. Their direction is according to our intentions, while their pace is somewhat disconcerting.”[707]

For financial officials within the NBH, the Ministry of Finance, and the IMF the importance of the election was of an entirely different order. Who won the election or whether it was a fully free competition was immaterial. As Nyers had said, the vote would merely “change the players in the crisis.” Instead, the value of the election lay in the unique opportunity it presented to legitimize austerity and structural transformation. In practical terms, this meant an opportunity to finally agree to an Extended Fund Facility (EFF) with the IMF – the three year financing program that Hungarian officials had been interested in since Fekete first approached the Fund for help in the spring of 1987.

Massimo Russo began 1989 by telling the Managing Director that his European Office doubted “that the Hungarians are ready to take the measures that would make it possible to discuss an EFF.”[708] At the start of the year, Hungarian-Fund relations were in the midst yet another cycle of pressure and accommodation, with Hungary failing to meet a number of performance requirements that were conditions of their stand-by agreement and Fund officials attempting to find ways to redefine the stand-by conditions so that Hungary would not lose the market’s confidence. The particular reform measures at issue in this cycle, or indeed throughout 1989, do not need to be recounted here. In November 1989, Russo summed the year up nicely for our purposes. “1989 was a bad year for Hungary,” he wrote to the Managing Director. “This is due to the Government’s preoccupations with political developments at the expense of the

[707] Document 16, “Memorandum of Conversation between M.S. Gorbachev and Károly Grósz,” March 23-24, 1989, in Ibid, pp. 133-34.
[708] Massimo Russo to the Managing Director and the Deputy Managing Director, “Your Telephone Call to Mr. Bartha,” Jan. 18, 1989, Box 34, File 1, EURAI CF, IMF.

management of the economy.[709] The reason for this was clear enough: 1989 had become an election year. Ministry of Finance officials told the IMF, "It is generally agreed that the size of the state's activities…should be reduced…While Parliament generally endorses this idea in principle, it has failed to provide any specifics…Nor have opposition parties articulated any specifics, given that it would most likely weaken their position in the upcoming election."[710] With these electoral dynamics in play, it was clear to all involved that 1990 would be "a more important year" than 1989 in terms of domestic economic and financial changes.[711]

Much more important for purposes of this chapter are the dramatic lengths to which the IMF went in order to keep Hungary in the good graces of capital markets throughout 1989. Everyone knew that one pessimistic sign from the Fund would cause an immediate financing crisis, and the county would soon become insolvent. Thus, with the US and UK governments stressing "the importance of the political changes under way" and reinforcing "the need for continued Fund support for those [Hungarian] officials favoring reform and adjustment," the IMF bent the rules throughout the year to prevent a deterioration of Hungary's creditworthiness.[712] In June, for instance, Hungary missed important performance criteria on the level of the budget deficit that were conditions of its stand-by loan. In order to preserve the credibility of its conditionality with other countries, the IMF suspended its stand-by financing, as was called for under the stand-by agreement. However, the Fund did not object to Hungarian

[709] Massimo Russo to the Managing Director and the Deputy Managing Director, "Brief for President Delors' Visit to Hungary and Poland," Nov. 14, 1989, Box 34, File 1, EURAI CF, IMF.
[710] Minutes of Meeting No. 7, "Hungary – 1989 Use of Fund Resources," Nov. 16, 1989, Box 34, File 2, EURAI CF, IMF.
[711] Minutes of Meeting No. 14, "Hungary – 1989 Use of Fund Resources," Sept. 5, 1989, Box 34, File 2, EURAI CF, IMF.
[712] Gérard Bélanger to the Acting Managing Director, "Hungary – Staff Visit and Request for Follow-Up," June 1, 1989, Box 34, File 2, EURAI CF, IMF.

officials characterizing the suspension as a "temporary…interruption" instead of "a total breakdown" in order to "limit market effects."[713] In addition, the IMF published a supplementary report that gave "credit to the appropriate actions taken by the authorities to confront the imbalances in the economy." Fund economist Manuel Guitián told the MD that the supplement "will call for delicately balanced drafting to avert the adverse consequences of this (hopefully temporary) interruption of our financial relationship with Hungary" because "if interpreted wrongly in the markets, such interruption could lead to critical financial strains in Hungary rapidly."[714]

A more serious Hungarian transgression surfaced in November 1989, and once more, the Fund worked to minimize the damage to the country's creditworthiness. On November 20th, Hungarian financial officials informed the IMF that they had been continuously underreporting the level of their foreign debt by about 10% since the late 1970s. Under normal circumstances this was a serious offense for members of the IMF, and Hungary could have faced stiff punitive action from the Fund. Over time, the Fund did end up punishing Hungary. But the immediate concern of the European Office upon hearing about the underreporting was to ensure that the news did not rattle the investors in Hungarian debt. Therefore the Managing Director phoned the Hungarian Finance Minister to coach him on how to announce this misreporting in Parliament in a way that would minimize the effect on the market. "I am afraid that what you will tell Parliament will be widely reported," Camdessus began, "It is absolutely imperative that there be no uproar otherwise you risk a major blow and the only way in my view is to say you are

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[713] Memorandum for Files, "Hungary – Telephone call from Mr. Szalkai," June 29, 1989, Box 34, File 1, EURAI CF, IMF.
[714] Manuel Guitián to the Managing Director and the Deputy Managing Director, "Hungary Again," June 30, 1989, Box 34, File 1, EURAI CF, IMF.

working with the IMF and the World Bank." The Finance Minister "agree[d] absolutely" and thanked the Managing Director for his "cooperative spirit."[715]

Thus, the IMF's effort to maintain non-monetary cooperation with Hungary was itself a form of financial assistance from the West. The mere fact of Hungary's unbroken association with the institution kept global capital in Hungary when it was ready to run at the first sign of trouble. This was not a direct form of assistance from Western governments or the global financial institutions. Indeed, the IMF cut off its stand-by loans when the performance criteria were broken in June. But it was the use of Western financial prestige, embodied in the institutional weight of the IMF, to prevent a financial crisis in Hungary during the uncertain months of its political transition.

Recognizing this has implications for the historiography of Western assistance to Hungary during the transition. Historical work of the foreign policy of US President George H.W. Bush remains in its early stages of development, but if there is one lasting impression (it is difficult to call it more than that at this point) of Bush, it is that he reacted cautiously to the dramatic events of 1989 and that the end of the Cold War happened in spite of, rather than because of, his efforts.[716] This chapter proposes something different. When Bush travelled to Hungary in the summer of 1989 to show his personal support for the reform movement, he was greeted with banners in the streets of Budapest that read, "Do not give money to the communists! Let us free from Yalta!"[717] Just like Solidarity in Poland, the Hungarian opposition believed that

[715] "Mr. Camdessus' Telephone Conversation with Mr. Bartha on Monday, November 20, 1989," Box 34, File 1, EURAI CF, IMF.
[716] The forthcoming book by Jeffrey Engel, perhaps the most authoritative monograph to date on the 41st president, will explore these themes. See *When the World Seemed New: George H.W. Bush and the Surprisingly Peaceful End of the Cold War* (Houghton Mifflin Harcourt, forthcoming).
[717] Quoted in Mong, 288.

tying Western aid to political and human rights conditions would bring about greater progress. And indeed, if one looks only at the actual hard financing that the Bush administration proposed in the summer of 1989 (a $25 million "direct investment fund"),[718] it is easy to conclude that the US government did not provide significant financial aid to Hungary either because of the president's innate caution or his administration's belief in the power of tying loans to political progress on the ground. Both of these could be true; we will have to await the opening of the archives. But no matter what the archives show, the evidence presented here suggests that the financial value of the IMF sustained relationship with Hungary in 1989 dwarfed any financing that the US government considered providing. On a regular basis, the NBH had to "roll over" at least $250 million of the country's sovereign debt. This could not have happened without the institutional backing of the IMF. Therefore, we can conclude that in 1989, it was not Western conditionality, but instead Western willingness to bend conditionality, which supported Hungarian reform the most. By lending the prestige of the IMF to Hungary during the transition, Western governments provided the country with a reprieve from the coercion of creditworthiness.

But it was only a reprieve. The IMF was only willing to hold the markets' pressure for structural adjustment at bay until the elections. Thus, by the summer of 1989, the attention of both the Fund and Hungarian financial officials turned to negotiating the reform package that the new government would use its legitimacy to implement. In practice, this meant drafting a three-year Extended Fund Facility. During a Fund visit to Budapest in August, Ferenc Bartha, the Governor of the NBH, told the IMF, "The Government had already discussed in late July a medium-term program covering the three years to 1992." A consensus had been reached, he

[718] "Briefing Paper – Use of Fund Resources," August 1989, Box 34, File 1, EURAI CF, IMF.

said, on "reform measures tackling…the problems of ownership, budgetary reform, monetary reform and decentralization of the banking system, development of a capital market and the restructuring of trade with the West and CMEA intended to foster the integration of Hungary in the world economy." In other words, the entire national economy. "It would be desirable," he said, "to reach understandings with the Fund on a medium-term agreement covering these issues which could be implemented by a government which would emerge from the pending elections."[719] In a later meeting, Hungarian officials told the Fund the reform program "would be submitted to various parties within the Government" and then "sent for information" to Parliament and the roundtable. "The program could only be approved after the pending elections," the officials said, but "whatever government emerged from the elections had little choice but to implement a program of market oriented reform, with a strict monetary regime and a reduction in the role of government."[720] In a September follow up meeting, Medgyessy told Fund officials, "The Government was resolute to submit the cornerstone legislation for reform to Parliament, preferably with full agreement of the Roundtable, but if necessary without such agreement." He assured the Fund, "the different [political] parties would not come up with any fundamentally different programs."[721]

Which brings us to the opposition. What did they think of economic reform and the foreign debt? By the late 1980s, Hungary had a hard currency foreign debt of roughly $17 billion and an annual budget deficit ranging from Ft 30 billion to Ft 60 billion year to year. Until

[719] Minutes of Meeting No. 1, "Hungary – Use of Fund Resources," Aug. 28, 1989, Box 34, File 2, EURAI CF, IMF.
[720] Minutes of Meeting No. 6, "Hungary- 1989 Use of Fund Resources," Aug. 31, 1989, Box 34, File 2, EURAI CF, IMF.
[721] Minutes of Meeting No. 18, "Hungary – 1989 Use of Fund Resources," Sept. 6, 1989, Box 34, File 2, EURAI CF, IMF.

1987, these figures were considered top secret and were restricted to top leaders in the Politburo as well as a narrow section of the NBH, Ministry of Finance, and National Planning Office bureaucracy. Society at large had no understanding of the nation's financial position. An important part of the "openness" and "democratization" launched in 1987 was informing the country of the nation's real financial state. One newspaper described the population as "shocked" when the numbers were made public. The numbers were indeed daunting. As the PPF economist Laszlo Bogar told a Hungarian newspaper in 1989, "Hungary today is one of the big debtor nations of the world…On a per capita basis Hungary is first in indebtedness among CEMA countries, leaving even Poland behind." He also warned that if current export and import trends continued, "the indebtedness process will come to a halt in 1997, and that the debt service rate will end in the year 2004, i.e. it will reach acceptable levels after 30 years from the beginning of our indebtedness."[722] Painting a similarly dire picture, Miklós Németh told the country in a 1989 nationally broadcast interview, "the interest burden, to mention only this, last year and this year amounts to $1.2-1.3 billion. If we convert this into forints, we see that here it is a question of 60 billion, some 60 billion forints. This money has to be taken out of the economy, away from the population or society…But this is a burden to the country. And we have to accept this burden in order to maintain our solvency."[723]

"We have to accept this burden." It was a conclusion that went virtually unquestioned by all of Hungary's new political parties. Two conclusions defined the discussion about the national debt after it became a topic of public discussion in 1987: one, the debt was part of a

[722] "shocked" and Bogar quotes from "The Plundering of Resources Did Not Begin With Foreign Indebtedness," *Heti Vilaggazdasag*, March 18, 1989, translated in JPRS-EER-89-050, pp. 42-44.
[723] Nemeth interview with "The Week," translated in Foreign Broadcast Information Service – Eastern Europe [FBIS-EEU]- 89-072.

global phenomenon; and two, the debt had to be repaid. In a 1988 article titled, "The State as Debtor," Istvan Garamvolgi wrote, "This decade we have been witnessing the explosion of debt in most countries of the world…mounting national debt is a worldwide phenomenon."[724] János Kis, a prominent member of the opposition Free Democrats, believed that the global nature of the debt problem made the future course of Hungarian development easy to predict. In a published debate with other leading opposition members, he wrote, "Let us not forget that…Hungarian crisis processes emanate from Hungary's Western financial dependence. In this respect Western creditors will exert pressure, the International Monetary Fund will offer package plans for the limitation of consumption, there will be Neckermann department stores for those who have convertible foreign exchange, and there will be empty Kozert [Hungarian grocery store chain] stores for those who do not." The point of comparison for Hungary's future was clear. "In brief: the West will mean to Hungary what the United States means to the masses of less fortunate Latin American countries."[725]

Ironically, Kris's party – the Alliance of Free Democrats – was both the most pro-market political party and the only party to even consider asking the international community for debt relief. In an August 1989 article, Tamas Bauer and Marton Tardos, the party's leading economists wrote, "Hungary may be able to manage its current debt burden for quite some time. It can do so, however, only at the price of further increasing the frightening impoverishment of part of the populace." Bauer and Tardos believed – and had the courage to say – that the West bore some responsibility for Hungary's debt. "The creditors acted in an irresponsible

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[724] Istvan Garamvolgyi, "The State as Debtor," *Magyarorszag*, Dec. 3, 1988, translated in JPRS-EER-89-012, pp. 35-36.
[725] János Kris in "Reform and Hungary, Szazadveg's Questionarre Concerning Reform," *Szazadveg*, No 4-5, 1987, translated in JPRS-EER-88-042, p.15.

manner…when they agreed to finance obscure plans which did not assure repayment." It was also "an unquestionable fact," they wrote, "that high and unpredictably fluctuating interest rates were caused by budgetary deficits in certain Western countries and by functional disturbances in the global economy, circumstances for which Hungary could hardly be blamed." Therefore, the economists believed, "there is a continued need for new loans. It is apparent, however, that the financial pressure chocking the Hungarian economy cannot be lifted by granting credit alone. The primary need calls for a reduction of the accumulated debt service and for a reduction of interest."[726]

All other parties, including the MSZMP, found such a proposal irresponsible and unnecessary. A typical viewpoint was expressed in the weekly business magazine, *Figyelő*. It „would be extremely disadvantagous for Hungary" to reschedule, the author wrote, "and in my view there is no need for it. Thus far Hungary has complied with its debt service obligations without disruption by using banking methods of finance, even though compliance has always required the assumption of new loans."[727]

Even if this was a widespread view in society, the NBH was not going to leave anything about the opposition's economic and financial views to chance. Bank officials led a coordinated effort to ensure that all parties viewed Hungary's international debt obligations and plans for structural reform as unbreakable promises. In an August 1989 interview, NBH President Bartha reported that he and his team had recently met with all of the leading opposition parties. "We tried to persuade them to include requirements for a strong central bank…in their demand, and

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[726] Tamas Bauer, Marton Tardos, et al. "Capitalist Support for Hungary: Target Premium," *Heti Vilaggazdasag,* Aug. 5, 1989, translated in JPRS-EER-89-103, pp. 41-42.
[727] Endre Szanto, "Selling Debts: Casting Aside Declarations," *Figyelő,* June 8, 1989, translated in JPRS-EER-89-087, p. 28.

told them to regard a tight money policy as a measure in the interest of the entire nation. We tried to convince them not to consider the rescheduling of loans and further increases in the indebtedness as passable." Asked to respond to the Alliance of Free Democrats' demand for a reduction in the interest rates on the debt, Bartha conceded that Bauer and Tardos were the "best prepared" economic team among the opposition, but nevertheless maintained, "the structure of Hungary's indebtedness is such that a reduction of interest payments would be inconceivable on technical grounds, if for no other reason. The bonds issues are dispersed all over the world." More important than the technicalities, however, was what the debt represented. "We assume responsibility for the past," Bartha said.[728]

With the opposition's views under control, the financial policymakers of the NBH and the IMF, there was just one problem left by the fall of 1989 - the elections kept getting pushed back due to pesky political quarrels, and the country was running out of money. After having initially been moved up to the fall of 1989, election day had been consistently moved back over the course of the year and was now planned for March 1990. At the end of September, Bartha projected that the country would face a financial crisis in early 1990 unless it received the three-year Fund EFF by that time. But with all the important structural adjustment postponed until a new government took power, the IMF could not grant the EFF until the perpetually deferred election actually took place. Officials projected that the country would need to borrow $1 billion in the first quarter of 1990, and without an EFF program, the NBH likely would not be able to find such funds.

728 "The Hungarian National Bank President and the Hungarian Democratic Forum: He's Bluffing," *Heti Vilaggazdasag*, Aug. 19, 1989, translated in JPRS-EER-89-104, p. 5.

This set in motion the endgame of Hungary's communist period. The European Community made available a 1 billion ECU bridge loan (European Currency Unit, precursor to the Euro) to "tide Hungary over" until the spring election, and made the loan contingent on the current communist government coming to terms with the IMF on yet another stand-by program before the election.[729] When an IMF team was sent to Budapest in December 1989 to negotiate the new stand-by, Fund officials gave up waiting for the elections to happen and demanded that the current government take a series of steps immediately. As Bartha protested in vain that it made "no sense to press for additional expenditure cuts" because "getting the budget through in its present form would be a major achievement," Patrick de Fontenay maintained that the government needed to do more. Officials needed to announce cuts in housing subsidies, increase interest rates, and provide "a list of enterprises against which liquidation procedures had been initiated;" moreover, the government would have to "show that it had the courage to introduce these measures itself instead of passing on the task to local authorities." Unless it took these measures by January, de Fontenay told them, the IMF would not agree to a financing program.[730] With no other option available, Hungarian authorities devalued the forint by 10%, increased interest rates, and passed a housing reform program that increased the average rent by 35% in December 1989. In January 1990, the authorities cut enough subsidies and freed enough prices to institute a 10% increase in the consumer price level, while also accelerating the closing down or restructuring of loss-making enterprises.[731]

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[729] Eva Kaluzynska, "Delors Suggest Bridging Loan for Hungary," Nov. 17, 1989, Box 34, File 1, EURAI CF, IMF.
[730] Minutes of Meeting No. 24, "Hungary – 1989 Use of Fund Resources," Dec. 6, 1989, Box 34, File 2, EURAI CF, IMF.
[731] G. Bélanger to the Managing Director and the Deputy Managing Director, Jan. 31, 1990. Box 159, File 2, EURAI CF, IMF.

In exchange, the Fund team agreed to abstain from its normal practice of waiting for a new government to form before submitting the stand-by agreement to the Executive Board. "To maintain confidence in financial markets," the IMF agreed to have the Board vote on Hungary's stand-by one week before the election took place in March. To ensure that the new government upheld the stand-by agreement, however, the Fund made each batch of loans beyond the first (stand-by agreements are administered in monthly segments) "subject to a review which would ensure that the new government endorses the program."[732] And so, one week before József Antall and the Hungarian Democratic Forum won the first free election in Hungary since the end of the Second World War, the IMF Executive Board approved an agreement that set the course of the Hungarian economy regardless of the election's outcome.

