

1 Introduction

In 1990, President Mikhail Gorbachev, in near desperation, prevailed upon Chancellor Helmut Kohl to persuade reluctant German banks to lend money to the USSR. At the time, international banks were not only reducing the supply of fresh credits to that country but refusing to renew its short-term credits as they matured. After several months of argument, the chancellor eventually persuaded his country's banks to grant a DM5 billion (US\$3 billion) loan to the USSR in the third quarter of 1990, under a German government guarantee. Its purpose was to pay for imports of consumer goods and help finance the USSR's trade deficit (Lines 1990; UNECE 1991: 95).

In 1997, after five years of economic liberalisation and reform in Russia, President Boris Yeltsin's government persuaded first (in June) the private US financier George Soros and then (in November) Western banks to provide in total more than US\$1 billion in short-term loans to help the government pay off arrears in pension payments and wages. Chancellor Kohl was also asked for assistance with this (*Economist*, 6 December 1997; *Financial Times*, 5 March 1998).

The coincidence of these acts provides an apt symbol of the effectiveness of reform in the Russian economy since the USSR collapsed. The broad lines of failure in the reform effort are well known: an economy which has virtually halved in size and where criminal elements have gained an inextricable hold at all levels of activity. That big story has been examined exhaustively elsewhere. This article aims to examine only certain central features of the economy, through which the government has conducted much of its policy: money and prices at the very centre, and closely associated with them, the financial system, especially banking. The remaining three sections discuss: monetary developments since 1992; the failure of a reform policy based on monetary stabilisation; and the lessons that can be drawn from this for the transition generally.

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The Price of Failure

Money, Prices and Economic Reform in Russia

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2 Monetary developments since 1992

Nobody has ever pretended that the economic situation facing the Russian government when the USSR collapsed at the end of 1991 was easy. Faith in central planning had collapsed and with the temporary outlawing of the Communist Party, that system's main political prop was removed. Gorbachev's half-hearted reform efforts, undertaken when his control over political events was decreasing by the day, had removed much of the planning structure without setting up new institutions in its place. Inflation was rapid² while, especially in major cities, there were severe shortages of goods in the shops. At the same time, the Russian government had to learn how to govern after the fall of the USSR (a difficult enough task in Moscow; but how much more so in the other 14 capitals), while the close economic integration of the USSR had been upset by the sudden independence of 14 new states. All this, while the government had to take the giant leap in the dark of converting the economy from central planning to a market system.

Russia's monetary situation at the time exhibited two rather odd phenomena: a so-called monetary overhang and the coexistence of three different pricing systems. The term 'monetary overhang' describes an accumulation of money in the population without any immediate use for it, either for the purchase of goods or for investment in savings instruments. The surplus had slowly accrued since the 1970s but its growth accelerated in 1991, in which year 'Moscow printed more money than had been created during the previous 30 years' (Hedlund & Sundstrom 1996: 893). As a result, by 1991 the overhang may have accounted for as much as one third of financial assets in the USSR (UNECE 1995: 190). Its very existence is a clear indicator of the failure of central planning, demonstrating as it did the inability of potential demand (expressed in the ownership of money) to stimulate supply to match it (the supply of most products under central planning was possible only under government order). As was widely recognised at the time, the combination of a monetary overhang with severe shortages posed a great risk of inflation when the time would come to lift the country's pervasive price controls.

The triple system of pricing in its turn indicated that the former system of administered rouble prices had already collapsed. As the first of the three tiers, prices of nearly all goods and services within the centrally planned system were administratively determined and reflected social and other criteria as well as economic ones. Most consumer goods prices barely moved for 30 years after a currency reform in 1958. However, by the end of the Perestroika period an increasing number of prices were determined by the market, resulting in rouble prices which were often substantially higher than those officially nominated under the plan. This created the second tier. At the same time, loss of confidence in the rouble led some products to be priced in US dollars: in Moscow in 1992, it was commonplace to be charged a dollar price for a meal that was 10 times higher than the rouble price demanded in another restaurant nearby.

