Monetary Stabilization in Russia: What Is to Be Done?

Nikolai Petrakov

Unfulfilled Expectations for the First Steps of Russian Reform

After the prolonged stalling of the Nikolai Ryzhkov government and Valentin Pavlov's half-hearted reforms, Boris Yeltsin decided to bet on the "tough boys" of the Yegor Gaidar team. The Gaidar reform plan attempted to copy, as precisely as possible, the Polish shock therapy option. Price deregulation was seen as the key to the elimination of the budget deficit, to monetary stabilization and ruble convertibility, and to the structural reform of the economy—not just a key anymore but a sort of magical "Open Sesame" for every lock on economic progress.

It became increasingly clear that the calculations of the young Russian theorist-reformers were not proving accurate for two reasons.

First, the price hike turned out to be far steeper than Deputy Prime Minister Gaidar supposed. He expected prices to increase by 2.5 or 3 times in January and February 1992. Yet typically, in the first month prices increased tenfold.

Second, the Russian government believed that following the price increases, the supply of goods would increase drastically and store shelves would be filled. These hopes were based on the following. The government had announced the price liberalization two months in advance and expected producers and traders to stock up on goods. In addition, there were hopes that business activity would be quickly energized in all spheres, and also that demand would fall with the decline of purchasing power.

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Only the latter came true. The purchasing power of a significant portion of the population fell drastically, and living standards took a nosedive. By the time reform entered its second month, the per capita monthly income for the bulk of Russia's population (96.2 million people of the 148 million residing in the Russian Federation), including all additional benefits announced and introduced prior to price liberalization, was 400 to 650 rubles. By then, however, the cost of basic subsistence had gone up to 920 rubles a month.

Leaving over two-thirds of the population under the poverty line, the Russian government was still unable to balance the market. Is this a paradox? No. Making a fetish of the Polish experience, the young reformers did not take into consideration the actual situation in their country and the specifics that set it apart even from Slavic and formerly socialist Poland.

Only unbelievable economic myopia can explain their decision to ignore at least three basic differences between pre-reform Poland and Russia.

First, Poland always had a powerful private sector embracing virtually all of agriculture as well as small business and services. That is why price liberalization in that country became an effective stimulus for the rapid growth of business activity in that sector, helping saturate the market.

Second, the Polish economy never had to contend with such a monster as the military-industrial complex. Russia's military-industrial complex not merely consumes a tremendous amount of natural and human resources but demands special centralized efforts and, most importantly, time for reorientation toward market forms of economic activity. Liberalizing prices and giving wide latitude to the enterprises of this complex are obviously a dead end, creating a potentially explosive situation in the very first stages of market reform. The more the government cuts investment in the military-industrial complex, the more it has to be involved in the processes of conversion to civilian production, altering the distribution channels for military products, and securing social guarantees for the workers.

Third, for at least two decades, Poland lived with the very dollarization our reformers so dread. This was a result of many factors, including the more liberal face of Polish socialism. The important thing is that the Balcerowicz reforms to strengthen the zloty were carried out amidst the fairly wide and legal circulation of foreign currency. It seems that this point is being completely ignored in the approach to the tactical tasks of stabilizing the consumer market in Russia.

The objective impossibility of carrying out the Polish reform option, combined with a passionate subjective desire to do so, led to a striking but logical result: the creation of the very situation that Gaidar's predecessor, Valentin Pavlov, wanted to bring about. Putting the privatization of state property on the back burner, Gaidar reduced price liberalization to a legal state monopoly on price setting. The heads of state-owned, cooperative, and private enterprises, traders, and the public—everyone understands that if state monopoly remains (and, in fact, the state sector accounts for 92 percent of manufacturing, 85 percent of agriculture, and 99 percent of transportation), prices will only continue to grow. If there is no competition, there is no incentive for the reduction or at least the stabilization of prices.

The government obviously underrated the degree to which the Russian economy is dominated by monopolies. Today, only rapid privatization and demonopolization of industry, agrarian reform based on private ownership of land, and a liberalized tax legislation can save reform.

But there is another, no less important issue: monetary policy. No market reform is possible if the government and the central bank cannot inspire confidence in the national currency. Unfortunately, even as the Russian government has to carry out its program, it lacks control over the processes affecting the monetary cycle. Attempts to balance the budget run into problems that are unsolvable in the short term. The two main problems are (1) social programs, which the Russian parliament and the labor unions want implemented; and (2) the financing of the military-industrial complex. The government has been very firm in dealing with the latter. Investment in the military sector has been virtually cut off, and state contracts for purchases of military technology have been reduced to a minimum. There still remains, however, the problem of paying salaries or unemployment benefits to millions of workers in the military-industrial complex. In the months to come, the government will not be able to wave aside this issue, and therefore will yet again have to resort to printing more money.