In May, the Managing Director visited Hungary and met with Antall, now the country's new Prime Minister. Antall told Camdessus, "the Government was determined to proceed with reform and that it would be done with appropriate speed but not overnight." To which the MD predictably replied, "while the appropriate speed would have to be determined in light of each country's circumstances (including political and historical factors), a minimum critical mass was needed at the outset and there were costs to being to gradual."[733] Clearly, the cycle of pressure and accommodation, which had been at the heart of the Hungarian-IMF relationship since the country first joined the Fund in 1982, had not ended. Instead, to borrow a phrase, the players had merely changed.

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[732] Massimo Russo to the Managing Director and the Deputy Managing Director, "Hungary-Follow-up Mission for the Use of Fund Resources," Jan. 10, 1990, Box 159, File 2, EURAI CF, IMF.

[733] G. Bélanger to Mr. de Fontenay, "Mr. Szapary's Report on the Managing Director's Visit to Budapest," May 16, 1990, Box 159, File 4, EURAI CF, IMF.

By November 1990, the Antall government had formulated its medium term reform program, titled the "Economic Program of National Renewal." Hungarian officials told the Fund that "strengthening Hungary's creditworthiness" was one of the primary goals of the program. "To this end," they wrote, "the Government is placing great emphasis on privatization, the reduction of the role of the state in the economy, and the strengthening of market mechanisms." They also reassured the Fund, "the Government has also reaffirmed in this context its firm intention to continue servicing its external debt without interruption."[734] After further rounds of negotiations, the Fund and the Antall government signed an agreement for a three-year EFF in February 1991. Almost four years after *PlanEcon* had published its warning about the financial crisis looming in Hungary, a Hungarian government had agreed to a long term structural adjustment program aimed at maintaining the market's favor. What *PlanEcon* and the rest of the world did not foresee in 1987 was that the Hungarian government signing the agreement was the country's first democratically elected government of the postwar period. As this chapter has sought to demonstrate, Hungary's financial crisis and the emergence of its first democratic government were intimately related historical processes.

[734] Imre Tarafás and Ferenc Rabár to Michel Camdessus, Nov. 13, 1990, Box 160, File 2, EURAI CF, IMF.

Chapter 8

In the Shadow of Austerity:

The Collapse of East Germany

Public surprises have private histories. The fall of the Berlin Wall shocked the world on November 9th, 1989, and people have debated the history of this stunning event ever since. Most often they have searched for the causes of this public surprise in the public histories of the period - the mass protests, mass emigration, ideological crisis, and rhetoric of protest that defined the final months of the German Democratic Republic (GDR). Nothing signifies this focus on public histories more than the widespread use of Albert O. Hirschman's Exit/Voice/Loyalty model to explain the collapse of the GDR. Published in 1970, Hirschman's book, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* put forth a sociological model for explaining how people respond to declining performance in organizations. Hirschman posited that members of an organization can respond to a decline in performance in three ways: they can leave the organization (Exit), they can protest to reverse the organization's decline (Voice), or they can keep their behavior constant (Loyalty). Hirschman's model was an extremely powerful explanatory tool that could be applied to a wide spectrum of social life, and it influenced the social sciences throughout the 1970s and 1980s.

In the summer of 1989, the Exit/Voice/Loyalty model appeared to receive a real-world test in the dramatic dénouement of East Germany. Beginning in May, East German citizens, fed up with the indefatigable deterioration in the performance of their government, sought means of expressing their dissatisfaction and chose precisely Hirschman's methods to do so. By the thousands, they crossed the GDR's border with Czechoslovakia and headed for Hungary, where the government had dismantled the so-called "Iron Curtain" border fence standing between Hungary and Austria, in the hope of being allowed to travel to West Germany (the Federal Republic of Germany, FRG). As the Exit portion Hirschman's model suddenly appeared, the Voice component quickly followed suit. Over the course of September, groups of protesters began to gather every Monday in Protestant churches in Leipzig and Dresden. At first called "peace meetings," the Monday meetings grew into mass protests throughout the GDR demanding political and economic reform. Soon it appeared that very few people remained loyal to the GDR, and when the Wall opened on November 9th, observers naturally drew connections between the pressures of Exit and Voice and the government's ultimate capitulation.[735] Over time, the pressures of Exit and Voice were folded into a broader narrative of 1989 that stressed the important role of civil society and mass protest in peacefully bringing down the communist regimes of the Eastern Bloc.[736]

In the two previous chapters on the political transitions in Poland and Hungary, I argued that this focus on "people power" and non-violent protest failed to recognize the communist parties' own attempts to use political liberalization as a means of implementing economic

[735] The *Frankfurter Allgemeine Zeitung*, the leading newspaper in what was then West Germany, published an article six days after the fall of the Wall titled, "Abwandern, Widersprechen: Zur aktuellen Bedeutung einer Theorie von A.O. Hirschman," [To exit, to voice: On the current relevance of a theory of A.O. Hirschman]. Hirschman himself details the wide and varied uses of his theory in explaining the GDR's demise in his article on the topic, "Exit, Voice, and the Fate of the German Democratic Republic," *World Politics*, Vol. 45, No. 2 (Jan., 1993), pp. 173-202, see p. 174, note 3. Since then, Stephen Pfaff's *Exit-Voice Dynamics and the Collapse of East Germany* explicitly adopted and interrogated Hirschman's paradigm.
[736] See Timothy Garton Ash, *The Magic Lantern*, Domber, *Empowering Revolution*. After returning to Cornell this year, a top priority will be using its wonderful library to expand my discussion of the historiography of 1989.

austerity and structural adjustment. This chapter builds on that argument in the context of the GDR's collapse by flipping Hirschman's Exit/Voice/Loyalty model on its head.

Instead of focusing on the choices available to the East German population, this chapter is structured around the choices available to the East German government. Exit, Violence, or Austerity: these were the three strategies of governance available to the leadership of the East German communist party (known by its German initials, SED) in 1989. As its citizens fled to the West through Hungary and mounted protests on the streets of East German cities, the SED leadership could either officially sanction their emigration (Exit) or forcefully suppress the protests and restrict travel (Violence). Hanging over each of these strategies was the looming prospect of national insolvency and a default on the country's debt to its Western creditors. In order to prevent such a development and maintain the country's creditworthiness on international capital markets, the government estimated it would have to cut East German living standards by 25-30% in 1990 (Austerity). This chapter argues that the East German leadership accepted Exit and hesitated to use Violence because it viewed Austerity as the worst of all their options and actively tried to avoid it. In choosing Exit, the leadership believed it could extract new loans from West Germany in exchange for opening its borders. In refraining from Violence, the leadership knew that if it cracked down on protesters in the streets, it would lose all access to the Western capital upon which the country heavily depended.

The German language historiography on the collapse of East Germany has been shaped by the exhaustive and pioneering work of Hans-Hermann Hertle. Hertle began researching the collapse of the GDR almost immediately after it happened and has continued to do so ever since. His works, ranging from monographs to published interviews and primary sources, leave a rich documentary and interpretative trail to follow.[737] Because Hertle pays a great deal of attention and ascribes substantial explanatory power to the GDR's indebtedness in explaining the regime's collapse, our narratives are closely aligned. This chapter is more single-minded in its focus on the country's debt than Hertle's most detailed monograph, *Der Fall der Mauer: Die Unbeabsichtige Selbstauflösung des SED-Staates* [The Fall of the Wall: The Unintentional Self-Dissolution of the SED State]. Additionally, it lays greater emphasis than Hertle on two facets of the collapse: the financial causes of the Hungarian government's decision to dismantle the fence along its Austrian border and open its Western border to East Germans, and the East German leadership's fear of the International Monetary Fund (IMF) in the late 1980s.

In the English-language historiography, the opening of the Berlin Wall has become intimately tied to contemporary political debates over the United States' role in the world. The recent work of Mary Sarotte, the leading historian of the collapse of East Germany writing in English, exemplifies this trend. In *The Collapse: The Accidental Opening of the Berlin Wall*, Sarotte makes her political commitments explicit: her focus on the accidental nature of the Wall's opening is meant to serve the political purpose of deflating narratives of post-Cold War American triumphalism. In the introduction to her book, she writes that her history points to "the costs of triumphalist assumptions made by outsiders about what happened in divided Berlin in 1989. In the United States the opening of the Wall lent credibility to the unfortunate motto 'From Berlin to Baghdad.'" The dramatic images of East Germans streaming through the Berlin

[737] Hertle's excellent and exhaustively documented, *Der Fall der Mauer: Die Unbeabsichtige Selbstauflösung des SED-Staates*, lays out his own interpretation of the collapse in greatest detail. His *Chronik des Mauerfalls* aims to a more popular audience, and the website which he curates www.chronik-der-mauer.de provides a rich collection of multimedia information about the history of the Berlin Wall. Other works that he co-edited include *Das Ende der SED* and *Der Plan als Befehl und Fiktion*.

Wall on November 9th, she writes, "contributed to a mistaken belief that Washington was the sole author of the collapse of the East German dictatorship, and that the United States could duplicate that success in other locations around the globe at little cost." In contrast, her history "shows the need for a more nuanced understanding of the significance of accident, contingency, and, above all, the agency of local actors." In prioritizing the agency of local actors, Sarotte concludes that her work affirms the narrative of "an extremely rare and heartening event: a citizenry that peacefully overcame an abusive regime."[738]

One need only visit the Ronald Reagan Presidential Library in Simi Valley, California, where a large section of the Berlin Wall stands as a monument to the late president's achievements, or revisit the cover of the Economist Magazine from the week Reagan died in 2004, where he was proclaimed to be "The Man Who Beat Communism," to understand Sarotte's efforts.[739] But the attempts to deflate American triumphalism in her work and the broader historiography on the end of the Cold War have left the current English-language literature on the collapse of East Germany and the end of the Cold War in general without an understanding of where power resided in the international system of the 1980s. For fear of adding fuel to the popular fire that Ronald Reagan won the Cold War, diplomatic historians have largely concluded that the institutions of "hard" Western power – military, diplomatic, economic,

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[738] Sarotte, *The Collapse*, Location 366. Domber, *Empowering Revolution*, approaches the history of the Polish transition in a similar manner. For a critique of these narratives, see Kotkin, *Uncivil Society*. Sarotte's concerted effort to make the opening of the Wall completely contingent and accidental also leads her to portray the SED leadership under Krenz as reactionary, inept, and completely ignorant to the precarious future that lay in front of it. The account presented here attempts to sympathize (in a historical sense) with the SED's circumstances in the fall of 1989. Rather than assuming SED's ineptitude, this chapter instead asks *why* the regime proved so inept.

[739] Cover, *The Economist*, June 12, 2004. In support of Sarotte's point, there is a headline on the very same cover that reads "New Hope in Iraq?".

or financial – played little to no role in causing the collapse of communist regimes in Eastern Europe.[740] Sarotte is willing to grant that "the freedoms of the Western countries played a profoundly motivational role in 1989" but sees no place for Western hard power in the collapse of East Germany.[741]

This chapter – and the broader dissertation of which it is a part – attempts to recover an understanding of the sources of Western power that influenced the collapse of communism without partaking in self-congratulatory triumphalism. It does so by focusing on the most important leverage that Western political and financial institutions had in the late 1980s – money – and by fully recognizing that this leverage more often than not produced consequences that Western actors did not foresee or intend.[742] With this leverage in focus, it becomes clear that the United States government did indeed play only a minor role in the collapse of East Germany, but other centers of Western political and financial power – namely, the West German government of Helmut Kohl, the IMF, and the global financial system – played critical roles in undermining the GDR's sovereignty, stability, and ultimately, its existence.

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740 Charles Maier's, *Dissolution: The Crisis of Communism and the End of East Germany*, is an exception to this trend. Maier focuses a great deal of his attention on the GDR's debt to the West.

741 Sarotte, Location 372.

742 "The West" is certainly a term in need of definition and clarification. First, in quotes throughout this chapter from East German sources, I will use "the West" or "Western" where East German documents refer to "the NSW:" the *nichtsozialistisches Wirtschaftsgebiet*, or non-socialist economic area. In the GDR, their sovereign debt was always to "the NSW," but for ease of understanding, I have substituted the term "the West." In my own use of the terms "the West" or "Western," I mean to refer to a diffuse group of political and financial institutions in the capitalist world that only loosely coordinated their relations with the GDR, if they did so at all. Nevertheless, I believe they can be grouped under the term "the West" as a shorthand because the effect they had on the GDR, intended or unintended, was to undermine its sovereignty. Thus, for example, a Japanese commercial bank, the IMF, and Helmut Kohl can all reasonably be considered part of the same "Western financial power," even if they never sought to coordinate their actions.

After the tumultuous years surrounding the Polish Crisis in the early 1980s, East Germany returned to financial stability in 1983 and 1984 through the two *Milliardenkredite* (billion Deutsch Mark loans) from the West German government. Alexander Schalck and Günter Mittag's decision to place the loans on deposit with Western banks instead of using the funds directly to pay for new imports improved the country's creditworthiness dramatically. Helmut Kohl's decision to grant the GDR the two massive loans had made clear that the GDR had a new, very rich lender of last resort in place of the Soviet Union. With hard currency in its bank accounts and a new Western financial umbrella to stand under, the GDR regained easy access to Western capital markets in 1984.

However, with the financial crisis of the early 1980s fresh in their minds, Mittag and Schalck knew that the country's problems were far from solved. Most importantly, the debt level needed to recede in the coming years if the country was to maintain its independence from the Federal Republic. Therefore, Schalck and Deputy Finance Minister Herta König devised a plan to fudge the nation's finances in order to make the situation appear worse than it actually was to the State Planning Commission, which ran the planned economy. They hoped that by painting a dire picture they could spur an increase in economic performance, particularly in the all-important area of exports to the West. If it did not, Schalck and König believed that their model would still ensure the nation's solvency by holding hard currency secretly in reserve.

What came to be known as the Schalck/König model relied on one simple trick – changing interest rates. During the GDR's most dire months on the brink of bankruptcy in 1982, the country had been forced to borrow money on a very short-term basis, usually 90 days, at a very high rate of interest. Short-term borrowing is always more expensive than long-term borrowing, but in the midst of the high interest rates of the early 1980s, it was particularly expensive. Schalck and König would later write, "In the years 1981-1983, during which the banks granted absolutely no credits and withdrew their own short-term deposits from our banks, all money needed to be generated through extremely short-term trade transactions, whose costs ranged from 35-45%, sometimes in Export/Import transactions up to 60% per year."[743] After the billion mark loans of 1983 and 1984, however, the GDR could once again get long-term loans from Western banks at lower interest rates. The Schalck/König trick was simply to pretend that the billion Mark loans had done nothing to lower the GDR's borrowing costs. When Gerhard Schürer, the director of the State Planning Commission, then went through his annual process of devising the national economic plan, he would calculate the national debt based on the inflated interest rates provided by Schalck and König. From this one change, two vastly different pictures of the GDR economy emerged from Schürer on one side and Schalck and König on the other.

A memo from Schalck and König to Mittag in January, 1985 shows this difference clearly. For the 1986-1990 Five Year Plan, the State Planning Commission proposed to achieve wildly optimistic[744] annual export surplus targets of 6.6 billion Valutamarks (VM)[745] through an

[743] Schalck and König, "Information zur Konstenentwicklung," 14.5.1986, DL/226/1145, BArch/Berlin, pp. 4-7.
[744] The highest export surplus the GDR had achieved to that point was 3.6 VM billion in 1982. In 1985 it would achieve its highest surplus ever at 4.94 billion VM, before significantly shrinking through the remainder of the decade. See Table 45 in Judt, *KoKo: Mythos und Realität*, p. 232.
[745] The Valutamark was the East German accounting term used to signify the value of 1 West German Deutsch Mark (DM) without using the term DM for ideological reasons. Throughout the chapter I will use the term Valutamark or VM to reflect the GDR's ideological viewpoint, but VMs can be thought of directly as DMs. The value of the DM in US dollars varied significantly throughout the 1980s, but in the late 1980s it ranged from 1.6-2.6 DM/1 USD. For the easiest and roughest estimate of a value of Valutamarks in US Dollars, divide any number quoted in VM by two.

aggressive reorientation of the country's export capacity to the West and a restriction of Western imports. If the economy achieved these surpluses, the planning commission projected that the country's Western debt would recede from 29.2 billion VM in 1985 to 17.4 billion VM in 1990. In contrast, Schalck and König proposed a less stringent and more politically palatable projection for achieving annual export surpluses ranging from 3.4-4.2 billion VM. They assured Mittag that their plan would nevertheless cause the debt to fall to 15.7 billion VM in 1990. How was this possible? The two authors knew that the GDR could borrow money at an average annual cost of 14%-20%, while the State Planning Commission worked under the assumption that the GDR faced annual borrowing costs of 25%. The authors summed up the magic of their trickery. "Thus, despite budgeting for roughly 12.5 billion VM less in export surpluses than the State Planning Commission, our projections nevertheless lead to roughly 1.7 billion VM [less] in the debt." As Karl Marx himself knew well, such was the power of interest. Despite their projection's good news for the country, the authors felt it was news best kept secret. "We recommend that the State Planning Commission currently not be made aware of the actual possible reserves (*Einschüsse*) and the possible development in [borrowing] costs," they wrote. This way "the pressure to achieve high export surpluses [will be] lessened under no circumstances."[746]

If knowledge is power, then the Schalck/König model significantly concentrated power in the German Democratic Republic. Because the model created a small circle of people with an accurate view of the nation's economic situation – in the mid-1980s, probably only Honecker, Mittag, Schalck, König, and the head of the Stasi, Erich Mielke – it delegitimized any criticism of the country's economic situation that came from outside this small circle. The State Planning

[746] Untitled, Schalck and König to Mittag, 29.1.1985, DL/226/1145, BArch/Berlin, pp. 178-185.

Commission was purposefully kept in the dark, so Schürer's criticism of the country's economic trajectory now received even less attention from Mittag and Honecker than it had in the 1970s. Moreover, because the State Planning Commission's plans were now built on false premises, the entire planning process turned into a farce. In 1985, the Politburo renewed its call to cut the national debt in half by 1990 (just as it had first done in 1980), and tasked the State Planning Commission with achieving this goal. Each year for the rest of the decade, Schürer and the planning commission produced the same wildly optimistic plans for exports and imports in order to make the debt recede on paper. When these numbers inevitably failed to materialize, the country would be left with a financing gap at the end of the year. At this point, Schalck and KoKo would step in with roughly two billion Valutamarks from the secret KoKo accounts to cover the remaining gap.[747] If the running joke among workers in communist countries was "They pretend to pay us, and we pretend to work," then the running joke in the East German hierarchy could have been "They pretend that we face looming bankruptcy, and we pretend to be scared." With no sense of the real economic situation and, for the moment, no real threat of insolvency if performance targets were not met, the East German *nomenklatura* resisted fundamental change and Honecker refrained from applying pressure for reform.