In November 1991, Boris Yeltsin appointed the young economist Yegor Gaidar as finance minister and deputy prime minister and placed him in charge of economic reform (in June 1992 he became acting prime minister). A shock economic reform and stabilisation plan was announced, to start at the beginning of January 1992. The centrepiece of this plan was the sudden freeing of most prices from administrative constraint (Murrell, 1997: 95; UNECE 1992: 143). It was expected that this would create a once-for-all inflation surge, and it was accompanied both by increases in price for those few basic goods which retained administered prices and by an increase in wages and monetary benefits for the population. Government expenditure was to be firmly reined in to prevent inflationary pressures from being further pumped up.

As much as to pilot the way to market-based economic processes, this was an attempt to cut the Gordian knot posed by the coincidence of severe supply shortages with excess holdings of money. However, the resulting inflation was much sharper than anticipated. Prices rose in January 1992 by 245 per cent and by March they had increased by 618 per cent, more than the government's 500 per cent target for the whole year (UNECE 1993: 160, 162). In the words of one later analysis, 'Wilfully unleashing inflation, in the hope that one will

² Russian consumer price inflation over the calendar year

1991 amounted to 143.9 per cent (EBRD 1996: 203).

subsequently be able to contain it, may be likened to starting a controlled brush fire' (Hedlund & Sundström 1996: 895).

By mid-year the governor of the Central Bank of Russia was replaced and the new governor embarked on a policy of easy credit for industry to counter the effects of increased prices. Fiscal control relaxed, and the state budget turned from a surplus worth 1.4 per cent of GDP in the first quarter of 1992 to a deficit of 10.6 per cent of GDP in the second (UNECE 1993: 163).³

The attempt at a shock-therapy reform was virtually over, but it had already had three devastating consequences. Firstly, Russian consumer prices increased by 2,318 per cent during 1992 (EBRD 1996: 203). Secondly, the monetary chaos led enterprises to mark up debts against each other when they could not pay their bills.⁴ Inter-enterprise arrears increased during the first quarter of 1992 from R40 billion to R751 billion (more than twice the amount of credit issued by the banking system), and further still to R3,100 billion during the second quarter (UNECE 1993: 161, 163). Gaidar had hoped that the monetary squeeze which accompanied the initial price rises would lead to an industrial shake-out in the form of bankruptcies and worker lay-offs, as happens in the outside world. But neither the economic institutions nor the cultural traditions for those events existed in Russia. Instead of cutting production, enterprises produced for stock (even if they could not pay for inputs): during 1992, inventories as a share of GDP rose by 16 percentage points (Kotz & Weir 1997: 181).

The third consequence was political: the rapid discrediting of economic reform in the public's mind, and with it also a discrediting of the democratic side of politics. The problem of the monetary overhang was removed, but only by virtue of the destruction of most people's savings by inflation. After the initial price reform, commentators remarked on how quickly the shops became filled with goods. But this

was as much because people could no longer afford to buy them as because of any increase in supply. According to Murrell, 'The political backlash was almost instantaneous'. In October 1991 the Congress of People's Deputies voted 876 to 16 in favour of Yeltsin's economic plan, but within two weeks of the programme's start Ruslan Khasbulatov, speaker of its main house, the Supreme Soviet, called for the government's dismissal (Murrell 1997: 95–96; Kotz & Weir 1997: 167). Many congress members turned against Yeltsin, sowing the seeds of the confrontation which eventually led the parliament to be stormed in the following year. In December 1992 Gaidar resigned as acting prime minister, to be replaced on a permanent basis by a stolid industrialist, Victor Chernomyrdin.

Subsequent Russian macro-economic policy has been dominated by the events of 1992. Firstly, a restrictive monetary policy was eventually established during 1993, and inflation came down steadily to reach 22 per cent year-on-year by the end of 1996 (**Economist**, 12 July 1997). This was done partly under pressure from the International Monetary Fund (IMF), for which the success of Russia's reforms was a very public test. Linked with the anti-inflation policy, the rouble was made convertible inside Russia (although it remains illegal to take the currency out of the country), and its real exchange rate steadily appreciated from the sharply undervalued level of early 1992, when domestic prices were about five per cent of world market levels (UNECE 1992: 145). In the wake of a currency crisis in October 1994, the Central Bank instituted a managed float which allowed the rouble to fluctuate within a band of values, declining from 4,300–4,900 per US dollar when instituted in July 1995 (**Economist**, 8 July 1995) to a level where a new rouble could be launched at 6.1 (=6,100 old roubles) per dollar in January 1998.