The formulation of a rational monetary policy runs into yet another serious obstacle that the current Russian government pointedly ignored in the preliminary work on the reform program and in the first stages of its implementation. The new states that have taken the place of the USSR are unwilling to cooperate with Russia in stabilizing the ruble. This is evident not only in the position of Ukraine, which is, in essence, actively pursuing a separate monetary reform, but also in the actions of the Baltic republics, Belarus, and Tatarstan, which are imposing various restrictions on the use of the ruble as a common currency unit.

One of the hottest topics of discussion in the Russian parliament, in political circles, and in the media right now is how long the present Russian government will last. It is difficult to answer this question. Much depends on the stance of Russian President Boris Yeltsin. But even he is forced to maneuver in this complicated situation. Naturally, these maneuvers will take place in the upper echelon of power, since the government's current policies do not have a constituency in any specific segment of society. Inflation alienates the intelligentsia, since scholars, doctors, teachers, and college instructors were the first to feel the blow of price hikes, offset by no increases in income. Entrepreneurs complain about the tax burden. Peasants see no real progress in agrarian reform. Workers believe that the only way to influence the government is to threaten a strike. Thus the government has no firm social base of support. To stay in power, it must answer the question: For whose benefit is it conducting reform?

An Analysis of the State of the Russian Economy

The uniqueness of the old Soviet economy, in addition to the already noted centralization and the hypertrophied state sector, was also in an entirely original manifestation of inflation. The Soviet form of inflation (also observed, for that matter, in the USSR's satellite countries) was labeled as "hidden" or "suppressed," which yet again attests to the power of the Bolshevist political doctrine that extended its characteristics to spheres adjacent to politics (the economy, culture, etc.). According to the data for the years preceding Mikhail Gorbachev's emergence in the political arena (1971–85), the cash supply increased 3.1 times, while the amount of money in the population's savings accounts increased by 5.2. In the same period, however, the production of consumer goods only doubled. According to a number of experts who worked at the time at the USSR State Bank and at the USSR Ministry of Finance, in 1968 the USSR State Bank adopted the clandestine practice of extending credits, with no obligation of repayment, to the USSR Ministry of Finance. By 1985, the state budget deficit had reached 18 to 20 billion rubles.

Gorbachev, assuming power in April 1985, was facing the complex problem of strengthening the economy. The economic crisis was reflected in the budget deficit, concealed from the Soviet public but known to Gorbachev, and in the hypertrophied export of raw materials at the same time that oil production and world-market oil prices began to drop. The last circumstance played an especially crucial role, since profits from oil sales were the Soviets' main source of funds for purchases of grain and many food products. It was by this irrational method that the myth of the viability of collective agriculture, and socialism as such, was sustained.

For a long time, however, Gorbachev's reformism left the economy untouched. It is now clear to everyone that Gorbachev's domestic political reforms (leaving aside his truly great accomplishments in international policies) turned out to be a colossus with feet of clay. The constant fear of a political backlash, the inordinate swelling of the political ambitions of regional authorities—all of this resulted from the absence of a strong social segment of private property owners. Gorbachev was not ready for the creation of such a social segment. That is why his legacy to the country's leadership was an economic crisis and political chaos.

Let us return, however, to the monetary system as an indicator of the progression of the economic crisis.

The ominous escalation of the money supply started in 1988, when Ryzhkov launched his so-called market reforms. His first step was not to sell off state properties or to cut the military-industrial complex but to print more money. This was despite the fact that the successes of the policy of "new thinking" proclaimed by Gorbachev in the international arena had created all the conditions needed for the conversion of industries to civilian needs. Ryzhkov, however, represented nothing other than the military-industrial complex itself, which viewed global détente as a breather in the arms race and an opportunity to get Western credits for the purchase of technologies that the Soviet industrial system, deprived of entrepreneurial incentive, was no longer able to create.

And then, the "snowballing effect" emerged: the cash supply increased by 13.6 percent in 1988, by 19.5 percent in 1989, and by 24.3 percent in 1990. And finally, in 1991, the efforts of Pavlov and the democrats who came to power in August resulted in a virtual doubling of the cash supply.

This money-printing orgy took place amidst a sharp drop in production. The net national product declined by 11 percent in 1991. There was a similar drop in oil and coal output. Production of synthetic fibers fell by 22 percent, timber production by 14 percent, and production of celluloid by 21 percent. But what had the most drastic effect on the consumer market was the 10 to 15 percent drop in production in light industry and the food industry.