As it ate away at the internal workings of the East German state, the false sense of security also fueled Honecker's resistance to Mikhail Gorbachev's perestroika and glasnost in the Soviet Union. The content of Honecker's criticism of Gorbachev's reforms was both practical and ideological. Practically, Honecker believed – and indeed rightly foresaw – that Gorbachev's attempt to modernize the Soviet economy would lead to significant shortages in the

[747] Schalck and König, "Standpunkt zum vorgelegten Material der Staatlichen Plankomission 'Grundlinien der Zahlungsbilanz für den Fünfjahrplanzeitraum 1986-1990," 19.3.1985, DL/226/1146, 144-147.

domestic supply of food and consumer goods. He became known among his Politburo colleagues for a rhetorical question he often repeated: Do you want perestroika or stocked shelves?[748] Ideologically, the economic implications of perestroika – greater uncertainty and instability for workers in return for higher performance – contradicted everything he had been building under the Unity of Social and Economic Policy since the early 1970s. In addition, Honecker saw Gorbachev's efforts to democratize Soviet society at the local level and open the public sphere to relatively free debate as a betrayal of the Leninist ideal of democratic centralism and an invitation for criticism from Western "bourgeois propaganda."[749]

Underlying Honecker's criticism was a confidence grounded in his sense that the East German economy suffered from none of the ills hurting the Soviet Union. Even in the autumn of 1988, after his country's dire position had become clear, Honecker told Gorbachev that the GDR had "no difficulties" providing for its population because "the economic development of the GDR isn't going poorly."[750] After Gorbachev once tried to warn Honecker about the dangers of the country's debt to the West, Honecker rejected his concerns as "unfounded."[751] Gorbachev later recalled that he "once tried to talk to Comrade Honecker about the GDR's debt. This had been curtly repudiated, as such problems would not exist [in the GDR]."[752]

In Honecker's view, economic problems did not exist in the GDR, and even if they did, any attempt to solve them would incite social unrest and damage the legitimacy of the SED. As long as he and Mittag had the Schalck/König model's assurances of solvency, they could afford

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[748] Krenz, *Herbst '89*, p. 214.
[749] Document 25, "Gespräch Gorbachew mit dem Staatsratsvorsitzenden Honecker am 28. September 1988 [Auszug]," in *Gorbatschow und die Deutsche Frage*, 104-109.
[750] Ibid, 107.
[751] Hertle, *Der Fall der Mauer*, 59.
[752] "Document 1: Memorandum of a Conversation Between Mikhail Gorbachev and Egon Krenz," *CWIHB*, p. 143.

to avoid the political risks associated with the reforms taking place in the Soviet Union, Poland, and Hungary.

One Last Great Leap Forward

Although the Schalck/König model's interest rate trickery gave the East German economy a great deal of leeway in meeting its performance targets, it still relied on the achievement of one very hard economic fact: a significant annual export surplus. If the East German economy failed to produce more than it consumed, no amount of accounting deception would save it from eventual insolvency. After the crisis years of 1980-1983, the country's Western trade performance had not met the aggressive targets set by the State Planning Commission, but trade surpluses had comfortably been achieved, going from 647 million VM in 1981 to 4.94 billion VM in 1985.[753]

Then, in the last two months of 1985, the price of oil collapsed on world markets. The trade surpluses of the early 1980s had been achieved at a particularly advantageous conjuncture in the global economy for the GDR. The Comecon pricing principle and the high market price of oil meant that the GDR had received crude oil from the Soviet Union at prices well below market level since the 1973 oil crisis. It was then able to sell products refined from this oil on Western markets at a handsome profit. By 1985, mineral oil refined from Soviet crude was the GDR's most important export to the West. When the oil price lost two thirds of its value from November 1985 to March 1986, these advantages disappeared as the price of refined products fell in lock step with the price of crude. In 1985, the GDR earned 2.5 billion VM from its mineral oil exports to the West, but that number dropped to 1 billion in 1986 and 900 million in

[753] Numbers citied from Table 45 in Judt, *KoKo*, p. 232.

1987.[754] Scholars have long looked at this oil price collapse as an important cause in the demise of the Soviet Union, but its effect on the GDR remains underappreciated outside the small circle of German historians of the GDR.[755]

The oil price collapse quickly changed Schalck's tune regarding the airtight assurances of national solvency he had been presenting in the Schalck/König model. Before the price collapse, in mid-September 1985, he and König presented a confident update of their model to Mittag. They assured him that for the upcoming period from 1986-1990 the economy could export 3.2 billion VM less and import 11 billion VM more than the State Planning Commission was projecting. The nation, they confidently asserted, would still be solvent at the end of the decade.[756]

By March 1986, they were far more uncertain. Rather than assuming a 4 billion VM annual trade surplus as they had the previous year, they now were forced to assume an annual trade surplus of 1.2-2 billion VM. As they wrote, "Compared to projections submitted earlier there is a significant deterioration." Instead of declining by 1990, the national debt would grow by 4.4 billion VM to 31.6 billion VM. To fund this growth in the debt, the annual borrowing requirements of the East German authorities would grow to 17.9 billion VM at the end of the decade. Such a development would leave the country open to the volatility of international capital markets – one external shock and Western banks might stop lending to the GDR. The main reason for the stormy outlook lay in the collapse of the oil price. "Based on international

[754] Export values cited in Steiner, *The Plans That Failed*, p. 175.
[755] The leading scholar of East German economic history, André Steiner, has produced a work of synthesis on the economic history of the GDR, *Von Plan zu Plan*, and an English translation appeared under the title *The Plans That Failed*.
[756] Untitled Letter, Schalck and König to Mittag, 16.9.1985, DL/226/1249, BArch/Berlin, pp. 213-214.

developments," they wrote, "it must currently be assessed that the oil price and therefore the prices of downstream products will remain at a low level." Therefore, they foresaw no possibility that the mineral oil industry could repeat its export performance from the previous five-year period in the five years to come. A dramatic change was necessary. If the rise in the debt was to be prevented, it was "essential" that "exports to the West receive a different status in the material distribution of the economy." Because the oil price had collapsed, achieving improved export performance in other areas of the economy besides oil derivatives had become a "vital issue."[757]

It was time for another attempt to catch up to the world market. Since the early 1970s, Eastern Bloc states had been trying unsuccessfully to produce globally competitive goods by importing Western technology. So far, it had failed in every country in which it had been tried, including the GDR. But with the leadership unwilling to consider cutbacks in East German living standards as a means of balancing the nation's books, growing the economy out of its debt problem was left as the only option. Economic growth, and particularly growth in exports to the West, required investment and Western technology. Therefore, in a series of Politburo meetings in May and June 1986, the leadership decided to make another attempt at importing Western technology on credit.[758] It fell to Schalck and Schürer to figure out exactly how to make this happen. In early August, Schalck wrote to Mittag with his proposal. "To ensure a rapid increase in performance, particularly in select export-intensive companies," Schalck suggested that KoKo be authorized to coordinate the import of "highly productive, technologically state-of-the-art computer-controlled machine tools and specialist machinery, automation equipment, [and] the

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[757] Untitled Letter, Schalck and König to Mittag, 6.3.1986, DL/226/1249, BArch/Berlin, pp. 296-298.
[758] Hertle, *Der Fall der Mauer*, p. 63.

most modern measuring and control devices." One of the biggest recipients of these targeted investments would be the East German microelectronics and computing industry. As Silicon Valley began its ascent in the United States in the 1980s, the GDR leadership – and Mittag, in particular – believed the country could be the Silicon Valley of the socialist world. All of these imports, Schalck wrote, "should be provided to companies as interest-free credits" and should not "burden the balance of payments from 1986-1990."[759] Because KoKo maintained large hard currency deposits and good relations with Western banks, it could get the Western loans independently from the East German state. Of course, KoKo would have to repay the loans at some point in the future, so it would eventually need to be repaid by the East German state. Under Schalck's plan, the day of reckoning would not come until 1991, at which point Schürer and the State Planning Commission would be responsible for paying KoKo back, hopefully by using the new hard currency profits that the technological investments would generate. Ghosts of the failure of this strategy during the 1970s in Poland, Hungary, and the GDR itself haunted the proposal, but with nowhere else to turn, Mittag and Honecker authorized the plan. Export growth to the West was now the only way the GDR could survive as an independent nation-state.

The Inflection Point

Instead, the trade balance worsened. 1985's export surplus of 4.94 billion VM fell back to 873 million VM in 1986 and turned to a 1.03 billion VM trade deficit in 1987.[760] In the autumn of that year, as the year-end trade deficit started to come into full view, Schalck and König realized for the first time that they could no longer ensure the solvency of the country over

[759] Schalck to Mittag, 05.08.1986, DL/226/1249, B/Arch, 180-181.
[760] Table 45 in Judt, *KoKo*, p. 232.

the coming years. Their model had always assumed at least a modest export surplus, and the falling export performance made clear that this assumption was no longer tenable. They began to sound the alarm internally of the country's impending insolvency. In October, they wrote to Mittag, "Stemming from the responsibility you gave us to ensure the solvency of our republic, we must inform you that…the solvency of the GDR can only be secured through 1990 if the 1988 export and import plan…is completely adhered to and at least the same growth rate in exports is achieved in 1989 and 1990 as is planned for 1988." They continued, "We must make this serious assessment based on the following considerations: in the years since 1982…planned exports to the West have not been met." The "inadequate development of internal economic productivity and efficiency, connected with an insufficient…reduction of imports has led to a constant growth in the debt of the GDR." Higher debt meant higher interest payments. They informed Mittag, "five to six billion Valutamarks are necessary <u>just for interest payments</u>" every year (all underlining throughout the chapter is original to the documents). "This is the price that our republic must pay every year for the anticipated national income of future years. At the same time, this means that <u>any</u> trade surplus <u>below 5 billion VM</u> will lead to a <u>further</u> increase in debt." Even if the economy achieved similar export results in 1989 and 1990 as were planned for 1988, the two officials told Mittag that the annual hard currency financing gap would grow from 11.3 billion VM to 21.3 billion VM in 1990. "We can," they told Mittag, "guarantee the solvency of the republic in 1990" but only if "the planned trade surplus is <u>actually</u> realized." "For the period <u>after</u> 1990," they told him, "it is a matter of life and death (*Lebensfrage*), that the improved performance of our economy…lead to an export surplus of 5 billion VM." If this was not achieved, then they told Mittag "we see no possibility of securing the solvency of the republic in 1991. This situation would apply already in 1989 or 1990 if the planned exports to the West are not achieved in 1988 – as has been allowed to happen in recent years." If exports were "allowed to develop as they did in 1986 and 1987, insolvency will occur already in 1989."[761]

Schalck made his newfound alarm even more clear at a working group of the country's top economists and economic managers taking place the same week in October. "If the GDR does not achieve an export surplus in 1987," he told the group, "the creditworthiness of the country will be critically burdened." In the 1970s, when petrodollar recycling was in full swing and the Western banking community believed in the "umbrella theory" for lending to Eastern Europe, all Eastern Bloc countries had been able to run ten consecutive years of trade deficits without losing access to Western capital markets. The Polish Crisis of the early 1980s and the subsequent Sovereign Debt Crisis in the developing world had fundamentally changed this. Schalck told his colleagues that the GDR's Eastern Bloc allies were already demonstrating in dramatic fashion that global capital markets no longer tolerated long periods of poor economic performance. "The example of Hungary, which for the past two years has not achieved a trade surplus, shows that the country's credit rating has severely deteriorated and it can only receive government-guaranteed loans." Because such loans came with conditions attached, Schalck concluded "this way is not politically or financially viable for the GDR."[762] If the Hungarian experience showed Schalck the perils of trade deficits, the Polish experience showed him the catastrophic consequences of insolvency. He later recalled, "[General] Jaruzelski…conveyed to

[761] Schalck and König, "Standpunkt zur voraussichtlichen Entwicklung der Zahlungsbilanz NSW 1988 -1990 und der NSW-Verschuldung," 16.10.1987, DL266-1143, pp. 47-52.
[762] Schalck quoted in Gerhard Schürer, "Information über die Beratung der Ständigen Arbeitsgruppe zur operativen Leitung und Kontrolle der Durchführung der Zahlungsbilanz der DDR mit dem nichtsozialistischen Writschaftengebiet vom 15.10.1987," 15.10.1987, DL/266/1143, BArch/Berlin, pp. 100-103.

me very clearly that a state which is insolvent loses and must lose its political power, and therefore its maneuverability. It can then govern only through bayonets [and] martial law; Jaruzelski…did this, but without success, because every military dictatorship must decide at some point how it will move forward - and it is not capable of this. So that [way] makes no sense."[763]

The KoKo chief's transformation from a beacon of reassurance to a prophet of doom in the fall of 1987 was an important development. Because he, König, and Mittag had done such a masterful job hiding an accurate picture of the country's finances from both domestic and international audiences, there were very few people either within the GDR or outside of it that could issue a credible warning to Erich Honecker about the country's approaching crisis. Schalck was one of the few who could, and after October 1987, he began to regularly warn that the country faced insolvency in the years to come. The illusions of security that his Schalck/König model provided Mittag and Honecker from 1983 to 1987 were now gone. Any continued resistance to beginning a process of economic reform now rested not on confidence in the nation's long-term solvency, but instead on fear of the political instability that reform would bring. Similar to the lessons Schalck learned about global capital markets, the leadership only needed to look at Hungary, Poland, or the Soviet Union to see this risk of instability play out in real time.

Just before Schalck lost his confidence in the nation's finances, Honecker undertook his long-awaited visit to the Federal Republic. As the General Secretary traveled around West Germany in September, 1987, the visit was hailed as a new step in inter-German relations, pan-European détente, the deepening thaw in superpower relations. For Honecker personally, the

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[763] Schalck interview in Pirker et. al. eds., *Plan als Befehl und Fiktion*, p. 148.

visit was a crowning moment of his career as he received almost all the official honors bestowed on a head of state, a sensitive topic for the leader of a country whose sovereignty had always been embattled and questioned. Ever since Chancellor Helmut Schmidt had visited the GDR in December 1981 and extended a reciprocal invitation to Honecker, the General Secretary had been deeply desirous of travelling to the FRG. But after the *Milliardenkredite* in 1983 and 1984, the Soviet government had been concerned that the GDR was falling under the orbit of the Federal Republic and had prevented Honecker from going. Gorbachev, despite his rhetoric of improving relations between the two European blocs, had shared this concern and prevented Honecker from travelling until the fall of 1987. Thus, the mere fact that a visit took place was taken as a sign by observers in both East and West that the European continent was heading toward a less divided future. In their joint communiqué issued at the conclusion of the visit, West German Chancellor Helmut Kohl and Honecker pledged "in light of the responsibility arising from their common history" to "make a special effort on behalf of a peaceful coexistence in Europe." To this end, they established a joint commission to further develop their economic relations and "dealt thoroughly with questions of holiday travel and visitor traffic."[764] The economic commission "proved to be a farce within a few months," according to Hans Hermann-Hertle. The travel discussions resulted in the Federal Republic's May 1988 agreement to increase its annual lump sum payment to the GDR for "infrastructure" to facilitate inter-German travel from DM 525 million to DM 860 million for the 1990s.[765] Such was the nature of inter-

[764] "Joint Communiqué by Erich Honecker and Helmut Kohl," September 8, 1987, http://germanhistorydocs.ghi-dc.org/docpage.cfm?docpage_id=109, Accessed June 27, 2016.
[765] This payment was a long-standing practice of the détente era and a significant source of hard currency for the GDR. Few believed that the GDR actually needed or spent this sum on maintaining roads and trains to facilitate inter-German travel, and most cynically viewed it as the GDR's ransom for maintaining open access between West Germany and West Berlin. "Farce"

German economic relations in the late 1980s – little real economic cooperation, but a great deal of cash transferred from West to East in the name of détente.

In the juxtaposition of Honecker's visit to the FRG and Schalck's conversion to prophet of doom, we can see the difference between public histories focused on the end of the Cold War as the culmination of détente and a private history focused on the end of the Cold War as the product of sovereign debt crises. Visible to the whole world, Honecker's visit reflected Gorbachev's embrace of superpower and intra-European détente, and his time in the Rhineland clearly improved the political mood in Europe. By late 1987, with the superpowers signing the INF Treaty to ban intermediate range nuclear weapons in Europe, and Gorbachev's declaration of his desire to create "a common European home" for both East and West, politics in Europe certainly *felt* different and better. But it is a central contention of this dissertation that it would be wrong to draw a causal line from these visible developments in European détente to the political revolutions that happened two short years later. Détente did not cause democracy. Debt crises did. And to understand the Eastern Bloc's debt crises, it is necessary to track the private concerns of a quiet operator such as Schalck. It is Schalck's private conversion, rather than Honecker's public diplomacy, that points the way to the decisive events of 1989. If one focuses on the outward signs of the Cold War – whether it be a sign of change such as Honecker's visit or an apparent sign of eternal stasis, such as the immovable presence of the Berlin Wall – then it is difficult to construct a historical narrative of 1989 that does not end in surprise, namely peaceful and quick democratic revolutions. If, on the other hand, one focuses on the financial

quote from Hertle, "The Fall of the Wall: The Unintended Self-Dissolution of East Germany's Ruling Regime," in *CWIHB*, p. 132.

history of the late Cold War, which was by its very nature a private - indeed confidential - history, then one finds historical antecedents for the surprising public events of 1989.

"Our Republic is Going Bankrupt"

At the end of 1987, the troubling outlook on world oil markets received a disconcerting jolt from the GDR's last line of defense, the Soviet Union. In December, the Soviet Union told its bloc allies that due to difficulties in the development and extraction of its oil supplies, it would have to reduce its oil deliveries after the current contract period expired in 1990. Additionally, in response to the emergence of the Common Market in the European Community and the limitations of Comecon, the Soviets proposed transforming the Eastern Bloc into a common market, where transactions would be completed directly between companies and settled at world market prices. As a precursor to making their currencies convertible to Western hard currencies, the Soviets also proposed making all bloc currencies convertible to each other. Hans-Hermann Hertle has written, "The reason for this [proposal] was obvious: about seventy percent of the GDR's imports from the Soviet Union were raw materials, while ninety percent of its exports to the USSR were finished goods. The raw material deliveries of the Soviet Union were valuable on world markets ("*NSW-wertig*"), the finished goods of the GDR were not."[766] The fact that such a development would result in lower raw material supplies from the Soviet Union to the GDR was plain for all to see, but Mittag eventually asked Schalck to think through precisely how dire the consequences would be. His conclusions were unequivocal, the "export failures, import increases, stresses on the balance of payments, and cash problems" that would result "would inevitably have a significant impact on the continuation of … [the] Unity of

[766] Hertle, *Der Fall der Mauer*, pp. 66-67.