The other two main planks of Russia's economic reforms over this period were the liberalisation of international trade and a thoroughgoing

³ The figures cover all consolidated central and local government expenditures and revenues. The EBRD shows a deficit of 18.8 per cent of GDP for 1992 as a whole, including extra-budgetary funds and unbudgeted import subsidies (EBRD 1996: 203).

⁴ This seems to have taken the place of an increase in

velocity of monetary circulation, which occurs more usually in situations of extreme inflation (see section 3 below). This in itself probably indicates the different role that money was locally understood to play in the economy where central planning was invented. The implications both for anti-inflationary strategy and reform policy could have been better noted.

privatisation of both large industrial enterprises and small retail and other firms (mostly through acquisition by their workers and managers). The economic consequences of these actions varied from sector to sector. The liberalisation of trade made it easier for producers of primary products such as oil, gas and metals to place their output on world markets (although the currency received in payment was not always brought home to Russia or placed by managers at the enterprise's disposal). On the other hand, it devastated many consumer goods industries, which could not match the design, quality, prestige and sheer novelty value of the foreign goods which suddenly appeared on the market.

While Russia's rushed privatisation found strong international support, it often achieved little real change in an enterprise beyond strengthening the power (and increasing the control over resources) of the director. The methods chosen generally failed to put badly needed new capital into firms, which were often insolvent and in desperate need of re-equipment; while turning employees of overstaffed companies into their shareholders made them all the less likely to take urgent steps required to increase labour productivity. Overall, Russia's privatisation has been scarcely more successful at making ex-Soviet enterprises respond effectively to market signals than was the attempt at a shock-therapy reform in 1992.

3 The economic failure of stabilisation-based reform

Among the consequences of this approach to Russia's transition from central planning were the following five items, none of them positive:

- a persistent budget deficit, which fuelled the flames of inflation created by price liberalisation;
- a sharp decline in the real stock of money in the economy;
- a continued general failure to undertake business restructuring;
- the growth of arrears of payments of all sorts, even among privatised enterprises, and a crisis in tax payments;
- the continuing lack of development of the financial system, including banks.

This section of the article discusses each of these items in turn.

Although government spending was cut back sharply to only 18 per cent of GDP by 1997, revenues have declined even further. This has led to a continuous three-cornered struggle over budget deficits between the government, parliament (the Duma) and the IMF. Since 1993 the overall deficit has fluctuated between about 5 and 10 per cent of GDP; this has only increased the pressure to keep monetary policy tight in the face of inflation. The methods used to bring in taxes, under strong pressure from the IMF, have often run counter to reform requirements (this question is discussed in greater detail below). Government bonds have been issued in recent years to finance the deficit in a non-inflationary way, and high interest rates have made them a profitable investment for the banks; but development of the bond market has been inhibited by the shortage of liquidity.

An examination of monetary statistics shows that notwithstanding the monetary overhang, M2 broad money supply (cash in circulation plus most bank deposits, including those in foreign currencies) was in the Soviet Union in the early 1990s no bigger in relation to the size of the economy than is normal in a developed market economy. Broad money in the USSR and its successor states amounted to R787.1 billion on 1 January 1991 and R1,422.2 billion on 1 January 1992, and on 1 July 1991, to R1,123.5 billion (UNECE 1992: 107). Russian GDP in 1991 is given as R1,400 billion (EBRD 1996: 203) and in 1990 Russia is said to have accounted for 58.7 per cent of the USSR's GDP (UNECE 1992: 137). If we assume that that was also Russia's share of Soviet money supply on 1 July 1991, the M2 figure then comes to R659.5 billion, or 47.1 per cent of the year's Russian GDP: a reasonable proxy for an exact figure.

By way of comparison, most developed market economies in recent years have had broad money supplies in the range of 60–100 per cent of GDP. In Russia, however, the equivalent figure by 1995 was 11.6 per cent of GDP. The figure was less than that in only seven out of 118 other countries for which it was given. Three of these (Azerbaijan, Belarus and Moldova) were the only members of the Commonwealth of Independent States, other than

Russia, for which such a figure was given, and their development since 1992 has closely mirrored that of the USSR's formerly dominant republic. In three of the other four (Cambodia, Sierra Leone and Uganda), the state had disintegrated in civil violence during the 1980s or 1990s. (The seventh in the list is Guinea.)