Not surprisingly, this aggravated the Soviet economy's permanent imbalance between the population's cash income and consumer spending. In 1991, the gap between the population's income and spending reaches 24 percent (about 300 billion rubles), up from 12 percent in 1990. The total cash income of the population was estimated at 1,250 billion rubles in late 1991, that is, 1.9 times the 1990 amount.

Such an imbalance was found not only in the consumer sector and not only in cash circulation. Serious disruptions in the monetary cycle were taking place across the board in the national economy. The cash circulation makes up only 15 percent of the total circulation of money. Along with the emission of cash, there is also non-cash credit emission, which actually determines the general state of the monetary system including its cash component. The total money supply (cash and non-cash) reached 18 trillion rubles by the end of 1991.

In describing the overall state of the economy on the eve of the Russian government's reforms, one must also consider the size of the budget deficit. By the government's own calculations, Russia's actual budget deficit stood at 108.4 billion rubles in 1991. Here, it must be noted that when the annual budget was approved by the Supreme Soviet of the Russian Federation, its revenues were set at 149.8 billion rubles. However, as a result of the events of August 1991, Russia ultimately had to take on a number of functions formerly performed by the leadership of the USSR. This had a considerable impact on the structure and the size of the revenues and expenditures in the Russian budget. For all intents and purposes, the Russian budget assumed virtually all the expenditures of the former USSR. Of course, it also took over the Soviet budget revenues; but it was a Pyrrhic victory.

Russia's Actions to Restore Monetary and Financial Health

The main goal the Gaidar government sought to achieve was a drastic reduction of the budget deficit. This problem was addressed in four principal ways.

The first, which was not disputed by anyone in the country, was to reduce administrative expenditures. However, in a purely numerical sense, the reductions had no real impact. Even if expenditures on the entire government staff were cut in half, the total amount of budget spending would be reduced by no more than 1.5 percent.

That is why the government chose as its main approach to the reduction of budget expenditures the second path: a drastic cut in military spending. This is undoubtedly right, given the hypermilitarization of the economy of the former USSR. Naturally, the bulk of military expenditures both on the maintenance of the armed forces and on the development and production of weapons was always borne by Russia.

It is worth nothing that the choice of this approach as the key to deficit reduction is proof of Yeltsin's courage, since a large and influential portion of Russian society has a stake in the military-industrial complex. Here, the interests of the army, of heavy industry, of many branches of science, and of a substantial proportion of highly skilled workers and engineers meet. The decision to make radical reductions in the budget financing of the military-industrial complex is a bold and historic choice on Yeltsin's part. It is a step Gorbachev did not have the nerve to take. He faltered and had to leave the political arena. Yeltsin did not falter. But whether he will be able to defeat the monster in open combat is something the near future will show. At any rate, in order to defy the military-industrial complex, Yeltsin had to begin by dismantling the Soviet empire politically and thus demoralized the army.

Of course, sharp reductions in defense contracts pose the risk that entire enterprises will grind to a halt, causing mass unemployment. Moreover, the paradox of our militarized economy is that in the transition to the market, the best-skilled workers and engineers will be the first to lose their jobs, since they are most highly concentrated in the defense sector of industry.

The third path of reducing the budget deficit is tax reform. The principal form of taxation introduced into the national economy in January 1992 was the value-added tax. The VAT rate has been set at 28 percent. In addition, the government has decided to tax profits at 32 percent. Exempted from this tax are profits reinvested in social and cultural development, the expansion of production for consumer needs, and environmental conservation measures.

We thus have a rather exotic combination of two kinds of taxation; moreover, the profits tax is levied even on profits that are reinvested in the economy, unless the investment is directly related to the production of consumer goods.

The combination of the two tax rates and their respective levels—28 and 32 percent—creates an extremely heavy tax burden on producers. In the effort to suppress inflation, government officials are discouraging economic activity through high taxes, and thereby creating no incentives for growth in the supply of goods and services. This generates a vicious cycle: measures to slash demand by reducing purchasing power lead to a reduction in the supply of goods.

The government has profound faith in the fourth lever of balancing the budget and stabilizing the monetary cycle: the liberalization of prices. As noted at the beginning of this paper, it was precisely in this area that the government has created a critical situation. Price liberalization unsupported by privatization of property and demonopolization has aggravated social tensions far more severely than the resolute attack on the military-industrial complex. But while the problems arising on the "military-industrial flank" of the frontlines of reform were inevitable and easy to forecast, the weakness of the pricing policy flank has been almost completely the fault of the reformers themselves: the plan and sequence of actions that they selected were far from the best. Underestimating the degree of monopolization in the state-sector industrial structures has led to monopoly-generated high prices and a simultaneous drop in production to a level at which high prices can be maintained. This leads to three consequences: a decline of budget revenues; a sharp drop in the living standards of the population, and, for the government, an explosive social situation and the impossibility of keeping the budget deficit under control.