Economic and Social Policy." A loss of Soviet raw materials "would give rise to fundamental political and economic questions regarding the situation of the GDR, as a state right on the border between the Warsaw Pact and NATO who confronts the powerful imperialist state, the FRG." Schalck concluded that his "considerations show the urgent need to safeguard the traditional goods and services from the USSR in the 90s."[767]

In the spring of 1988, however, all signs pointed toward a Soviet abandonment of its traditional economic role. This prospect caused Gerhard Schürer to break his silence and call for a change in course. In preparation for a Politburo meeting in early May, he composed a proposal to change the country's economic direction fundamentally. "Our conclusion must be," he wrote, that "each object, no matter how important it is" must be confronted with "the harsh economic conditions of the world market." The "crucial issue has become not what is produced, but at what cost and at what profit." Specifically, Schürer criticized the 1987 decision to attempt another Great Leap Forward by investing in unprofitable areas of the economy, particularly microelectronics. The head of the State Planning Commission foresaw no way that his institution would be able to repay Schalck for the recent hard currency loans because he foresaw no way that East German industries would be able to produce globally competitive exports in the next three years.

Seeing no prospect of sufficient economic growth in the future, Schürer saw only one remaining option to ensure the country's solvency – austerity. Although he believed in the state's mission to provide the working classes with a high quality of life, he recognized that "the benefits for the population from the state budget for housing, price supports, fares, education,

[767] Letter, Schalck to Mittag, 21.10.1988, and Letter, Schalck to Mielke, 20.10.1988, DL/226/1247, BArch/Berin, pp. 147-150.

health, culture, sports and recreation" were far outstripping the country's ability to pay for them. Knowing that Honecker had always rejected changes in this area because they would be unpopular, Schürer optimistically wrote that reforms to the country's subsidized prices and welfare system "could find the understanding and support of the population."

They would need to because Schürer believed the party could no longer afford to insulate the population from the world market. He detailed how the GDR's external economic conditions had deteriorated since the mid-1970s. "The imports from the USSR, for example, increased 245% from 1975-1985" in nominal terms, "but only 107% at constant prices." He noted, "out of a total import volume of 260 billion VGW during this period, 145 billion VGW were only price increases." This meant that the GDR had been forced to divert more of its goods to the Soviet Union to pay for the same amount of imports in return. Left behind in this process had been exports to the West. Here Schürer stated plainly "a fundamental change in exports to the West is necessary. The growth and profitability of exports to the West must permanently receive a higher priority in the national economy."[768] In sending the document directly to Honecker, Schürer later recalled, he wanted to make it clear to the General Secretary, "Our republic is going broke."[769]

Schürer's proposal was the most direct challenge to the Unity of Economic and Social Policy - and by extension Honecker's leadership - since its implementation in the early 1970s. Honecker forwarded it to Mittag and asked him to formulate a response for discussion in the Politburo. Mittag's reprisal went straight to the point. Schürer's proposal would "call into

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[768] Schürer, "Überlegungen zur weiteren Arbeit am Volkswirtschaftsplan 1989 und darüber hinaus," 26. April 1988, DE/1/58736, BArch/Berlin, pp. 318-330. Quotes at 320, 325, and 326-327.
[769] Quoted in Hertle, *Der Fall der Mauer*, p. 69.

question…the Unity of Economic and Social Policy" and his "suggestions for price changes" to consumer goods, rents, and energy were connected with issues of "significant mass appeal (*großen Massenwirksamkeit*)".[770] He sarcastically doubted such changes could find the support among the population that Schürer claimed. With regard to the recently attempted Great Leap Forward, Mittag held to the position that the only way out of the current impasse was export growth, which required investment in the latest technologies. Microelectronics, Mittag argued, needed to be "a strategic task of the first order" if the GDR wanted "to maintain its social and socio-political room for maneuver and to strengthen its position in world markets."[771] The choice between Schürer and Mittag boiled down to a difference of belief in the ability of the East German economy to compete on the world market. Schürer believed it could not. Mittag believed it had to. After the Politburo had discussed the two positions, Honecker sided with Mittag and declared, "The positions of Comrade Mittag are correct." He directed his comrades to find a way out of the crisis without implementing austerity.

The Politburo meeting in early May began six months of fruitless discussions within the leadership about how to move forward. All the while, the financial straightjacket around the country grew ever tighter. At a Politburo meeting in late June, Prime Minister Willi Stoph told the assembled group that the economy needed to achieve a 2.1 billion VM trade surplus in 1988 and a 4.2 billion VM trade surplus in 1989 in order to avoid insolvency. Despite the daunting numbers, Honecker renewed the strict limits he had set on economic reform. He would not allow state companies to go bankrupt. "What was already present, must remain.…Why dissolve whole companies here?... The elimination of companies that often have a long tradition is a mistake."

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[770] Günter Mittag, "Zur Prüfung des Materials des Vorsitzenden der Staatlichen Plankomission, Genossen Gerhard Schürer…", undated, but May 1988, DE/1/58736, BArch/Berlin.
[771] Quoted in Hertle, *Der Fall der Mauer*, p. 69.

Where a reformer might contemplate devaluing the East German Mark to increase the competitiveness of East German exports, Honecker held to the long-standing point of political pride that one East German Mark should equal one West German Mark. “The state-owned companies must be confronted with the world market in costs and production,” he said, “and they must produce what is marketable. Going forward, however, we cannot value one [East German] Mark as worth only twenty-five pennies.” Because the capitalist countries had high unemployment, growing poverty, and deteriorating living conditions for the working class, Honecker believed the generous East German social system was “very advantageous” and needed to be maintained. “We must always keep the improvement of the workplace and living conditions of the workers in mind." It naturally followed from this that consumer prices should not be increased. The General Secretary believed the recent events in Poland, where the government’s 1988 price increases had spawned widespread strikes, confirmed his point of view. He told his comrades, “Countries where price spirals were set in motion find themselves in a deep crisis. Comrade Jaruzelski told [me] that his decision to increase prices was wrong and that they are now looking at other options.”[772]

Indeed, as the East German leadership sought a way out of its economic crisis in the summer of 1988, it could very easily look at events in Poland and Hungary as direct evidence of what lay ahead if they tried to lower East German living standards. In May 1988, economic reformers had forced János Kádár out as General Secretary of the Hungarian communist party in order to implement the demands of the International Monetary Fund. In response, popular discontent was rising and opposition groups were taking shape on the ground in Budapest. In

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[772] Heinz Klopfer, “Persönliche Notizen über die Beratung im Politbüro des ZK der SED am 28.6.1988”, 28.6.1988, DE/1/58736, BArch.

Poland, Jaruzelski tried to quiet the discontent caused by price increases by agreeing to open the Roundtable negotiations with Solidarity. Inflation was accelerating and lines at Polish stores were increasing as food and goods became more scarce. All the while, the prospect of renewed labor unrest hung over developments in Warsaw.

Thus, by September, Honecker could at once declare that "the decisive issue" was "the problem of ensuring the solvency of the GDR"[773] while also pointing to the country's neighbors as evidence that price increases and austerity measures were not viable solutions. "All countries that have begun the price-wage spiral have then gone bankrupt, see Poland [and] Hungary - in Czechoslovakia, the same thing looms. We can not go the Romanian way [because] the situation with the FRG does not allow for it."[774] In the Politburo on September 4th, Harry Tisch summed up the nature of the country's economic problems with precision, "Our people want social security, safety, job security, and education from us and the department stores of the FRG." And Werner Jarowinsky returned to the horrible track record of reform in other Eastern Bloc states. "Nobody has achieved better solutions with so-called economic reforms. They all have debts," but their attempts at economic reform destroyed "the basis of trust and optimism" in society. Therefore, he said, "We need to keep the GDR stable."[775] Through the end of the year, the Politburo did, and the debt to the West continued to grow.

In February 1989, Schürer approached Egon Krenz, the heir apparent to Honecker, about overthrowing the General Secretary on the grounds that he had run the country into financial

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[773] "Arbeitsniederschrift über eine Beratung beim Generalsektretär des ZK der SED, Genossen Erich Honecker, zu den Materialen des Entwurfs der staatlichen Aufgaben 1989," 6.9.1988, DE/1/58738, BArch/Berlin.
[774] Quoted in Hertle, *Der Fall der Mauer*, p. 71.
[775] "Arbeitsniederschrift über eine Beratung beim Generalsektretär des ZK der SED, Genossen Erich Honecker, zu den Materialen des Entwurfs der staatlichen Aufgaben 1989," 6.9.1988, DE/1/58738, BArch/Berlin.

ruin. “Schürer confirmed to me that Honecker bore a large personal fault for the debt of the GDR,” Krenz recalled. “A reduction in the debt is impossible” with Honecker leading the country, Schürer told him. But not yet feeling the sense of dire urgency required to make such a move, Krenz declined.[776] This left Schürer to desperately report in May to a group of leading officials that the country’s debt to the West was increasing at a rate of 500 million Deutsch Marks per month and to plead for the adoption of “a series of measures in the area of consumption” to ward off the insolvency. But no one could bring themselves to support austerity. “What would we say to the people?” Harry Tisch asked rhetorically. Krenz continued to see no way out. “For me it is no question whether the Unity of Economic and Social Policy will continue,” Krenz said. “It must be continued, because it is socialism in the GDR!”[777]

If the experience of Poland and Hungary showed the Politburo that price increases and austerity measures were unpopular, it also showed us in the previous two chapters that communist leaders avoided implementing austerity until they believed they had no other choice. With its creditworthiness still in tact and its borders still secure through the spring of 1989, the East German leadership still had choices, so it collectively chose short-term stability over long-term solvency. Events along the Hungarian border would soon change these choices. But as the rest of this chapter demonstrates, the leaders of East Germany would choose any path – including even opening the Berlin Wall – if it allowed them to avoid the implementation of austerity.

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[776] Quote in Krenz, *Herbst ’89*, p. 120; Also see Gerhard Schürer, *Gewagt und Verloren*, p. 158.
[777] Quoted in Hertle, *Der Fall der Mauer*, p. 73.

Creating the Exit Choice

Scholars widely recognize the opening of the Austro-Hungarian border on September 10th, 1989 as a critically important moment in the collapse of the GDR. With the Hungarian government's decision to allow East German citizens to cross the border into Austria and move on to West Germany, East Berlin lost the power to control the movement of its own people. But why did the Hungarian government betray its ally and open its borders? Why did it take down the barbed wire fence – the so-called "Iron Curtain" – that ran the length of the Austro-Hungarian border earlier in the spring of 1989?

These decisions have traditionally been viewed as part of the broader reform communism movement in Hungary – a movement that aspired to join the West, to be included in the European Economic Community, and to abide by international human rights norms. As Mark Kramer, one of the leading historians of the end of the Cold War, has written, "the Hungarian government sought to burnish its liberal, pro-Western credentials by dismantling 'the Iron Curtain.'"[778]A group of scholars has also drawn attention to Austro-Hungarian diplomatic relations, which they label "a masterpiece of European détente," as a critical factor in the decision to open the border.[779] However, the most recent German monograph on this history, Andreas Oplatka's *Der Erste Riß in der Mauer* ("The First Crack in the Wall"), rightly stresses the financial motivations behind the Hungarian government's decisions. This is central to understanding the history of 1989, because it is in Hungarian financial history that we see the strongest evidence of how events began to cascade and accelerate in the late 1980s. Only

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[778] Mark Kramer, "The Demise of the Soviet Bloc," *Journal of Modern History*, Vol. 83, No. 4 (December 2011), 788-854, p. 832.
[779] Tamás Baranyi/Maximilian Graf/Melinda Krajczar/Isabella Lehner, "A Masterpiece of European Détente? Austrian–Hungarian Relations from 1964 until the Peaceful End of the Cold War," in *Zeitgeschichte* 41 (2014) 5, 311–338.

because of Hungary's financial problems did its domestic reforms become a question of East German emigration. Only because of Hungary's sovereign debt did the Exit/Voice and in turn the Exit/Violence/Austerity dynamics of East Germany's dénouement come into being. Therefore, an exploration of Hungarian financial history is required to understand the GDR's predicament in 1989.

By the late 1980s, the border fortifications separating Hungary from Austria and the broader West had become dilapidated. The electronic signaling system along the border, which was meant to alert border guards to any attempted crossing, regularly sounded false alarms because of gusts of wind or wild animals. It needed to be modernized if it was to be maintained. In the fall of 1987, the head of the border guard wrote a report for the Hungarian Interior Ministry detailing the current system's failings and annual cost, as well as estimating the costs of a system renovation. In a country with an annual budget deficit of 30 to 60 billion forints, the report's numbers detailed an unwelcome prospect: the annual cost of the system was 42-50 million forints, and a renovation of the system would cost 1.2 to 1.5 million forints per kilometer along a 366 kilometer border.[780] The chief of the border guard believed that the cost of the system far outweighed the benefits, and recommended that it be removed.

The benefits of such a system were particularly low by the late 1980s because of the political changes then underway in Hungary. As discussed in the previous chapter on Hungary's democratic transition, the Hungarian government passed a law in the spring of 1987 that enabled all of its citizens to travel to the West and exchange a fixed amount of Hungarian forints into hard currency to finance their travel. As of January 1, 1988, all Hungarians would be allowed to travel to the West with new so-called "world passports." This new law was an extremely

[780] Oplatka, *Erste Riß*, p. 25.

popular measure among the Hungarian population, and it was adopted precisely for this reason. At a time when the Hungarian communist party had begun to implement extremely unpopular IMF-mandated austerity measures, it sought refuge in the new travel law as a means of bolstering its standing in society.[781] Hungarians' newfound freedom to travel called into question the need for a fortified border fence separating the country from the West. Imre Pozsgay, the leader of the reform communist movement, called the Iron Curtain fence "both historically as well as technically and politically" outdated after a visit to the Hungarian border in October 1988. Now that Hungarians had world passports, Pozsgay said, they would not need to cross the border illegally.[782]

As the pressures of IMF-mandated austerity increased in the fall of 1988, the Hungarian General Secretary Károly Grósz resigned from his post as Prime Minister and installed the reform economist Miklós Németh in his place. Németh would prove to be the driving force behind the decision to open the border in the months ahead. For the new Prime Minister, there was a direct connection between his dealings with the IMF regarding the nation's finances and his decision to dismantle the border fence. As discussed in the previous chapter, the Hungarian government had been under constant pressure from the IMF since 1987 to cut its budget deficit and implement austerity measures. Now, as Németh took office, he went through the country's books line by line to look for areas he could cut. When he came across the line item detailing the annual cost of the border security system, he "unceremoniously" drew a line through it with his pencil. Andreas Oplatka has written, "Today, looking back on the success of the border opening, it would no doubt be easy and tempting for Németh to say that he made his decision" as a reform

[781] See page 39 of Hungary chapter.
[782] Pozsgay paraphrased in Oplatka, *Erste Riß*, p. 32.

politician "thinking in European dimensions." But, "the former prime minister openly and frankly says the opposite. He admits that at the time it was all about cost savings."[783]

Németh still needed the rest of the leadership's approval for this decision, so in February 1989 he went to the Politburo with a report detailing the costs of modernizing the border security system. It would be expensive: a simple renovation of the old system would cost up to 560 million forints; its replacement by a modern system (such as the one in East Germany) would cost up to 1.25 billion forints; and building new housing for the border guards and their families would cost 2.4 billion forints. Oplatka writes, this "financial factor was particularly convincing." After hearing of it, "No one opposed the dismantling." He concludes that this was because the Politburo had "discussed the extremely tense financial situation of the country and the demands of the International Monetary Fund five days before." At that meeting on finances, "dramatic tones prevailed, and a swear word or two were used on occasion."[784]

Having gained the assent of the party, Németh moved on to seek the next level of authorization in the Eastern Bloc's chain of command: Moscow's. On March 3rd, 1989, the Prime Minister arrived in the Kremlin for his first visit with Mikhail Gorbachev. During their discussion, the two leaders touched on many subjects ranging from the status of Soviet troops in Hungary, to the merits of a multi-party democratic system, to the challenges of Hungarian economic reform. Eventually, Németh broached the issue of the border security, saying, "We have decided to gradually do away with the electronic signaling system between now and January 1, 1991." Gorbachev hesitated, and then responded, "I see, frankly, no problem."[785] Surprised at the ease of the acquiescence, Németh and his party returned to Budapest resolute in

[783] Oplatka, *Erste Riß*, p. 36.
[784] Oplatka, *Erste Riß*, p. 46.
[785] Oplatka, *Erste Riß*, p. 67.

their decision to move forward with the dismantling of the border fence. First, however, they would need to inform their socialist comrades of their decision.

In mid-March, the Hungarian Foreign Ministry called the ambassadors of the Warsaw Pact countries together for a meeting. There, the leadership informed them that the government had decided to dismantle the border fence. They provided no timeline, but did provide the reason for their decision: "The step was required for economic reasons[.] Hungary could no longer afford the fence."[786] Despite the change, Hungarian officials told their allies not to worry. This was a change in cosmetics, not in practice: the border would continue to be heavily patrolled and citizens of other Eastern Bloc states would still be barred from leaving Hungary for the West.

In April, Hungarian authorities began taking down the border security system to little public attention. It gained increasing notice, however, after the Hungarian and Austrian Foreign Ministers, Gyula Horn and Alois Mock, held a symbolic wire cutting in front of TV cameras and newspaper reporters on June 27th. Immediately the image of the two foreign ministers was published across Western Europe, and thus beamed into East Germany through West German television. East German citizens began to travel to Hungary with the hope that the Hungarian government would eventually relent and allow them to cross the Austrian border. A Stasi analysis concluded that the main motivations for the emigration were a lack of consumer goods, the poor state of the medical care, the limited possibilities for travel, the sorry workplace conditions, the bureaucratic attitude of the state, and the lack of free media - in other words, life in the GDR.[787] Many of the refugees holed up in the West German embassy in Budapest (and to

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[786] Paraphrased in Oplatka, *Erste Riß*, p. 71.
[787] Sarotte, *The Collapse*, Location 815 of 8079.

a lesser extent in Prague and Warsaw), believing that the West German government would eventually pay the GDR for their release to the West, as it had done many times before for East German political prisoners stuck in East German jails. By July, the Exit had begun.

In August, local civil societies groups in the town of Sopron along the Austrian border began organizing what would eventually be billed as the "Pan-European Picnic." Set for August 19th, the picnic would celebrate Hungarians' new freedom of travel by allowing residents to freely cross the border into Austria for three hours during the afternoon. Hearing of the plan and sensing political opportunity, Pozsgay co-opted the local plan and worked with the Austrian royal Otto von Hapsburg to raise its profile to become an international symbol of European détente. In the run up to the picnic, Németh nervously endorsed the event as a means of testing how the Soviet Union would react to a complete, if temporary, opening of the border. On the afternoon of nineteenth, somewhere between 1500 to 2000 people took part in the picnic by crossing the border north of Sopron. Roughly six hundred East Germans used the temporary opening to flee across the border. The border guards decided not to prevent them from crossing, and the refugees freely fled to the West. In the days to come, the Pan-European Picnic and the six hundred East Germans who escaped became global news and another sign of the evaporating barriers between East and West.[788]

The event also put further pressure on Németh to permanently solve the refugee problem. The picnic had demonstrated to the Hungarians that the Soviets would not intervene, but it had also demonstrated to East Germans that the Austro-Hungarian border could be crossed. This only increased their numbers. Németh was spurred to act. The choice was between either sending the refugees back to East Germany or opening the Austrian border for all East Germans

[788] Oplatka, *Erste Riß*, p. 154 – 164.

to cross freely. The Prime Minister began by weighing his country's commercial relationship to the two Germanys. He asked his team if there was any economic damage that the GDR could inflict on Hungary if he acted against East German interests. They could come up with nothing.[789] In contrast, the economic benefits of a good relationship with Bonn were obvious – the Kohl government held the keys to Hungary's fortunes in Western Europe and, along with the United States, determined the country's fate in the IMF. This was enough to convince Németh. He would open the border to Austria. On August 22nd, he confirmed the decision with the highest ranks of the leadership, and immediately requested an emergency secret meeting with Kohl to inform him of the decision.