Another way of looking at the question is to consider the actual value of money in circulation (that is, after discounting inflation and irrespective of the size of the economy). Kotz and Weir (1997: 171) report that the real value of M2 broad money supply (taking only roubles into account) declined by 79 per cent in the first three months of 1992. The UNECE (1994: 124) shows a decline of 81 per cent in M2 (including foreign currencies) over 18 months to June 1993.⁵

So it appears that until 1995 at least, rouble money supply grew more slowly not only than prices but also than nominal output. And there does not appear to have been a compensating increase in money's velocity of circulation:

Data on the changes in monetary and credit aggregates ... show that the high dynamics of consumer prices did not translate into an increase in the velocity of circulation, which is a typical development in an economy with high inflation. This was partly caused by massive non-payments and delayed payments, which in turn were linked to the contraction of the real money supply. (UNECE 1994: 124)

This indicates that there arose instead a massive shortage of liquidity in the economy, which still continues. The domestic use of foreign currencies (mainly US dollars) in lieu of roubles has compensated for this in part; but the actual volume of transactions is also greater than the GDP figures because of the large informal sector.

As we have seen, the Gaidar government in early 1992 expected that the shock of a surge of inflation accompanied by a monetary squeeze would lead enterprises to cut back their output, reduce their labour forces and, where they could not remain solvent at all, go into liquidation, as happens in the

outside world in such circumstances. To this day, almost none of that has happened (except for the cut in output). But although it has been reported that 47 per cent of Russian companies traded at a loss (**Financial Times**, 31 December 1997), bankruptcy laws have scarcely been used to take insolvent companies out of the system. In the province of Nizhni Novgorod, for example, an analysis showed that the large farming sector in aggregate (which contained 775 farms at end-1996) was insolvent according to Russian legal norms in each year from 1993–96; its aggregate losses in 1996 amounted to almost US\$100m. Yet in those years only one farm in the province was declared bankrupt (Lines 1997).

Job losses and bankruptcies are of course not **desirable** outcomes in any circumstances. But without them, the extreme difficulties of an inefficient economy facing a severe liquidity crisis can only fester and grow worse. This is a necessary counterpart to the development of management techniques which are essential for survival on the market but were not required under central planning, and which itself has taken place only to a limited extent. What interest will many managers see in altering their ways of doing things if they think their firms will survive anyway?

How have they performed the trick of making them survive? The simple answer is by deciding which bills they will pay and ignoring the rest (Kuznetsova and Kuznetsov, 1996: 525). Firms often do not pay for supplies that are delivered to them; but deliveries continue to be made, a continuation of the physical input-output traditions of central planning. There is no tradition, and only a little-tried mechanism, for the enforcement of payments under contract. Instead, most suppliers in turn decide which of their creditors to honour and dishonour, and so on down the line. Besides other firms, companies fail to pay their employees' wages or the government's taxes on time. As a result, 'even on conservative estimates, the stock of arrears in Russia at the end of 1996 amounted to almost twice the stock of total nominal broad money (domestic currency) in the Russian economy' (UNECE 1997: 72). The government also, meanwhile, failing to receive its tax revenues, delays payments on public-sector wages,

⁵ On this author's estimate, based on figures cited above, the real value of rouble M2 money supply in

1995 was 16.1 per cent of that in 1991.

pensions and welfare benefits. Across the economy as a whole, it was recently reported that 40 per cent of the workforce had not received wages in the previous month (**Financial Times**, 26 November 1997).

Where companies are technically insolvent, or at best highly illiquid, but still trading, they are likely to avoid contracts that require monetary payments. In Soviet times, there was a considerable amount of informal bartering between enterprises in order to overcome the supply shortfalls that were an endemic feature of central planning; and international trade between the Soviet-bloc countries, and often also with countries outside the bloc, was conducted on barter or countertrade terms. The development of monetary relations under a market economy might have been expected to put an end to barter as a business instrument. But on the contrary, it has been estimated 'that barter rose as a proportion of all industrial sales in Russia from about 10 per cent in mid-1993 to 40 per cent by the end of 1996' (**Economist**, 15 March 1997, citing the Russian-European Centre for Economic Policy).