What Is to Be Done?

First of all, we must presume that a continuation of the government's current program without corrections along the way dooms the country to hyperinflation. In order to avoid it, strong medicine is needed. Of course, it is necessary to alter tax policies, making all profits that go toward reinvestment tax-exempt.

Furthermore, a land market, a housing market, and markets for other kinds of real estate must be created immediately. Speedier privatization of industry and trade is necessary, as is radical agrarian reform that would end the monopoly of collective farms and state farms.

Undoubtedly, legislation regulating foreign trade and foreign investment must be changed to conform to international standards, creating firm political and judicial guarantees for foreign investors.

But for these steps to have the desired effect, the Russian government must define the geographic and political space in which the reforms will be implemented.

The fact is that the entire package of economic agreements among members of the Commonwealth of Independent States (CIS), achieved in December 1991, was completely disavowed as early as January 1992. Among the agreements that were shelved was the accord on the nonintroduction of republican currencies until the end of 1992. Yet the Baltic states, which are not a part of the Commonwealth, abided by this principle for a longer time than one of the CIS co-founders, Ukraine.

The fast disintegration of the ruble zone will be encouraged by two factors. First, there are the political ambitions of the new countries' leaders. A currency of one's own is regarded by them as a ritual symbol of sovereignty, in the same way as an anthem, a state seal, and a flag.

Second and most importantly, the monetary system is undermined by the hyperinflationary project of market reform adopted by the Russian government. The problem is exacerbated by the fact that, having eliminated the USSR State Bank, the founders of the CIS have not made any decision to create either a central CIS bank or an interstate banking union. This has led to a legal and economic absurdity: Russia is supplying 14 independent states with its own currency. This situation is pregnant with a conflict that can only lead to an economic war. And we already witnessing just that. The Russian leadership has sentenced the Soviet ruble to death.

What could be proposed to stabilize the monetary system within the framework of a ruble zone?

It is now realistic to speak of the creation of an interconnected network of national currencies. I am not excluding the possibility that two or three republics can agree on a common currency; but that is not going to change the whole picture. The most important thing is to concentrate on developing a joint monetary policy. There is a danger that the new states that have emerged from the ruins of the USSR will follow the pernicious course of the former COMECON. The creation of national currencies will be divorced from resolving the problem of their convertibility, that is to say, their integration into the international monetary system. This task has two aspects: the monetary system must contribute to the preservation (or recreation) of a common economic space and, at the same time, encourage integration into the world market.

Given the current political situation, Russia can play a leading role in the stabilization of the monetary system. But even Russia, faced with a 15–20 percent drop in production and unfavorable conditions in the global oil, gas, and gold markets, is unlikely to be able to handle this task without support from the world community. The ideal option would be an international project to organize a monetary system in Eastern Europe. Before the process has started to develop spontaneously, a currency chain of mutual convertibility on the basis of the new Russian ruble can be created. The economic attractiveness of the Eastern Currency Union would be a powerful boost to political stabilization in the territory of the former Soviet empire.

WHAT WENT WRONG?

Judy Shelton

Nikolai Petrakov has given us an informed critique of the "shock therapy" approach to Russian economic reform implemented under Deputy Prime Minister Yegor Gaidar. In Petrakov's opinion, the decision to emulate the Polish model was a mistake; he contends that Russia's lack of a private sector and the huge scale of its military-industrial complex render it incapable of achieving a market economy merely through the liberalization of prices.

Lest anyone be tempted to categorize Petrakov among those political hardliners in Russia today who are opposed to free markets and democratic reform in general, it is important to point out that Petrakov chose to resign his post as Gorbachev's chief economic adviser in January 1991 rather than continue to serve a government that sought to undermine genuine economic reform and used military repression against Lithuania. Petrakov was particularly critical of the Soviet leadership at the time for losing control over spending and the money supply; he believed its actions effectively sabotaged the transition to a market economy.

Rhetoric versus Reality

When Petrakov aims his ire at Gaidar and company, rest assured he is not concerned with personalities but with principles. Petrakov's most stinging criticism of the Gaidar program is that prices were "freed" in the absence of meaningful competition. "Putting the privatization of state property on the back burner," he notes, "Gaidar reduced price liberalization to a legal state monopoly on price setting." That statement is consistent with remarks made by Petrakov to the press at the beginning of 1991 when he complained: "Prices set by the

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