On August 25th, Németh and his closest advisors departed Budapest under the utmost secrecy for Bonn aboard an airplane not normally used for official business. When they landed, they boarded a helicopter of the West German border police to fly to Gymnich Castle outside of Cologne, where Kohl and West German Foreign Minister Hans-Dietrich Genscher secretly waited. What happened next remains the subject of dispute among the participants. Genscher wrote a memorandum of the meeting, but it fails to mention the refugee issue at all, probably because he feared that the Stasi would find out. Retrospective accounts from Kohl, Genscher, Németh, and Hungarian Foreign Minister Gyula Horn differ in important respects, but Andreas Oplatka gives the most weight to the accounts of Kohl and Németh.[790] If one trusts these two accounts, then the meeting went as follows. After a discussion of the precarious Hungarian economic situation, Németh announced to his hosts that the Hungarian government had decided to open its border to Austria for East Germans. Kohl, with "tears in his eyes," thanked the Prime

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789 Oplatka, *Erste Riß*, 178.

790 He does so because the two leaders' accounts support each other, Genscher's account lacks detail, and Horn goes out of his way in his memoir to put himself at the center of events.

Minister for his decision and asked what kind of financial compensation he wanted in return. Németh proudly responded, "We do not sell people." This was an allusion to the mercenary Romanian (and, for that matter, East German) practice of selling the emigration of their dissident, German, and Jewish populations to West Germany in exchange for a substantial amount of hard currency. Németh, at least officially, wanted no part in such a practice. Instead, he asked for Kohl's assistance in bringing Hungary closer to the European Community. Kohl readily agreed and added that the Federal Republic would compensate Hungary for any retaliation carried out by its socialist "brother countries."[791] The meeting concluded with both sides agreeing to work together to coordinate the logistics and timing of the border opening. On September 10th, the Hungarian government opened the border to the 7,000 East Germans now waiting to leave for the West.[792] According the one Hungarian estimate, 600,000 East Germans followed suit in the weeks to come.[793]

If there was no quid pro quo in fact, there was certainly one in perception. In the weeks after their meeting, the Kohl government granted the Hungarians a DM500 million loan in support of "a reform process of pan-European importance" and in recognition of the Hungarian decision "against closed borders, and for the free movement of all citizens."[794] The Hungarians delayed signing the loan until mid-December to perpetuate the appearance of independence, but it fooled nobody. In a meeting on October 7th, Honecker and Gorbachev discussed the loan and lamented Hungary's betrayal of socialism in exchange for money. Gorbachev folded the news

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791 Oplatka, *Erste Riß*, pp. 194-197.
792 Serge Schmemann, "Hungary Allows 7,000 East Germans to Emigrate West," September 11, 1989, *New York Times*, http://www.nytimes.com/1989/09/11/world/hungary-allows-7000-east-germans-to-emigrate-west.html?pagewanted=all. Accessed June 27, 2016.
793 Sarotte, *Collapse*, Location 889 of 8079.
794 Document 57, "Schreiben des Bundeskanzlers Kohl an Ministerpräsident Németh," October 4, 1989, in *Deutsche Einheit, Sonderedition*, p. 442.

into a broader explanation of the disintegration of the socialist bloc going on around them. "The West promises great gifts of grace [*Gnadengeschenke*] in exchange for renouncing positions," the Soviet leader said. "We were also goaded to borrow more. We have difficult processes [happening] in society, but it is not so easy to approach us. Hungary and Poland are another matter. Their prosperity has been created on an artificial basis over several years, and this has now moved them into a position of dependence."[795]

So why did the Hungarian government decide to dismantle the Iron Curtain and open its border for East Germans? There were many reasons, among them that its leadership had lost the ideological conviction to defend the GDR's repressive brand of socialism. But as Prime Minister, Németh had to think in terms of the Hungarian national interest. In this regard, the financial power of the West and economic weakness of the East significantly shaped his choice. From the West, carrots and sticks abounded. The US ambassador to Budapest Mark Palmer told Hungarian officials throughout the summer of 1989 that if they sent the East German refugees back to the GDR, "the United States would not invest another cent in this country."[796] In the broadest sense, Németh and his closest advisors believed that the country's future lay in Western Europe, not in what remained of the Eastern Bloc. They had been trying to establish ties with the European Community for almost a decade, and they now hoped to gain access to the European Economic Community and the future European Common Market. The West German government would ultimately decide whether and when this happened. Kohl could easily promise to compensate the Hungarians for any East German economic retaliation because East Berlin had few means with which to retaliate. He did not even have to mention the retaliatory

[795] Document 46, "Gespräch Gobachev mit dem Staatsvorsitzenden Honecker am 7. Oktober 1989 [Auszug]," in *Gorbachew und die Deutsche Frage*, pp. 187-190, quotes at 189.
[796] Oplatka, *Erste Riß*, 172.

power he could wield if the Hungarians chose in East Berlin's favor and sent the refugees back. The fate of the Hungarian economy, and with it, the political fortunes of Németh and all the reform communists, depended on the good graces and financial power of Bonn. The DM500 million loan, whether directly tied to Németh's decision or not, was the most visible manifestation of this broader financial context that pushed the Hungarian government to permanently open the Exit option.

Avoiding Violence to Avoid Austerity

At the Warsaw Pact's summit in Bucharest, Romania in early July, Mikhail Gorbachev officially renounced the Brezhnev Doctrine, the Soviet Union's commitment to intervene in the internal affairs of its satellites in order to "protect socialism." The summit's concluding document announced that future relations within the bloc would take place "on the basis of equality, independence and the right of each country to arrive at its own political position, strategy, and tactics without interference from an outside party."[797] Although this only put in writing what Gorbachev had been telling his Eastern Bloc allies since his first day in office,[798] its official enshrinement arrived to the great consternation of Honecker and Krenz, who represented the GDR at the summit. Adding injury to insult, Honecker fell ill at the conference with a biliary colic and had to fly home early for medical treatment. Although his condition initially stabilized, the General Secretary was forced to have surgery in mid-August to remove his gallbladder and take a leave of absence until the end of September.

Honecker's illness paralyzed the East German leadership's response to the constantly

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[797] Quoted in Hertle, "The Fall of the Wall," in *CWIHB,* p. 133.
[798] A point I will make in my chapter, "Mikhail Gorbachev and the Challenge of Perestroika."

deteriorating domestic and international circumstances. The week after Hungary opened its border, the GDR worked with the anti-Western government of Czechoslovakia to end East German travel to Hungary all together. But the Exit movement was now in full bloom, and emigrants continued to leave undeterred. Instead of travelling all the way to Hungary, they now simply stopped in Prague and went to the West German embassy. There, thousands were camped out in miserable conditions by the end of September. As Honecker finally returned to work at the end of the month, he agreed to strike a deal with the West German government. He would "expel" the East Germans in the Prague embassy from the GDR, thus retaining his nominal control over who got to leave the country, while also allowing them to travel to the West. On the nights from September 30th to October 1st, the refugees travelled by trains from Prague through the GDR and on to the Federal Republic. On October 3rd, Honecker made a last gasp attempt to shut down the Exit option by completely closing the GDR's borders.

This decision only served to enrage the domestic protest movement that was now gaining steam. Since the spring of 1989, a small group of dissidents had been using the peace prayer service that took place in the Nikolai Church in downtown Leipzig every Monday to organize protests against the regime. By the time of the peace prayers on September 18th, hundreds of Leipzig residents had joined in, and the next week, the protesters began to take their voices out into the streets and call for reform. On Monday October 2nd, roughly ten thousand people set out to march around the city's ring road, and security forces dispersed the crowd with clubs, dogs, and shields. As the trains carrying a last group refugees from Prague rolled into the Dresden train station on October 4th, an estimated 20,000 protestors surrounded the station and blocked the tracks until police forcibly dispersed them. Then, in the days leading up to the SED's celebration of the 40th anniversary of the GDR on October 7th, countless protests in cities throughout the country were put down with force. In all cases, the authorities stopped short of killing protesters, but there was little doubt that their intention was to discourage dissent through intimidation and repression.

The increasing boldness of the protests and the state's response set the stage for the climatic protest in Leipzig on October 9th. Since June, when Deng Xiaoping and the Chinese leadership had ordered its security forces to shoot protesters in Tiananmen Square, it had been an open question among East German citizens and foreign observers whether Honecker and the SED leadership would do the same in the GDR. If there was going to be a "Chinese Solution" in East Germany, it was going to come on October 9th. Why no "Chinese Solution" transpired – in other words, why the East German leadership did not choose Violence – owes to a complex interplay between domestic and international factors.

The country's precarious financial position played a role. Krenz wrote in his memoirs, and documentation from Schalck's papers demonstrates, that Schalck had been keeping him informed about the real state of the country's financial situation for many years before 1989.[799] Honecker had been grooming Krenz since the 1970s to be his successor as General Secretary, and given Honecker's advanced age, it made sense to keep Krenz informed. With this context in mind, it is very likely that a memo dated September 18th, 1989 in Schalck's papers was seen by Krenz as well as Mittag and Mielke. Although the document is not attributed to any author, it has all the hallmarks of being composed by Schalck. In addition to being stored in his papers, it also contains a comparison of the "real" economic numbers against those used by the State Planning Commission.

The document – and the myriad of unrecorded and informal conversations Schalck surely

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[799] Krenz, *Herbst '89*, p. 120.

had with leading officials at this time – laid out in significant detail the GDR's financial dependence on the capitalist West and suggested how this dependence affected the country's political sovereignty. Schalck began by stating that in contrast to the previous year's urgent demands for a trade surplus in 1989, the country would in fact run a 2.5 billion VM deficit. Despite the horrific economic performance, Schalck and his team had successfully prevented capitalist banks from questioning the GDR's creditworthiness by refusing to publish information on the nation's financial position. But the continued flow of capital, Schalck now wrote, hung by a thread. He warned that the country's solvency depended on whether the "annual borrowing of 8-10 billion VM can actually be secured. Such a credit volume is an extraordinarily large sum for a country like the GDR, which means we are highly dependent on capitalist banks to maintain our solvency." He continued, "The particularly high risk of dependence lays in the finance credits [loans not tied to any particular investment or trade transaction] that are indispensible for us. Maturing principle and interest payments can only be made through finance credits." Like the Hungarians in 1987, Schalck now told the leadership that the country's solvency depended on the continued inflow of Japanese capital. "Currently more than 75% of finance credits come from Japanese banks. Should the Japanese government no longer allow the further granting of loans, for example, if the United States blackmails the Japanese government due to its credit boycott policy, there is no way to cover the shortfall in loans through banks in other countries."

Beyond American blackmail, Schalck explained that there were other factors that would influence the readiness of capitalist banks to keep lending money to the GDR. These included, "the impact of political factors on the lending willingness of capitalist banks, and the position of the governments of countries such as Japan and the FRG, which has a signaling effect on banks in other countries." With this in mind, Schalck informed his readers, "During the visit with the Director General of the Bank of Tokyo on September 13, 1989…the President of [East German] Foreign Trade Bank was asked to assess how the departure of so many young people will affect the economic development of the GDR. Similar issues were also discussed with the President of Crédit Commercial de France." As a final warning, Schalck wrote, "A failure to meet the loan repayment commitments of the GDR or a late payment of interest would lead to a total suspension of credit by capitalist banks."[800]

It is impossible to know precisely how this memo affected the leadership (which, at this point, was still without Honecker due to his leave of absence), but it is clear that discussion of the nation's financial situation continued to grow within the leadership as the protests grew in the streets. "Corresponding to orders given" to them, all of the leading economic officials of the state – Schalck, Schürer, König, the Minister of Foreign Trade Gerhard Beil, and the President of the State Bank, Werner Polze – composed another extended memo examining the nation's financial position on September 28th. Sounding the alarm, they began, "we already are <u>significantly dependent on capitalist banks</u> to meet our payment obligations of principal and interest as well as to implement our yearly import plan." The "extraordinarily high sum" of 8-10 billion VM needed to "be mobilized <u>annually</u> from approximately 400 banks at any one time." This mobilization was growing increasingly difficult because "capitalist banks set country limits for their credit orientation toward socialist countries, just as they do for developing countries. Due to the already high debt, banks are not willing to significantly increase this limit for the GDR." The GDR's access to credit markets in the years to come, the authors warned, was "largely

[800] Unauthored, "Standpunkt zur Sicherung der Zahlungsfähigkeit bis 1995/96," DL/226-1258, 153 – 157.

dependent" on "the impact of political factors on lending willingness of capitalist banks and the positions of the governments of countries such as Japan and the FRG, which are among the most important creditors of the GDR." Even if the country managed to keep the markets' favor, it would still need to double its exports in the next five years while also holding imports constant. As this chapter has shown, such export growth would have been unprecedented in the history of the GDR. Indeed, it must have appeared as pure fantasy to those who wrote and read them.

Nevertheless, any deviation from these surpluses would certainly lead the country into insolvency, the authors warned, and insolvency would have dire consequences. "Assuring the solvency of the Republic without conditions is the crucial prerequisite for the political stability of the GDR and further economic development." This was because, "Failure to meet upcoming repayment obligations on loans or untimely payment of interest would lead to the total cessation of credit granted by capitalist banks. With this, no more loans would be available for the GDR's imports." Just as Schalck had drawn lessons from Hungary's example two years prior, the economists now urged the leadership to look to Poland to see the disastrous results of failing to maintain solvency. "The example of Poland demonstrates all this," they wrote. "Poland has received no new loans from capitalist banks since its cession of payments in 1981." The Polish example showed that the world of finance had become more demanding of debtors in recent years. Debt rescheduling agreements with few or no conditions attached "no longer exist," the economists wrote. "For years now, debt rescheduling agreements with capitalist banks have only been concluded with the involvement of the IMF."

As we saw in the "Bailouts of Eastern Europe" chapter,[801] East German leaders saw the IMF as an organization hell-bent on dismantling socialism. The economists believed the history of socialist countries' relationship with the IMF in the 1980s only provided new, disturbing evidence to support their conviction. They wrote, "The prerequisite for a possible debt restructuring is the fulfillment of conditions that have been issued by the IMF." From the experience of other socialist countries, it was clear these conditions would include: "the renunciation of the state's right to intervene in the economy (example of Poland); the reduction of [state] subsidies with the intention to abolish them (examples Poland, Yugoslavia, and Hungary); [and] the liberalization of imports from Western countries, that is, the renunciation of the state's ability to determine its import policy." In other words, dealing with the IMF would mean the forced repeal of socialism. This led the group to one overarching conclusion. "Therefore, the issue of assuring the solvency of the Republic is to be granted the highest political and economic priority."

Here, just as in Hungary and Poland, the coercion of creditworthiness was at work. The economists proposed adopting unpopular domestic policies that would invite social unrest in order to maintain the country's international creditworthiness. They wrote that the current financial situation made the following policies "necessary": "a systematic change in the basic proportions between accumulation and consumption…; a reduction of societal consumption – and if that is not enough – also individual consumption; and the development of industrial export sectors, including the redistribution of labor for the benefit of…export-critical branches within industries."[802] Put simply, maintaining solvency would require the hallmarks of austerity - price

[801] With quotes from Schalck, Schürer, and Honecker, I will make clear in this chapter that East German officials abhorred the prospect of joining the IMF in the early 1980s.
[802] Schürer, Beil, König, Schalck, and Polze, Untitled, 28.09.1989, DE/1/58166

increases, cutbacks in social benefits, and unemployment – as well as the continued support of the country's Western creditors.

Schalck reiterated this last point in a memo to Krenz four days after the October 9th protest in Leipzig. Although the memo was written after that fateful day, it almost certainly put ideas already floating through the two men's minds on paper rather than proposed something completely new. "The attitude of the FRG government and the business circles of Federal Republic influence the attitude of the other [European Community] states and Japan toward the GDR to a large degree," Schalck wrote. We must take "the political and economic influence of the FRG, especially in the European Community and also in relation to financial circles and credit markets outside Europe very much into account."[803] Thus, if it was not written plainly on a document to be found in the archives, it was certainly plain for Egon Krenz to see that if he chose to use Violence against protesters in Leipzig or elsewhere, the country would soon be insolvent. Insolvency clearly meant one thing: a repeat of the Polish experience in the 1980s. As this chapter has demonstrated, no one in the leadership welcomed such a prospect. Perhaps we can then conclude that Krenz did not implement a "Chinese solution" because he wanted to avoid "the Polish experience."

What Krenz, rather than Honecker, believed in the early days of October is important because by October 9th the overthrow of Honecker had been set in motion. Honecker held on to power long enough to celebrate his country's 40th birthday on October 7th. But by the next day, according to Krenz's memoirs, the plot to bring him down had finally begun to take shape.[804] On October 8th, Honecker issued orders to all local leaders and security forces that they should

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[803] Schalck to Krenz, October 13, 1989, DL/226-1195, BArch/Berlin, pp. 17 – 20.
[804] Krenz, *Herbst '89*, p. 146.

prepare "measures" to prevent future "riots" "from the outset."[805] But when decision time came the following day in Leipzig to put down the protest or let it go on, the party's acting leader in Leipzig, Helmut Hackenberg, called Krenz and not Honecker because he had already heard that Krenz had begun planning Honecker's overthrow.[806] Had the perception still existed among the GDR's rank and file that Honecker remained in full control, it is difficult to know how events on October 9th would have unfolded. Two things, however, are certain – Honecker had always shown a low regard for his country's financial position and he was furious when he learned that the October 9th protest had succeeded without any resistance from the security forces. Had he been in full control, he likely would have embraced violent repression and dealt with the consequences of insolvency another day.