In short, the most striking recent trend in the Russian economy has been its demonetisation. Far from giving root and flower to monetary relations, the development of the market economy has been accompanied by a steady withdrawal from them. When one considers the central role that money, and the price system built around it, have to play in a market system, this appears bizarre and unnerving.

The trend has been exacerbated by two other failures in the market reforms of recent years, in the financial and fiscal arenas. In the USSR there were effectively no banks as normally understood: that is to say, no organisations that took deposits off one group of customers and used their judgment to lend the money on to others. Credits, in the sense of loans which have to be paid back, scarcely existed. Since 1990 thousands of organisations have been set up in Russia with the name of banks (nearly 1,800 survived at the last count: **Economist**, 10 January 1998), but few of them actually are banks in the normal sense of the word: they do not play the role of financial intermediation just described. In the years since 1992, they have found it more profitable first to speculate on the currency market,

and more recently to invest in government bonds. The failure of banking to develop has been exacerbated by government tax policy, itself pursued in a certain way at the behest of the IMF. This policy has also made the national liquidity crisis and demonetisation of the economy significantly worse. In the Soviet Union, taxation of enterprises and individuals did not exist as it does elsewhere; where individuals were taxed, it was by prior deductions by employers from their pay packets, of which (unlike the PAYE deductions of UK income tax) the employees were not even aware (Cosman & Rosenblum 1995). This was hardly a propitious setting for complicated new imposts such as income tax and value-added tax. In 1997, the government's tax revenues amounted to just 10.8 per cent of GDP (at most, one third of the level in developed market economies), while its expenditures came to 18.3 per cent of GDP (**Financial Times**, 24 March 1998).

The IMF, looking as usual at the major macro-economic indicators, has over a long period put pressure on the Russian government to increase its tax revenues. (From October 1997 to January 1998, a US\$700m tranche of IMF credit was suspended due to dissatisfaction on this count.) In response, the government has instituted a harsh system of tax police, who can visit enterprises at will to inspect their accounts and confiscate money and liquid assets to offset any tax liabilities deemed to have been identified. The banks cooperate by permitting the government to sequester funds from private accounts for this purpose:

The tax inspectorate, the customs service, the State Employment Service, and a number of other agencies and regulatory bodies are entitled to withdraw funds from the accounts of legal and/or physical persons without their consent. In many, if not most, cases, the right of the administrative agency to withdraw the funds is 'uncontested' (*besspornyi*), meaning that it need not seek the permission or approval of a court or some other higher authority. (Tompson 1997: 1,168.)

In extreme cases the authorities can, and often do, freeze an enterprise's bank account: the enterprise is then almost forced to resort to barter. These practices provide a powerful disincentive to use bank

accounts or hold liquid assets in any form, thereby greatly reducing the efficiency of market transactions. Where liquid assets are held, they are often not officially declared. (It is considered normal for Russian firms to keep two sets of accounts: one for their own use, the other for the authorities).

Now, this has an extremely detrimental effect on the development of banking: firms will hardly be willing to deposit money in bank accounts if they know that at any time the deposits might be seized by the taxman. Of the banks generally, Tompson writes:

The functions performed by Russian banks resemble those of their Soviet predecessors more than those of banks in developed market economies. During the Soviet period, banks functioned as servants of the state rather than of their clients: they served as organs of financial control over client enterprises, as channels for the allocation of state funds and as means of mobilising domestic savings to finance the state's internal debt. What banks did not do in the Soviet system was to bank, i.e. to intermediate funds. (Tompson 1997: 1,159–60.)

Yet the emphasis on tax collection at all costs attacks only one aspect of a deeper malaise; and by placing only the budget deficit in its sights, it risks aggravating the liquidity squeeze and demonetisation. The present crisis can only be resolved by tackling underlying failures of the transition, many of them at the micro-economic level. The competing pressures on monetary and fiscal policy are acute, leaving the government with almost as little room for manoeuvre and facing as big a set of dilemmas as when the reform process started in 1992.