Which brings us back to the protest on the ground in Leipzig on October 9th. Neither the country's financial weakness nor Krenz's scheming against Honecker were known to the East Germans who gathered that day. To them, the East German state remained a mass of repressive instruments that could be and would be used against citizens who spoke out in dissent. This did not stop roughly 70,000 of them from gathering outside Nikolai Church after the Monday peace prayers and attempting to peacefully circle the ring road that surrounded the city center. The ring road had become the weekly battleground between protesters and the security forces. As the protesters began to make their way around, Hackenberg made his call to Krenz to report that the protest was far larger than anyone had predicted and ask what he should do. Krenz hesitated and told him he would call him back. According to accounts of personnel at the scene, it took him a half hour or forty-five minutes to call back, by which time Hackenberg had individually decided

[805] Quoted in Hertle, *Der Fall der Mauer*, p. 114.
[806] Sarotte, *Collapse*, Location 1849 of 8079.

that he would not order his forces to disperse the protest without a firm order from East Berlin and Krenz in particular. The protesters peacefully and successfully circled the ring road. The next morning, the consequences of the previous evening were clear: the protest immediately became a symbol of the growing power of the people in the GDR, and the population lost its fear of the state's power of repression.[807]

In taking forty-five minutes to call back, Krenz ultimately did not decide how events unfolded that night, but a more decisive leader would have. The reasons for his hesitance to call back that night are unclear, but the reasons for his hesitance to use violence were manifold. In retrospect, he has always claimed to have had a deep personal conviction to not use force in the autumn of 1989, and Gerhard Schürer confirms this conviction in his own memoirs.[808] In addition, by the fall of 1989 Gorbachev had made his support for non-violence well known and had officially renounced any Soviet willingness or obligation to intervene in allied countries to defend socialism. The current historiography is well aware of Gorbachev's push for peace, and has attributed a great deal of explanatory power to it.[809] In contrast, scholars have so far failed to understand the financial pressures on the GDR,[810] and therefore failed to connect this pressure to the leadership's reluctance to use violence. As this section has demonstrated, if they implemented a "Chinese solution," the East German leadership understood that national

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[807] Sarotte, *Collapse,* Location 2118 of 8079.
[808] Krenz's *Herbst '89* is replete with claims that the author never considered using violence. On p. 164 of *Gewagt und Verloren*, Schürer quotes Krenz as saying "There will not be a Chinese solution while I am General Secretary."
[809] Kramer, "The Demise of the Soviet Bloc," 842.
[810] Hertle, as always, is the exception. See his, "The Fall of the Wall," in *CHIHP,* p. 134. Even as this chapter supports Hertle's argument, it presents new evidence from Schalck's papers that has not been used before.

insolvency would soon follow, and they would be forced to deal with the IMF. They stopped short of Violence, I argue, because they feared Austerity.

Endorsing Exit to Avoid Austerity

Krenz's official move against Honecker came at the Politburo meeting on October 17th. Krenz worked before the meeting to line up support from the entire Politburo except for Honecker, Mittag, and the propaganda chief Joachim Herrmann, who would all lose their leadership positions. Prime Minister Willi Stoph presented the motion to dismiss the General Secretary at the start of the meeting as a *fait accompli*. Each member took a turn affirming their support for the decision to dismiss the three leaders. Erich Mielke, the Stasi chief, told Honecker plainly, "'Erich' it is 'the end,'" and indeed it was.[811] The next day at a meeting of the broader SED Central Committee, Honecker announced his resignation due to "health reasons," and asked the committee to elect Krenz as the new General Secretary.

Upon his official election, Krenz gave a speech defining the direction he intended for the country. He announced what he called "the Turn," in German *die Wende*. In time, Krenz's *Wende* would be criticized from all sides for lacking clear priorities, but on the 18th, the new General Secretary made a few points clear. The party should begin "a sincere political dialogue" with society, but the discussion should still center on a single priority, "to expand socialism in the GDR." This dialogue should begin with the understanding that "Our socialist German republic is and will remain a sovereign country. We solve our own problems." The biggest of those problems – the freedom of movement – Krenz committed to resolving through a new travel law, though he gave no timeline for its implementation. Lastly and most importantly, Krenz said,

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[811] Sarotte, *Collapse*, Location 2194 of 8079.

"We are guided by the firm conviction that all problems in our society are politically solvable." It remained unclear what the GDR was turning towards with the *Wende* – Krenz believed such direction should be set at the 10th Meeting of the Central Committee coming up in early November - but Krenz made clear that wherever the country was headed, it would do so peacefully.

As he launched his *Wende*, the new General Secretary clearly felt constrained by the nation's economic and financial circumstances. On the day the Berlin Wall opened, he told the Central Committee, "The balance of payments sets limits for us; it prevents us from making political decisions that would be necessary." He continued, "Every day new facts become apparent that affect our economic situation. And without the economy nothing else works."[812]

To solve the country's economic problems, Krenz turned to the problem of Exit. Even before he had officially overthrown Honecker, Krenz had developed (or had someone develop) a draft of new travel regulations and asked Schalck to review it for its financial implications. Schalck responded on October 13th after reviewing the plan with König and the central bank president, Werner Polze. "The decisions and principles laid out in the draft are of seminal importance in order to continue socialist development in the GDR and improve the attractiveness of our society. At the present time, we see no other solutions," Schalck began. Furthermore, he told Krenz, the government should expect "a significant pent-up demand in East German travel to the West, particularly to the FRG but especially also to West Berlin." This is important because Sarotte, in particular, strongly argues that Krenz and the SED leadership had no intention of opening the Berlin Wall at any time before November 9th. She argues that they planned to allow East Germans to exit to the FRG through only one border crossing in a remote

[812] Hertle, ed., *Das Ende der SED*, p. 269.

location of the inter-German border.[813] In contrast, this memo demonstrates that East German travel to West Berlin (and its requisite implications for opening the Berlin Wall) were part of the leadership's plan from the very beginning. Schalck and his colleagues assumed at least 5 million East German citizens would want to travel to West Germany in the first year, and a further 5 million would want to travel to West Berlin. All of this would cost the East German state money that it did not have – 300 million DM in the first year, according to Schalck's calculations. "Immediately after a decision on and before the publication of the regulations, I think it would be absolutely appropriate to obtain through informal talks a reasonable financial contribution from the FRG government to enable this policy, which the FRG has sought for a long time." Schalck envisioned a lump-sum contribution of 300-500 million DM from the FRG to fund East German travel. He believed this would solve the immediate travel problem and that the government could then return to the travel issue in the mid-1990s, presumably after solving their looming debt problems. "At a later date (possibly the middle of the 1990s) we should examine to what extent opportunities exist to provide GDR citizens an amount in foreign currency every three years…for traveling abroad in the West."[814] Krenz held a meeting with the rest of the leadership (except Honecker and Mittag) on October 16th to discuss the travel question, and the group adopted Schalck's basic strategy.

In pursuit of this objective, Krenz sent Schalck to Bonn on October 24th to open "informal discussions" with the FRG about new forms of cooperation. Schalck later wrote in his memoirs, "For the past two to three years, it was clear to me that the GDR was headed toward an economic confederation with the FRG. Only with West German financial power could the GDR

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[813] See Sarotte, *Collapse*, Location 2468 of 8079.
[814] Schalck to Krenz, October 13, 1989, DL/226-1195, 3-5.

be preserved. I certainly knew better than most of my comrades that the economic and financial support would come at the price of significant political changes." As he left for Bonn, he wrote, "I still hoped that the price would not be self-sacrifice."[815] He described his orders from Krenz for the negotiations as follows, "I should explore the possibility of closer economic cooperation, while upholding [the GDR's] socialist system. Meanwhile, it was clear that travel would be unlimited – it was only a matter of time. I thought pragmatically of the costs associated with this for the GDR. New border crossings and an expansion of transit routes [would] increase the need for hard currency. I knew that we did not have the money for this. One had to get the Federal Republic to pay, through a packaged deal if necessary: money in exchange for expanded travel."[816]

Schalck's first meeting took place with Rudolf Seiters and Wolfgang Schäuble, senior ministers in the Kohl government. In opening the discussion, Schalck attempted to stand by his orders to increase cooperation while also upholding the GDR's socialist system. He told Seiters and Schäuble that it was "the firm intention" of the party leadership to implement "extensive renewals and reforms" through "a comprehensive dialogue with all levels of society." But, he maintained, "the socialist system of the GDR is not up for debate" and "the SED will continue to play the leading role…in the process of renewal." He then informed Seiters and Schäuble that the GDR would be implementing a new travel law, which would dramatically expand the foreign travel of East German citizens, particularly to West Germany. In view of the "clear additional economic burdens" such a law would impose on the GDR, Schalck told Seiters that the two sides should find "shared solutions" to the problem. In sum, he said that the SED leadership foresaw

[815] Schalck, *Errinerungen*, p. 322.
[816] Schalck, *Errinerungen*, p. 323.

the possibility of raising inter-German relations to "a new level" as long as it was based on "the principles of equality, regard for sovereignty, and non-intervention" in each other's internal affairs.

Seiters and Schäuble responded with questions and concerns of their own. First and foremost, they told Schalck that officials in the Federal Republic "observed with great attention and also with concern the economic development of the GDR in recent years." Here they were concerned "particularly about the effectiveness of the GDR economy and the growth in debt." Because any new forms of cooperation between the two states would require West German money, they would only be justifiable "from the standpoint of the Federal Republic if the GDR thought through important questions in its economic policy" and took decisions that increased "the efficiency in the economy." To the Kohl government this meant, "it would be necessary, for example, to cut subsidies and take steps to ensure the international competitiveness of East German companies." Seiters and Schäuble also said the West German government would need the GDR to clarify the status of all East Germans who had left for the West through Hungary or were in West German embassies in Prague or Warsaw. Lastly, because they anticipated that East German travel laws would stress the capacities of West Berlin, both sides should explore "in what ways the interests of West Berlin" could be addressed "in other areas."[817] With the first hints of conditionality lingering in the air, the two sides parted ways to consult with their respective governments.

[817] "Vermerk über ein informelles Gespräch des Genossen Alexander Schalck mit dem Bundesminister und Chef des Bundeskanzleramtes der BRD, Rudolf Seiters, und mit dem Mitglied des Vorstandes der CDU, Wolfgang Schäuble, am 24.10.1989" in Hertle, *Der Fall der Mauer*, pp. 439-443.

Krenz was furious upon reading Schalck's detailed report of his conversation. To him, the intentions of the Kohl government were now obvious. As he wrote in his memoirs, "It is not about their 'brothers' and sisters'' freedom of movement at all. Bonn is not interested in whether or not East Germans can travel. Bonn wants everything; Bonn wants the GDR."[818]

Two days later, on October 26th, Kohl and Krenz spoke for the first time by phone. After an exchange of greetings and well wishes, Kohl said he had high hopes for Krenz's announced *Wende*. In particular, he told the General Secretary that he believed resolving three issues was "especially important": a new law on the freedom to travel, an amnesty for political prisoners arrested during the recent demonstrations, and "a positive solution" to the question of refugees. "If one can connect your name with a generous step," Kohl said, "it will not only have a very considerable effect here [in the FRG], but also in the GDR." This was politely veiled conditionality, and Krenz saw it for was it was. He replied, "a turn (*Wende*) does not mean upheaval (*Umbruch*)" because "a socialist GDR is also in the interest of stability in Europe." He then informed Kohl that the SED leadership had made the decision "under the complete sovereignty of our country" to implement a new travel law. However, the law would bring "considerable additional economic burdens" with it for the GDR, which he hoped the FRG could cover. He pressed Kohl for the earliest possible agreement on financing the law, but the Chancellor refused to discuss any specifics or make a clear declaration of financial support. Instead, he played for time and committed to making Seiters and Schäuble available for further discussions.[819]

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[818] Krenz, *Herbst '89*, p. 224.
[819] "Ton-Aufzeichnung", p. 447.

Schalck, who sat next to Krenz during his conversation with Kohl, wrote in his memoirs "something decisive happened during this phone call." He wrote, "Up to that point, the Federal Republic had simply followed the events in the GDR attentively, [but] now Kohl presented demands for the first time"[820] – new rules for the freedom of travel in East Germany, an amnesty for political prisoners, and a positive resolution to the embassy refugee crisis. "That, and not November 9th [the night the Wall fell], was for me the key situation. That was the *Wende*. On the same day we came up with a package of measures to implement the points raised by Kohl. From that moment on, the Federal Republic ruled the GDR."[821] In the days that followed, the Ministry of the Interior and the Stasi began drafting the new travel law.[822]

A key component of Krenz's *Wende* was to make the real economic situation of the country clear to the full Politburo and Central Committee. To this end, in late October he tasked Schürer, Schalck, and the other economic leaders of the country with writing a comprehensive report on the economy for discussion at the Politburo meeting on October 31st. The report they produced, "An Analysis of the Economic Situation of the GDR with Conclusions," served as a stinging indictment of Honecker's Unity of Economic and Social Policy and an urgent call for change. After swiftly acknowledging the "clear successes" that the GDR had achieved during its forty-year history, the authors listed an array of shortcomings and misjudgments. "The debt to the West has grown since the 8th Party Congress [when the Unity policy had been announced] to such a level that it calls into question the solvency of the GDR." Higher domestic consumption than domestic production had caused "debt to the West to grow from 2 billion VM in 1970 to 49

[820] Schalck, *Errinerungen*, p. 325.
[821] Schalck, *Errinerungen*, pp. 325-326.
[822] The Interior Ministry and the Stasi has also received direction from the Politburo on October 24th to begin drafting the new travel law. Sarotte, *Collapse*,

billion VM in 1989." This meant that "social policy since the 8th Party Congress was not met completely by domestic growth, but instead led to growing debt to the West." [823]

The economists made plain that the debt now left the country completely dependent on Western capital. "1989's planned hard currency income can only cover about 35% of the hard currency payments…. 65% of the payments must be financed through bank credits and other sources." For a country like the GDR, this was unusual and precarious. "In the analysis of a country's creditworthiness it is internationally assumed that the debt service ratio…should not be more than 25%. 75% of [the money received from] exports should be available to pay for imports and other expenses. Based on its hard currency exports, the GDR has a debt service ratio of 150%." They outlined the implications of this position for the domestic economy. "If we are to prevent the debt from rising in 1990,…[it] would require a reduction in consumption by 25-30%." An export surplus of 2 billion VM would have to be achieved in 1990, and this number would have to grow to 11.3 billion VM in 1995 merely in order to keep the debt level stable.[824]

If this did not happen, the economists told the Politburo the penalties would be stiff. "The consequences of imminent insolvency would be a moratorium (debt restructuring), in which the International Monetary Fund would determine what must happen in the GDR." The IMF would "demand that the state renounce its right to intervene in the economy, the re-privatization of companies, the restriction of subsidies with the aim of abolishing them entirely, [and] the

[823] Gerhard Schürer, Gerhard Beil, Alexander Schalck, Ernst Höfner, Arno Donda, "Analyse der ökonomischen Lage der DDR mit Schlußfolgerungen, Vorlage für das Politbüro des Zentralkomitees der SED, 30.10.1989," in Hertle, *Der Fall*, pp. 448-460, here 451.
[824] Ibid, p. 454.

renunciation of the state[’s right] to determine import policy. It is necessary to do everything to avoid going down this path.”[825]

What did they propose for the years ahead? “The basic task of the new economic policy lies in bringing output and consumption back into agreement.” The country could “only consume domestically what is available after the deduction of the necessary export surpluses.” This meant that in the years ahead the country would need to consume far less than it produced “in order to ensure the solvency of the GDR to the West.”[826] Furthermore, wage increases would need to be connected to higher performance, price would need to be raised and subsidy would need to be cut, and the planning and administrative mechanisms of the state would need to be reduced at all levels. In total, the authors struck an ambiguous note, writing that their goal was “the development of a socialist planned economy oriented toward market conditions” that used “an optimal design of democratic centralism.”[827]

Even if all of these measures were implemented, however, the authors believed “the necessary trade surplus required for the solvency of the GDR is not foreseeable….Just freezing the debt would require a reduction in living standards in 1990 by 25-30% and make the GDR ungovernable.”[828] Therefore, they proposed that the government look for ways to expand cooperation with as many Western countries and companies as possible. “It is essential for the assurance of solvency in 1991 to negotiate with the government of the FRG at the appropriate time about 2-3 billion VM in finance credits above current credit lines.”[829] They ruled out “any

[825] Ibid, p. 455.
[826] Ibid, p. 455.
[827] Ibid, p. 457.
[828] Ibid, p. 458.
[829] Ibid, p. 459.

idea of reunification with the Federal Republic or the creation of a confederation.**"**[830] But, "in order to make the FRG aware of the serious commitment of the GDR to our proposals" they recommended that the SED make clear that "conditions could be created" in the years to come that would make "the currently existing form of borders between both German states superfluous."[831] This last line was struck from the version published after the Politburo meeting because of its political sensitivity, but as Hans Hermann-Hertle has written, that "erasure alone could not eliminate [the fact] that the leading economists, as a last resort to secure the political and economic survival of the GDR, considered a proposal to use the Wall as a bargaining chip (*Tauschmittel*) with the Federal Government for new loans."[832]

Krenz recalled his reaction to the document in his memoirs, "The biggest problem of the analysis for me is the debt to capitalist countries." He noted the particular challenge this posed to the GDR. "Is that state bankruptcy? Not at all. A state does not go bankrupt if it has debts. Otherwise the majority of the countries in the world would have to perish or would have perished long ago. Our problem is that we have debts to a political adversary who is working towards the liquidation of the GDR. This is the real danger." The looming 25-30% reduction in consumption convinced him of the proposal's urgency. "With their warning about the 'un-governability of the GDR', the authors of the document emphasize just how existentially necessary it is for the GDR [to implement] a fundamental change in its economic policies." The SED needed to implement this transformation because the authors made clear that it was necessary "to exclude the dictates of the International Monetary Fund from the GDR."[833] He also noted that the economic analysis

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830 Ibid, p. 459.
831 Specifically, the report said these conditions could be created "still in this century." Ibid, p. 460.
832 Hertle, *Der Fall der Mauer*, p. 148-149.
833 Krenz, *Herbst '89*, p. 246.

was “connected with far-reaching political conclusions,” most importantly the suggestion that the current borders between the two German states could be slowly dismantled. Such a change would clearly require the consent of the Soviet Union, Krenz wrote, but he nevertheless believed the “Analysis” should be put to the Politburo unaltered on October 31st for discussion. “I know perfectly well that my hands are tied in so many things. The tight straightjacket, which I want to take from the economists, I am now putting on policy and on myself personally.”[834] As was standard practice, no transcript of the October 31st meeting was taken, but Krenz would go on to describe the discussion as follows. “With Honecker, [Politburo] sessions lasted two to three hours at most. Today the session lasts almost the whole day. The discussion is laden with emotions.”[835]

In times of crisis, it had been a forty-year tradition for the leader of the GDR to seek refuge in Moscow’s protection. Krenz was no different, so the next morning he flew to the Soviet capital for his first meeting with Gorbachev. He believed Soviet economic, rather than military, support was the key to his country’s survival. “If we are unable to raise the necessary economic cooperation with the Soviet Union to a higher level, the renewal of our society will remain a dream,” he wrote.[836] Packing Schalck and Schürer’s “Analysis” in his briefcase for the trip, he knew it would “be a crucial point of [his] talks in Moscow.”[837]

Gorbachev had long been urging the SED, and particularly Honecker, to undertake political and economic reforms, but with Krenz now in power, the merits of reform were a settled issue. Instead, the issue that lay at the heart of the November 1st meeting between the two

[834] Krenz, *Herbst ’89*, p. 249.
[835] Krenz, *Herbst ’89*, p. 254.
[836] Krenz, *Herbst ’89*, p. 249.
[837] Krenz, *Herbst ’89*, p. 250.

leaders was resources, specifically whether the Soviet Union could increase its economic support to its most important ally in its time of greatest need. After an initial exchange of pleasantries and a discussion about the error of Honecker's ways, Krenz steered the conversation to his first priority, the economy. It was for him "the decisive problem."[838] He told Gorbachev that by the end of 1989, East Germany's debt would reach $26.5 billion or 49 billion VM; he also said that the country would have $5.9 billion in income in 1989 with which to pay $18 billion for debt service and imports. This would leave the GDR with a $12.1 billion shortfall, and it meant that the GDR would have to take out new loans from Western banks and governments.[839] Krenz said, ""Our job is to maintain solvency. If the International Monetary Fund gets a say in [our affairs], it will be bad for us."[840] Through a variety of sources including the Stasi chief, Erich Mielke, Gorbachev was well briefed on the state of the GDR economy. Nevertheless, he was "astonished" to learn of these numbers and asked whether they were precise because "he had not imagined the situation to be so precarious." Krenz confirmed that they were, and he went on to explain that the debt had grown so high because of the measures the government had been forced to take in the early 1980s to stay solvent. This had resulted in debt taken out at very high interest rates. In addition, he said, new demands to modernize the economy simultaneously emerged alongside "new expectations by the population that could not be satisfied." Krenz told Gorbachev that if the standard of living was based "exclusively on the country's own

[838] Krenz, *Herbst '89*, p. 266.
[839] Document No. 1: Memorandum of Conversation Between Egon Krenz, Secretary General of the Socialist Unity Party (SED), and Mikhail S. Gorbachev, Secretary General of the Communist Party of the Soviet Union (CPSU), 1 November 1989," *CWIHP* Reader, p. 144.
[840] Krenz, *Herbst '89,* p. 267.

production," it would have to be lowered "by 30% immediately." But, he said, "This was not politically feasible."[841]

For Gorbachev, this was now a familiar refrain - one that he had heard variations of from Hungarian and Polish officials in recent years. The Soviet General Secretary told his East German counterpart that he had to come clean with the population and confront them with the nation's economic reality. The SED leadership, he told Krenz, "had to find a way to tell the population that it had lived beyond its means in the last few years….It was increasingly necessary to tell the truth….Slowly the population had to get used to this idea already."[842] Just as he told his Hungarian and Polish comrades the previous year, the Soviet Union would do its best to meet the raw material deliveries it had already committed to in the 1986-1990 Five Year Plan, but it could provide nothing above and beyond this.[843]

To fix the GDR's economy, Gorbachev therefore told Krenz to look to the West. This, he said, was what Hungary and Poland had done. "They, after all, had no choice in this matter," Gorbachev said, "It was often asked what the USSR would do in this situation. But it could do very little in economic terms. It was an absurdity to think that the Soviet Union could support 40 million Poles. The root of the problem lay with [former Polish leader Edward] Gierek who had taken on loans totaling $48 billion. Meanwhile the Polish comrades had already paid back $52 billion and still owed $49 billion." In Hungary, "Comrade Kádár was given an ultimatum by the IMF in 1987; in case of non-compliance with the numerous demands, a suspension of the loans

[841] Document 1: Memorandum, p. 144.
[842] Document 1: Memorandum, p. 144.
[843] Krenz, *Herbst '89*, p. 267. In 1987, Honecker had Gorbachev to restore the two million tons of oil deliveries that it had suspended in 1980, but Gorbachev declined citing his poor domestic economic situation. See their discussion on May 28, 1987 in *Gorbachew und die Deutsche Frage*, p. 32.

was threatened."[844] These two statements appear to have sent a clear and lasting message to Krenz. In his memoirs, he quotes these words exactly, and then writes, "I understand Gorbachev as follows: You cannot expect additional economic assistance from the Soviet Union, but don't let it come to joining the International Monetary Fund under any circumstances. Help yourself, as best you can!"[845] After four hours of conversation and a comradely lunch replete with vodka toasts to the future of socialism, Krenz boarded his plane bound for the GDR with the weight of such thoughts on his shoulders.

He returned to a country in freefall. Under the threat of strikes from workers, the government decided to repeal its October 3rd decision and reopen its borders to the Eastern Bloc on November 1st. Immediately, the refugee problem resurfaced, as four thousand East Germans filled the West German embassy in Prague once more. Fearing a spillover destabilization of their own country, the Czechoslovak leadership now pressured East Berlin to fix its travel regulations quickly. To make matters worse, the Federal Republic's Permanent Representative to the GDR informed the SED that the West German mission in East Berlin would soon reopen, two months after closing for "renovations" (in fact, it had closed to prevent refugees from filling it like they had the embassies in Prague and Warsaw.) Its reopening would surely mean a massive refugee crisis in the heart of the GDR. As pressure from east and west mounted, so too did it build on the streets of the capital. On November 4th, an estimated half a million people flooded Alexanderplatz in East Berlin to demand reform.[846] Continuing the chant first used in

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[844] "Document No. 1: Memorandum of Conversation Between Egon Krenz, Secretary General of the Socialist Unity Party (SED), and Mikhail S. Gorbachev, Secretary General of the Communist Party of the Soviet Union (CPSU), 1 November 1989," *CWIHP* Reader, p. 144.
[845] Krenz, *Herbst '89*, p. 276, Location 4766.
[846] Sarotte, *Collapse*, Location 2340 and 2377 of 8079.

Leipzig weeks earlier, "*Wir sind das Volk!*" ("We are the people!"), they dared their leaders to take their slogans about democracy seriously and demanded a say in their country's future.

Amid the public upheaval, Schalck quietly travelled again to Bonn for another conversation with Seiters and Schäuble. This time he arrived with the more concrete offer that the GDR was "prepared to implement generous regulations for travel between the capital of the GDR and West Berlin via newly opened border crossings" as long as the Federal Republic was prepared to cover the "significant financial and material costs." Additionally, he informed his interlocutors that the GDR was seeking "long-term loans up to ten billion VE [accounting units, most likely DM]" over the next two years that would be "paid back over a period of at least ten years" to support new forms of cooperation, such as "joint ventures and equity investments (*Kapitalbeteiligung*)" from West German companies. On top of this 10 billion, Schalck said his government "saw the necessity of discussing additional lines of credit in hard currencies that could begin in 1991 and total DM 2-3 billion annually." This would be required "to meet the demands" of new levels of cooperation. The KoKo chief made clear, in short, that if the Wall was going to be bought and sold, its price was going to be extremely high.

But while Schalck's price had increased, so too had the Federal Republic's. Schäuble told Schalck "that much depended on the General Secretary's speech at the 10th Meeting of the Central Committee of the SED" coming up on November 8th. In it, Krenz would have to make clear "the credibility of the *Wende* course" and would need to appoint "credible and new people" to implement the announced reforms. "A fundamental problem in this context," Schäuble said, "was Article 1 of the GDR constitution, which guaranteed the leading role of the Marxist-Leninist party." Schäuble "strongly advised" that the SED make it clear that it was willing to allow a "peaceful transition supported by all political, social and religious organizations" and to constitutionally change “the leading role of the SED into a constructive, consensus-building cooperation with all democratic forces in the interests of socialism and the GDR.” He also told Schalck that the “state border with West Berlin” should be made “more permeable,” and that the West German government continued to assume that the GDR would “decisively dismantle its subsidies” to the economy. “Among the other issues of development of cooperation, particularly in the economic field…further consideration by the Federal Government was still required.” The Kohl government was “not yet able to make concrete proposals for binding agreements.” In closing, Schäuble suggested “urgently once again, that General Secretary Krenz take up the ideas expressed [in this meeting] in his speech. Otherwise Chancellor Kohl would not be able to justify in the Bundestag financial assistance from West German taxpayers.”[847]

Schalck went straight to Krenz upon returning to East Berlin. In his memoir, Krenz termed the demands made at this meeting “blackmail.”[848] Schalck expanded further, “Diplomatically it was an outrage (*Ungeheuerlichkeit*) - an interference in the internal affairs of the GDR. Historically, it was consistent. For the West German government, there were no internal affairs of the GDR anymore. Due to the political upheavals and the desperate economic situation of the GDR - I brought to the conversation a demand for credit in the amount of 10 billion Deutsch Marks - the internal affairs of the GDR had become inter-German.”[849]

While Schalck met with Seiters and Schäuble, East German newspapers published a preliminary draft of the new travel law in the hopes of appeasing the population’s demand to leave the country. It failed spectacularly. Most importantly, the law still required East Germans

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[847] Schalck, “Vermerk über ein informelles Gespräch des Genossen Alexander Schalck mit dem Bundesminister und Chef des Bundeskanzleramtes der BRD, Rudolf Seiters, und dem Mitglied des Vorstandes der CDU, Wolfgang Schäuble, am 06.11.1989” in Hertle, *Der Fall*, pp. 483-486.
[848] Krenz, *Herbst ’89*, p. 302.
[849] Schalck, *Errinerungen*, p. 327.

to obtain a visa from the state before being allowed the exit, and such visas could be denied at the state's discretion. Even if a citizen received a visa, the law provided no commitment on behalf of the state to finance foreign travel with hard currency. Because Schalck had not yet secured from the FRG a means of paying for East Germans' foreign travel, the government still had no way to pay for all the travel that was to come. Therefore the draft law announced that the "approval of an application for travel does not mean that the citizen is entitled to any means of paying for the trip." Clearly, this was no sign of progress, and more than half a million people jammed the streets of Leipzig on the same day in protest.[850]

That evening, having learned of the protest in Leipzig and received a report from Seiters and Schäuble about their conversation with Schalck, West German policymakers met to discuss their next move. The document prepared for the discussion noted that the conversation with Schalck showed that "the new government [in the GDR] seeks a fundamental restructuring of the economy…but would like to avoid fundamental reforms of the political structure." In particular, the GDR leadership did not appear "open to a restriction of the SED's monopoly on power and to concessions in the direction of pluralism." Instead, "they expect massive financial and material support from us for their restructuring efforts and simultaneously our renunciation of efforts to work towards a change in the political system." However, the enormous scale of Schalck's financial request also made clear that "the GDR - at least in the short and medium term – does not expect to obtain the necessary amounts of economic assistance from anyone other than us. The alternative would, in fact, be a policy of austerity."[851] This left the FRG in a powerful negotiating position, and officials in the Kohl government knew it. After being briefed

[850] Sarotte, *Collapse*, Locations 2396 and 2423 of 8079.
[851] Document 74, "Besprechung der beamteten Staatssekretäre," 6 pm, November 6, 1989, in *Sonderedition: Deutsche Einheit*, p. 482.

by Seiters and Schäuble on their meeting, Kohl decided that the time had come to set firm preconditions for the his government's financial support.

The next day, Seiters called Schalck to transmit a message directly from Kohl for Krenz. The Chancellor told Krenz that he needed to "declare publicly that the GDR is prepared to guarantee that opposition groups will be permitted and affirm that free elections will be held within a period to be announced if the GDR wants to receive material and financial assistance from the FRG. This applies also to the financial arrangements regarding travel." The message continued, "It should be noted that this path is only possible if the SED relinquishes its claim to absolute power." The party "should be prepared to work on equal terms, and in consensus, with all societal forces, churches and religious communities to discuss a true renewal, with the goal of achieving democratic socialism." Seiters told Schalck that if these conditions were met, "the Chancellor thinks a great deal can be achieved and every option can be explored."[852] Krenz again called this "blackmail" and "a crude attempt to interfere in the internal affairs of the GDR." But he saw no alternative. "Once again it is clear how constrained my political freedom of movement is," he wrote. "Ultimately, everything depends on the economy."[853] The next day, Kohl further increased the pressure by publicly announcing these conditions during his "State of the Nation" address in the Bundestag.[854]

With their first attempt at publishing a new travel law proving to be a disaster, the Politburo reconvened on November 7th to work out a new policy. Because their Czechoslovak comrades were now threatening to close their border to the GDR if the government did nothing

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[852] Document 3: "Letter from Alexander Schalck to Egon Krenz, November 7, 1989," in *CWIHP*, p. 153.
[853] Krenz, *Herbst '89*,
[854] Text provided untitled in *Sonderedition: Deutsche Einheit*, p. 491.

to stop the flow of emigrants, the leadership decided to immediately put into effect the portion of the travel law allowing East German citizens to permanently emigrate. Although the documents do not spell out the reasoning for this decision in detail, it appears to have been the most expedient choice for two reasons. First, any East German leaving for the FRG through Czechoslovakia had to assume that their exit was permanent, so this law would fix this problem (and assuage Czechoslovak concerns) by allowing permanent emigration through the GDR's own borders. And second, permanent exit required the government to provide no hard currency – citizens could expect their government to fund their foreign tourism, but not their permanent emigration. As they moved on to preparations for the 10th Meeting of the Central Committee, the Politburo handed responsibility for drafting the revised law back to the Interior Ministry and the Stasi.

At this point it is worth reflecting on where the GDR was headed on November 8th, the day *before* the Wall opened in dramatic and accidental fashion. This section has demonstrated that the country's financial position and the Soviet Union's inability to provide extra economic support had driven the leadership to embrace four policy positions. First, financial dependence on the West was not the only factor restraining the leadership from using violence, but it was an important one. Second, Krenz and the Politburo had not endorsed an uncontrolled opening of the Berlin Wall, but they had endorsed a strategy of trading the opening of the Wall in return for hard currency. Third, this strategic choice and the anticipated financial shortfall of the early 1990s had led the leadership to negotiate with the Federal Republic as a means of avoiding insolvency and negotiations with the IMF. Contrary to the widespread historiographic assumption that the GDR was dependent on the FRG alone, this chapter demonstrates that the country's financial dependence was much more broadly based in the global financial system.

The leadership's choice to negotiate with the FRG was therefore a strategic decision based on its belief that the FRG's demand for the freer movement of people posed a smaller risk to the GDR than the IMF's demand for austerity and structural adjustment. Exit was safer than Austerity. Lastly, the protests on the ground in the GDR drove the Kohl government to expand its conditionality in the early days of November beyond the freer movement of people to include demands for a complete reform of the East German economy and a renunciation of the SED's one-party state. As part of his *Wende*, Krenz had shown a vague inclination to couple political liberalization with economic reform, but by November 7th, the Federal Republic's conditionality left him with no choice but to implement this strategy. In other words, before the Wall fell, the GDR's circumstances were already pointing the country down the path recently taken by Poland and Hungary. Therefore, by the afternoon of November 9th, the collapse of the GDR was a historical certainty.

What remained the be determined – and what the opening of the Wall decisively influenced – was *how* and *how fast* the GDR collapsed. These were far from trivial contingencies. As the next chapter will make clear, they proved decisive in the Soviet Union's decision to peacefully withdraw from East Germany. The accidental opening of the Wall, therefore, was not essential to the collapse of the GDR, but it was essential to the process of German reunification that soon followed.

The Final Accident

On the morning of November 9th, officials from the Interior Ministry and the Stasi met once more to draft a revised travel law. This time their orders from the Politburo were to immediately authorize permanent emigration from the GDR to the FRG and – crucially - West

Berlin as well. After seeing the reaction to the first draft law, Gerhard Lauter, the senior Interior official at the meeting, felt that allowing permanent emigration but not temporary travel would only stoke popular resentment, so he rewrote the law to immediately authorize both permanent and temporary travel. All historical evidence suggests that he received no direction from his superiors to make this change, and it certainly did not conform to Krenz's and Schalck's strategy of leveraging freer travel to gain more hard currency. Thus, it stands as a decisive moment of contingency in which a local actor altered the trajectory of his nation. Nevertheless, as Lauter himself would later say, it was a change in how fast policy would be implemented, not a change in policy itself. In explaining his mindset that morning, he said, "we still had the task ahead of us to put forth a draft of the travel law in 1989 that would bring about the freedom to travel. In principle, November 9th could also have been December 21st, and then it would have happened legally and not been surprising. We had all of this in the back of our minds."[855] Under the now obsolete title, "On Issues of Regulation of the Permanent Departure of GDR Citizens Across the Border of the CSSR [Czechoslovakia]," Lauter's group sent the new law up the bureaucratic chain of command, where it reached Krenz by noon on November 9th.

Since he had overthrown Honecker in mid-October, Krenz had placed all his hopes for the renewal of the SED and the launch of an economic reform program on the 10th Meeting of the Central Committee, which was set to take place from November 8-10th. The first day and a half had not gone according to plan, as the meeting had gotten bogged down in endless debates about the reorganization of the party leadership. In the mid-afternoon of November 9th, Krenz interrupted the meeting to gain approval of the revised travel law. "Comrades!...You are aware that there is a problem that wears on us all: the question of exit [from the GDR]," he said. "The

[855] Gerhard Lauter interview in Hertle, *Der Fall der Mauer*, p. 330.

Czechoslovak comrades are increasingly finding it a burden, as our Hungarian comrades did earlier. And, whatever we do in this situation, it will be a move in the wrong direction."[856] The General Secretary read the full draft of the new law to the committee, and eager to get back to what they considered bigger issues, the members had only minor tweaks to suggest. The draft was quickly approved, and Krenz gave it to Günter Schabowski to announce at press conference to be broadcast live on East German television and covered by international news outlets that evening.

As his press conference came to a close, Schabowski announced the travel law revision almost as an afterthought. Haltingly, he told the world, "We have decided today (um) to implement a regulation that allows every citizen of the German Democratic Republic (um) to (um) leave the GDR through any of the border crossings." After a barrage of questions burst forth, Schabowski decided it would probably be a good idea to read the precise law as it was given to him. "Applications for travel abroad by private individuals can now be made without the previously existing requirements….The travel authorizations will be issued within a short time. Grounds for denial will only be applied in particular exceptional cases….Permanent exit is possible via all GDR border crossings to the FRG." Asked when the regulation would come into effect, Schabowski looked down at his papers and found the word 'immediately.' "That comes into effect, according to my information, immediately, without delay," he said. And what about West Berlin? "Does this also apply for West Berlin?" someone asked. Skimming the document again, he found the words, "Permanent exit can take place via all border crossings from the GDR to the FRG and West Berlin, respectively." Well then what about the Berlin Wall? "What is

[856] Document 7: "Transcript of the Tenth Session of the SED Central Committee," in *CWIHP,* p. 156.

going to happen to the Berlin Wall now?" someone asked. Here, at the logical but unresolved endpoint of the past four weeks of negotiations over trading the freer movement of people for hard currency, Schabowski realized he had no answer and quickly ended the press conference.[857]

As word spread that the government's new law allowed *all* citizens to travel or emigrate *immediately* through *any* border crossing, East Berliners took to the streets to test out the new reality. In droves, they began showing up at crossings in the Wall demanding to be let through. Because the travel law was, in fact, not supposed to go into effect until the next day (despite its talk of "immediately"), the border guards were caught completely unprepared. For five and a half hours after the press conference, tension and confusion reigned at the border crossings while the guards tried to seek clarification about the new law. Receiving none, Harold Jäger, the officer on duty at the Bornholmer Street crossing, ordered his subordinates to open the gates at 11:30 pm to the thousands of East German citizens pressing to get across. Within an hour, all of the border crossings had been opened and the Berlin Wall had fallen.[858]

Conclusion

Public surprises have private histories. This chapter has sought to tell the private history of two public surprises, the fall of the Berlin Wall and the precipitous collapse of the German Democratic Republic. Since Albert Hirschman's Exit/Voice/Loyalty model was first applied to the GDR in the days following November 9th, 1989, historians and popular memories, particularly in the English speaking world, have focused on how the public history of 1989 contributed to the end of East Germany. And rightly so. There can be no doubt that the

[857] Document 8: "Günter Schabowski's Press Conference in the GDR International Press Center," in *CWIHP*, pp. 157-158.
[858] Sarotte, *Collapse*, chapter 6.

pressures of Exit and Voice decisively influenced the opening of the Wall and the collapse of the GDR. But the success of the public pressures of Exit and Voice depended on the private financial histories of the GDR and Hungary detailed in this chapter. Hungarian financial difficulties first created the Exit choice; the growing East German financial crisis deterred the SED regime from responding to Voice with Violence; and the threat of insolvency led the GDR's leaders to choose Exit as a means of preventing Austerity. The accidental opening of the Berlin Wall unexpectedly disrupted these dynamics, but the contingency of November 9th lay in how and how fast the GDR would collapse, not whether it would collapse at all. The combination of Exit/Voice and Exit/Voice/Austerity dynamics had already ensured the GDR's peaceful demise.