In the present decade Russia and other countries of the former Soviet Union have faced the most rapid peacetime collapse in output of any major economy in the history of industrialism: more rapid even than the worst-hit economies during the Great Depression of the 1930s (Hedlund & Sundstrom 1996: 889). Russia's successive GDP growth rates in the six years from 1991 to 1996 were: minus 13.0 per cent (1991), minus 14.5 per cent, minus 8.7 per cent, minus 12.6 per cent, minus 4.0 per cent and minus 6.0 per cent (1996). Russian GDP in 1996 was just 56.6 per cent of that of 1989 (EBRD

1996: 203; UNECE 1997: 225). In part, no doubt, the real monetary contraction was a consequence of the decline in activity. But the extreme extent of that contraction was surely responsible for a good part of the decline: we have just observed some of the channels through which its contribution was made.

4 Russian money and the transition

Russia's transition since 1992 has rested on three main lines of policy: macro-economic (monetary) stabilisation, the liberalisation of prices and trade, and the privatisation of productive assets by transfer of ownership to insiders. This article does not argue that any of these in itself was undesirable; they, or something like them, would all have been essential parts of any policy of transition from central planning. The argument is over the way in which these policies were conducted, and what was omitted in the process.

This can be elucidated by a brief examination of a problem we alluded to earlier: the monetary overhang of the early 1990s. As we have seen, when compared with other industrial economies, the total money stock at that time appears to have been far from excessive in relation to GDP. But a closer examination suggests that the monetary overhang was in fact an overhang of **cash** alone; the other component of broad money, bank deposits, was almost certainly very small. Thus, in 1994 currency in circulation in 13 ex-Soviet countries amounted to 8 per cent of GDP, compared with 6 per cent in 18 member countries of the Organisation for Economic Cooperation and Development. Bank deposits in the former, however, amounted to only 12 per cent of GDP, compared with 67 per cent in the OECD countries (World Bank 1996: 101). A relatively small volume of deposits was to be expected in an economy emerging from central planning, since neither bank deposits nor credit played an important part in the functioning of that system, as they do in a market economy. (The equivalent figures in 10 countries of East and Central Europe were comparable: currency at 17 per cent of GDP and deposits at 25 per cent.)

Now, it seems reasonable to suppose that the ratio of cash to deposits was similar in 1991 to what was reported three years later (i.e. 2:3, compared with

about 1:11 in OECD countries). On that basis, the estimated M2 money stock in 1991 would have broken down as roughly worth 19 per cent of GDP in cash and 28 per cent of GDP in deposits. A more rational policy to deal with such a large cash overhang would have been to encourage the holders of cash to deposit it in bank accounts, where it could have financed credit for working capital and investment, as savings normally do in a market economy. Put another way, the way to right the monetary overhang would have been by encouraging the development of the institutions of a market economy, not by the crude tools of inflation and monetary suppression.

A monetarist's description of the monetary overhang is as a form of repressed inflation. The overhang represented potential demand in a situation of endemic shortages; if prices ceased to be controlled by administrative fiat, the inevitable result would be inflation. As we have seen, this is just what happened. But paradoxically, although the overhang was destroyed, the shortage of liquidity which succeeded it also represents repressed inflation (UNECE 1997: 72). In 1992, the underlying cause of repressed inflation lay in the failure under central planning to provide adequate supplies of goods and services, coupled with administrative prices. Now it is the insufficient supply of money that is keeping inflation down. Actual payments have been

replaced by the build-up of arrears and the use of barter: release enough money to meet monetary demand, and Russia has another inflationary crisis on its hands. The real monetary contraction which has intervened, accompanied by fiscal deficits, seems to have had no more effect than squeezing part of an inflated balloon does: if the balloon does not actually burst, the inflation merely moves to another part of it.

The inescapable conclusion is that six years involving sharp corrective inflation followed by harsh monetary policy have failed to remove the inflationary potential from the economy. This probably cannot be achieved by manipulating monetary and fiscal policy alone: underlying causes in economic structures and institutions also have to be tackled. This means turning enterprises around so that they can meet the competition of the market, and developing the capitalist institutions of banks (in their proper role as financial intermediaries), enforcement of contracts and the liquidation of insolvencies. And that surely is what the transition from central planning is: the replacement of that system's economic institutions by those that are required on the market. By that yardstick, and despite all the pain of more than half a decade of sustained collapse, Russia's economic transition seems firmly stuck in its early stages.

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