Postscript: Knowledge is Power

Five days after the Berlin Wall opened, Schalck and König wrote to Schürer to tell him that they had been lying to him about the debt for the past eight years. "The debt is actually 12.6 billion VM lower than you previously thought," they wrote. Detailing the secret accounts that KoKo and the Ministry of Finance had maintained since the 1970s to store extra hard currency, they told Schürer that the actual debt at the end of 1989 would be roughly 38 billion VM, or $20.6 billion. Despite the difference, they maintained that the billions of Deutsch Marks stored in their accounts were still "not enough to solve the liquidity problems arising in 1991/92."[859]

Nine years later the German Bundesbank was not so sure. In 1998, the bank went back to examine the GDR's balance of payments situation in the 1970s and 1980s. It discovered that even Schalck – the keeper of the country's financial secrets – did not accurately understand his country's financial position. Rather than the $20.6 billion in debt that Schalck quoted above, the Bundesbank found that the GDR in fact only had $10.8 billion in debt at the end of 1989. East German leaders believed they confronted a financial reality in 1989 that threatened the existence of their regime, but it was in many ways a *false* reality. In retrospect, all of the numbers cited in this chapter turned out to be inaccurate. The GDR's financial position in 1989 was so threatening only because its leaders believed it was. The real financial picture, although not without problems, was much less foreboding. The Exit/Voice/Austerity dynamics discussed in this chapter derived their power from a socially constructed reality built on faulty foundations, but they were no less powerful for it. Social constructions, as forty years of academic theory has demonstrated, derive their power precisely from their ability to determine what is real and what is not.

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[859] Schalck and König to Schürer, November 14th, 1989, DL/226/1206, pp. 55-59.

Conclusion:

The Triumph of Breaking Promises

> "Essentially, we are talking about a contract with the entire Soviet population, like that of Jean-Jacques Rousseau's 'The Social Contract.'"
>
> - Viktor Nikonov in the Soviet Politburo, June 20, 1988[860]

If there was a single point when the ideological competition between democratic capitalism and communism ended, this moment when Lenin's successors in the Kremlin began to approvingly compare their actions to one of the central figures of the "bourgeois" Enlightenment would have to be a leading candidate. Viktor Nikonov was a relatively minor member of the emerging disciples of "new thinking" in the Soviet Union. But the man he served, Mikhail Gorbachev, was leading one of the greatest and most unexpected attempts at social, economic, and political transformation in modern history when these words were spoken in the summer of 1988. Gorbachev, of course, was spectacularly unsuccessful in this attempt, and within three years, both the socialist empire he oversaw and the country he led ceased to exist. With blessed few bullets fired, the Cold War ended and the authoritarian rulers of communist societies peacefully withdrew from the halls of power. People across Eastern Europe

[860] A. S. Chernyaev, Georgy Shakhnazarov, and Vadim Medvedev, eds., *V Politburo TsK KPSS* (Moscow, 2006), p. 331.

and the West celebrated the stunning turn of events, and welcomed the spread of political and economic freedom to new corners of the world.

Or, rather, *most* people celebrated *most* of the time. As the reader will recall, the introduction to this dissertation began with an angry and sarcastic letter from one Laszlo Kezdi, a Hungarian pensioner living in Budapest, to the Hungarian Minister of Finance, which appeared in one of the main Hungarian newspapers in December 1989. Even as political progress rapidly swept across the Eastern Bloc in that year, Kezdi had the more prosaic, but no less significant, concerns of daily life on his mind. How would he pay his mortgage? How would he heat his apartment? How would he buy his medicine? How would he put food on his table? These were the questions that drove him to acerbically ask the Finance Minister to send him a rope that he could use to hang himself.

This dissertation has been motivated by the conviction that it was no mere accident that these two sentiments – one in the highest reaches of the Kremlin, the other at the level of ordinary life in communist societies – appeared at roughly the same time during the events we now label the end of the Cold War. As we have seen in the previous chapters, the spread of political freedom and economic austerity went hand-in-hand during the last years of communism in the Eastern Bloc, and they did so for a very particular reason. Although the Cold War had begun as a race between communism and capitalism to make promises to their people, it became in the 1970s and 1980s a competition between the two blocs to break promises made to their people. The Politics of Breaking Promises favored governments that had political legitimacy, so the leaders of the Eastern Bloc went in search of such legitimacy in the late 1980s. In place of the implicit social contracts that underlay late socialist authoritarianism, they instead attempted to create public acceptance of their rule using the tools of democracy. As the Polish leader

Wojciech Jaruzelski explained in February 1989, he decided to launch the roundtable and partially free elections because the "difficult economic situation…requires unconventional methods and difficult decisions… [that] would not be possible without the understanding and backing (or at least neutrality) of all significant social forces."[861]

Gaining the acceptance of society for difficult economic policies had also been the challenge of Western societies in the 1970s. They, too, had been forced to confront the Politics of Breaking Promises. At that time, in a quote that serves as this dissertation's epigraph, the British economist Fred Hirsch had written, "Individuals can be expected to restrain the exercise of their individual power in the interest of protecting the fabric of their society if, but only if, they believe the society as a whole to be a just one."[862] By the late 1980s, the leaders of communist countries had come to fully agree with Hirsch's conclusion, and they set about creating more politically just societies in the hope that the citizens they governed would refrain from using the immense power for disruption and resistance that they possessed. Rather than legitimizing the communists' power, however, the democratic reforms that communist leaders undertook merely exposed the fact that they had lacked any true legitimacy all along. Only the likes of Mazowiecki, Antall, Havel, Kohl, and Yeltsin could convince Poles, Hungarians, Czechoslovaks, East Germans, and Russians that they were living in a just society, so it was they who took up residence in the halls of power throughout the collapsing Eastern Bloc.

The global intertwined history of oil, finance, and austerity that swept across both sides of the Iron Curtain in the wake of the oil crisis of 1973-74 drove these stunning developments. I have sought to reconstruct this interconnected history through the framework of the Privatization

[861] Quoted in Jacqueline Hayden, *The Collapse of Communist Power in Poland: Strategic Misperceptions and Unanticipated Outcomes* (New York, 2006), p. 60.
[862] Fred Hirsch, *The Social Limits of Growth*, p. 152.

of the Cold War. In the privatized Cold War that prevailed after 1973, nation-states' guns and butter became dependent on loans and oil, so maintaining access to oil and capital markets became a fundamental component of preserving a state's power and legitimacy. As I have shown in the preceding chapters, this dependency on oil and finance placed a social question at the heart of the late Cold War: how to revise the postwar social contracts that developed in both the East and the West after the Second World War. States' ability to discipline their social contract proved to be the key difference between those who survived the Cold War intact and those who went extinct. Revisions to the social contract needed to be justified in ideological terms to domestic constituencies, so nation-states adjusted their governing ideologies and political structures to meet this challenge.

The pressures to adapt to the privatized Cold War produced the collapse of communism and, in turn, significantly contributed to the end of the Cold War. In the introduction, I identified the essential features of the end of the Cold War, defined a number of challenges that a history of the end of the Cold War would have to meet, and raised three questions that a compelling explanation of it would have to answer. The end of the Cold War, the reader will recall, comprised four distinct processes – the end of the nuclear arms race between the Soviet Union and the United States, the end of the global ideological competition between democratic capitalism and state socialism, the peaceful and democratic collapse of state socialist regimes in Eastern Europe and the Soviet Union, and the reunification of Germany. These processes occurred both within and between nation-states, and involved changes in both power and identity. The fact that change occurred across these four diverse dimensions led me to argue that explaining the end of the Cold War as a geopolitical conflict required an explanation of the collapse of communism as a system of governance.

Over the last eight chapters, I have put forth such an explanation. In chapters 4 and 5, we saw how changes in oil and financial markets produced a significant disparity in the relative power of the United States and the Soviet Union by the mid-1980s, and drove Gorbachev and the rest of the Soviet Politburo to seek nuclear arms control agreements with the United States. In chapter 5, it became clear how Gorbachev's desire to initiate economic reform in 1985 forced him to confront the challenges of disciplining the implicit social contract that underlay Soviet rule. To overcome this challenge, the Soviet General Secretary tried to redefine communist governance as a system that would be politically legitimate, but also one that would promise its citizens significantly less economic security. These changes left communism with few ideological reasons to oppose democratic capitalism, and the global ideological competition between the two systems precipitously collapsed. The economic burden of the Soviet empire in Eastern Europe led Gorbachev to repeal the Brezhnev Doctrine in 1986, which in turn left the communist governments of Eastern Europe no choice but to confront the Politics of Breaking Promises on their own. Under pressure from global financial markets to discipline their own domestic social contracts, the leaders of Poland and Hungary initiated democratic reforms in order to legitimize austerity. Fearful of the prospect of having to implement their own austerity program, East German leaders attempted to leverage the opening of the Berlin Wall for more Western loans, only to see the Wall accidentally open on November 9th, 1989. Taken together, these chapters have demonstrated that state socialist regimes peacefully collapsed in the Soviet Union and Eastern Europe because their governments tried, but failed to implement the Politics of Breaking Promises.

In light of this history, answers to the three central questions of the end of the Cold War can be given succinctly. Why did the holders of imperial and authoritarian power in the Eastern

Bloc willingly give up power? Because they decided that Politics of Breaking Promises could only be successfully implemented if their citizens deemed communist governance to be politically legitimate. Why did they do so at the end of the 1980s? Because the global history of oil and finance made the challenge of disciplining the domestic social contract unavoidable in the Eastern Bloc by the late 1980s. And why did electoral democracies and market economies emerge from the ashes of state socialism? Because they were the best political and economic systems for breaking promises.

Ultimately, then, the history presented here changes our understanding of both the causes and meaning of the end of the Cold War. These changes in causes and meaning can best be discussed by returning to the two issues I briefly raised in the introduction and committed to return to in the conclusion. First, in contrast to the prevailing historiography, which places a great deal of causal weight on Mikhail Gorbachev in explaining the end of the Cold War, I suggested in the introduction that all of the conditions for revolution in Eastern Europe would have been present in the late 1980s had Gorbachev never become General Secretary of the Soviet Union in 1985. Historians often believe that considering counterfactuals place them on tenuous footing, but as Fredrik Logevall has noted, "thinking about unrealized possibilities is an indispensable part of the historian's craft…. All historians, whenever they make causal judgments, are engaging in speculation, are envisioning alternative developments, even when these alternatives are not stated explicitly."[863]

Best then to consider at least one very important alternative explicitly. What if Yuri Andropov had lived longer? The Andropov counterfactual is one often raised by scholars of the

[863] Fredrik Logevall, *Choosing War: The Lost Chance for Peace and the Escalation of War in Vietnam* (Berkeley, CA, 1999), p. 395.

end of the Cold War to argue for the unique and essential influence of Gorbachev.[864] If Andropov, the former head of the KGB and General Secretary for a short thirteen months in 1983 and 1984, had not succumb to an untimely death on account of kidney failure, these scholars argue that the end of the Cold War would not have occurred. He would have continued the arms race, maintained the ideological competition, not launched political liberalization within the Soviet Union, and not allowed Eastern Europe to choose its own fate. As a result, the state socialist regimes of Eastern Europe would not have collapsed and Germany would not have been reunified.

How does the history presented here alter our understanding of this counterfactual? First, and most importantly, this history has demonstrated that the collapse of Eastern European regimes in 1989 was not a result of Gorbachev or perestroika and glasnost. The revolutions were dependent on only one Soviet decision - non-intervention – and were instead driven by international pressure emanating from the global economy to discipline the social contracts in Poland and Hungary. These pressures would still have pressed upon the leaders in Warsaw and Budapest in 1986 and 1987 regardless of who was leading the Soviet Union. Because military power was of no use in resolving this pressure, the only way the Soviet Union could have prevented the leaders in Poland and Hungary from reacting to the pressure to break promises would have been to provide them with further economic aid. But as we have seen in chapters 3 and 5 of this dissertation, this was a step that every Soviet leader from 1981 onward refused to countenance. Thus, the central tension that drove the revolutions of 1989 would still have been

[864] The author has heard Tom Blanton, a leading expert on the end of the Cold War, discuss this counterfactual at a conference. Mark Kramer has also used a version of it to refute the arguments of William Wohlforth. See Kramer, "Ideology and the Cold War," *Review of International Studies*, Vol. 25, No. 4 (October 1999), pp. 539-576, at 566.

present, even if Gorbachev had never become General Secretary. How would Andropov have responded to a push for reform in Eastern Europe in the late 1980s? There is no reason to think that the decision he reached in the crucible of the Polish Crisis would not have held in the years that followed. As was discussed at the beginning of chapter 5, Andropov concluded in December 1981, "Even if Poland falls under the control of 'Solidarity' that is the way it will be." Soviet intervention to prop up the government in Warsaw would "be very burdensome for us. We must be concerned above all with our own country and about strengthening the Soviet Union." As the pressure on Poland, Hungary, and eventually East Germany mounted to discipline their social contracts and the Soviet Union grew even weaker economically in the late 1980s, there is no reason to think that Andropov would have acted differently than Gorbachev to stop political revolution in Eastern Europe.

And those revolutions very likely would have occurred anyway. To this day, basic misunderstandings persist in the minds of the leading scholars of 1989 over what caused the events of that year. "Unlike Poland in 1980," Timothy Garton Ash has written, "it was not a turn of the economic screw that precipitated mass popular protest in any Eastern European country in 1989."[865] But a turn of the economic screw, in the form of cuts to Polish real wages, is precisely what motivated the only popular resistance that played a decisive role in actually causing the revolutions – the May and August 1988 strikes in Poland that led the regime to seek the roundtable negotiations. What caused the regime to seek to impose a cut in real wages? Pressure from the global economy delivered through the institutional mechanisms of the

[865] Timothy Garton Ash, "The Year of Truth," in Tismaneanu, *The Revolutions of 1989*, p. 111. Garton Ash does note in the sentences directly preceding this statement that Poland and Hungary's hard currency debt was "one of the main reasons why…[they] led the field in the first half of 1989." But he draws not concrete connection between the debt and popular protest, and still reaches the conclusion above.

International Monetary Fund. Thus, even in an alternative world where Mikhail Gorbachev never becomes Soviet General Secretary in 1985, the causes of the revolutions of 1989 would still be present. This does not mean that Gorbachev did not influence *how* those revolutions unfolded, but it does mean that he and his reform efforts in the Soviet Union did not cause them.

If it was not Gorbachev, but rather pressure from the global financial markets, that drove the collapse of state socialist regimes in 1989, then this dissertation has revised our understanding of the West's influence on the end of the Cold War as well. Historians have been extremely reluctant to ascribe any Western influence to the end of the Cold War for fear of reinforcing notions of Western triumphalism, but this dissertation has detailed an unmistakable Western influence on the end of the Cold War. As I described in the introduction, one of the strongest levers of statecraft in the privatized Cold War was powerful states' control over other states' access to capital markets. Because the state socialist regimes of Eastern Europe had lost their access to global capital markets by the late 1980s,[866] Western states exerted enormous power over the course of events in Warsaw, Budapest, and East Berlin because they controlled the conditions under which Eastern Bloc governments would regain access to global capital markets. Through the IMF, the United States and West Germany demanded that the Polish and Hungarian governments implement the Politics of Breaking Promises, which set off a chain of events that led to the collapse of those regimes. The need for further Western credit is what drove the East German government to negotiate the opening of the Berlin Wall in the fall of 1989, and the GDR's desperate need for credit is what allowed the Kohl government to demand fundamental political changes in the GDR in return for further access to credit. Taken together, these moments of Western financial leverage amounted to significant power, and they signal a

[866] Or, as in the case of East Germany, feared that they would lose it soon.

decisive Western role in precipitating the collapse of communism and causing the end of the Cold War.

Lastly, there is this. If we think of the end of the Cold War as the triumph of breaking promises, then our understanding of its meaning changes as well. Since the Cold War's end, scholars and the public at large have been tempted to see it as a fundamental turning point in the international system, the definitive end to a bygone era or the fresh start of something new. "I see 1989 not as an end, but as a beginning. It created the international order that persists until today," Mary Sarotte writes.[867] But 1989 was neither the end of an old international order nor the beginning of the order that we currently inhabit. It was rather a chapter, albeit an extremely important one, in the global history of oil, financial, and austerity that flowed from the oil crisis of 1973-74. Indeed, that was the moment that an old order slipped away and a new one, the one we still inhabit, began to take shape. The basic elements of the privatized Cold War – nation-states' dependence on finance and oil to fund their domestic social contracts, the international pressures to implement the Politics of Breaking Promises – are still with us to this day, even if the Cold War is not.

Our understanding of the West's triumph in the Cold War changes too. Democratic capitalism won the competition to break promises because its societies were more just and its governments were more legitimate than those in the communist bloc. Liberalism, electoral democracy, the rule of law, and respect for human rights were decisive advantages in fostering a shared sense of justice within Western societies and granting legitimacy to Western governments. But this shared sense of justice and legitimacy could be used under the Politics of

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[867] Mary Sarotte, *1989: The Struggle to Create Post-Cold War Europe*, p. xi.

Breaking Promises in both East and West to restrain individuals from, as Hirsch said, "using the exercise of their individual power" to disrupt "the fabric of their society."

That, ultimately, is the contradiction that lies at the heart of the collapse of communism and the end of the Cold War. Government, as Václav Havel told the people joyously gathered in Prague on New Year's Day 1990, was returned to the people in a wave of peaceful revolution. But it returned to them only so that their power to resist could be overcome. The end of the Cold War was both a moment in which the people's power peaked and a moment in which it was, in the end, transcended.

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