Studies & Analyses
44

WHAT WENT WRONG?

THE REASONS FOR THE FAILURE OF STABILIZATION IN RUSSIA IN 1992

by

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1. Introduction

When the Gaidar team took over the running of the Russian economy in November 1991, its intention was to introduce a stabilization/liberalization programme very similar to the one which had been implemented with considerable success in Poland in 1990 under Leszek Balcerowicz[1]. Two years later this aim had still not been achieved, and most of the radical reformers and "westernizers" had left the Russian government after the elections of December 1993. We examine four main kinds of reason for Gaidar's failure:

1) problems arising from the process of designing the programme;

2) failures of implementation;

3) problems arising from Russia's economic structure;

4) problems arising from Russia's political structure.

In a final section we consider the sequencing debate regarding whether stabilization or privatization should take place first.

2. The Design of the Liberalization/Stabilization Programme in Russia.

The Gaidar team had two months for the preparation of the Russian stabilization programme - significantly less time than did their counterparts in other PCEs[2]. Furthermore, it was not until the end of November 1991 that the absolute political primacy of Russian Ministers over their Soviet counterparts was finally established[3]. Most important, however, was the informational and conceptual chaos which reigned at the time. Part of this chaos was due to the fact that many of the definitions used in government were unsuited to a market economy. Thus, to give one example out of dozens, in Soviet practice budget revenues were defined to include the

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[1] The success of the very similar Klaus programme of 1991 in Czecho-Slovakia strengthened their conviction that this was the right approach.

[2] Four months in the Polish case and over a year in the Czecho-Slovak.

[3] The agreement to dissolve the Soviet Union came on 8 December 1991 at Bialovezha, and followed upon the Ukrainian presidential elections and referendum on independence of 1 December.

increase in savings deposits of the population which were then automatically passed on to the government, although these should have been classified as financing of the deficit. On the other hand, revenues and expenditures resulting from the purchase and sale of foreign currency at various prices in the multiple exchange rate system (including all export tax revenues) were excluded from the state budget and included in a special "foreign trade budget"[4]. The problem was not that the new team was incapable of understanding what the correct classification of various items was, but rather that they had so very little time to do it in.

Further massive confusion was caused by the ending of the USSR. The Russian Ministry of Finance had to decide just which of the expenditures of the USSR it would take over, and in what amount. The same, of course, went for the revenue side. Budget planning under such circumstances became almost impossible, particularly as these difficulties were laid on top of the usual difficulties of estimating the budget under conditions of high inflation resulting from the so-called Tanzi effect, which makes the real value of revenues highly sensitive to variations in inflation and in tax payment delays[5]. Additional budget planning problems arose from the fact that much of budget revenue was to come from a completely new tax, the VAT.

Equal confusion existed on the monetary planning side. A key instrument of monetary policy is the planning of the evolution of the liabilities of the central bank - so called "high powered money"[6]. The Central Bank of Russia (CBR) took over the State Bank of the USSR (Gosbank) in early December 1991, yet it was to take it over a year to integrate the balance sheets of the two institutions. Thus although the Gosbank ceased operations at this time, there was enormous confusion as to what the

[4] The purpose was to hide the surplus which was expected on this budget in 1992, so that the "internal" budget could register a deficit, which was expected to appeal more to the populist parliament.

[5] With a given delay between the time a given economic activity takes place and the time the tax due on it reaches the exchequer, the higher the rate of inflation the lower the real value of the tax revenue raised. Furthermore, the incentive to delay tax payments as long as possible increases as inflation increases, augmenting the Tanzi effect. During stabilization the Tanzi effect is reversed, increasing the real value of budget revenues. The problem is that it is very difficult to forecast either effects quantitatively, yet doing so is vital for effective budgetary planning.

liabilities of the CBR actually were. As a result of this, for any given absolute increase in high powered money, it was very difficult to know what the rate of increase was[7].

Because of the informational and conceptual chaos, the IMF felt it had little understanding of what the current situation regarding the budget and the money supply was, and what is more, it felt unable to follow the evolution of key macroeconomic variables over time. It felt unable therefore to define criteria against which to measure Russian performance, so as to determine whether any commitments the Russian government made were being adhered to or not. As a result no agreement was in place between Russia and the IMF when the stabilization programme began in January 1992[8]. Such agreements had been, of course, agreed with both Poland and Czecho-Slovakia before their programmes were initiated. Such a programme would have provided two things: a very large stabilization fund (of $5 billion in the Russian case) to support a fixed exchange rate for the ruble, and a coherent framework in which stabilization policies could have been assessed and if necessary adjusted.

If the Russian government had the $5 billion stabilization fund available to it in the first quarter of 1992 there is a very good chance that the stabilization programme would have succeeded. M2 at the end of January 1992 was about 1050 billion rubles, or about $9 billion at the current exchange rate. The stabilization fund would thus have provided the Russian government with backing for over half of the money supply. Since such backing was clearly unnecessary, the international value of the

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[6] Mainly cash and deposits of the commercial banks with the central bank.

[7] Another example was the problem of how to treat the hard currency accounts of state enterprises at the Vneshekonombank (the Foreign Trade Bank of the USSR), which had been frozen by the Soviet authorities (and which the Russian authorities did not have enough international reserves to unfreeze for the foreseeable future). These amounted to $6 billion. The devaluation of the official exchange rate of the ruble on 1 January 1992 from rubles 5/US dollar to rubles 130/US dollar, meant a hypothetical increase in the value of these accounts from 30 billion rubles to 780 billion rubles - an increase of 750 billion rubles, or a further 70% on the money supply for January 1992!

[8] A key problem for the IMF was that neither Russia, nor the USSR before it, were actually members. However, this difficulty need not have stood in the way of the G7 acting outside the formal context of the IMF.

ruble could have been fixed at a far higher rate, say 30 rubles/US$[9]. As it was, even with practically no reserves available, the ruble maintained its international value unchanged between January and mid-June, in spite of a tenfold increase in prices. On the back of a rapidly nominally appreciating ruble, domestic inflation would have been quickly limited, with positive effects on the budget and most important, on the political situation. What is more, true internal convertibility[10] for the ruble could then have been introduced at the beginning of the programme. Finally, with a nominally appreciated ruble the increases in energy prices necessary to bring these closer in line with world prices would have been far smaller. As a result, the supply shock to the economy resulting from such nominal price increases [Rostowski 1994a and 1995] may have been proportionally smaller, reducing - at least somewhat - the fall in industrial output. The economic policies of the pro-Western government, supported critically by Western aid, could have been shown to be successful. There is thus little doubt that the absence of an agreement with the IMF played an important part in the failure of stabilization in Russia in 1992[11].

The question which arises is whether, given these circumstances, the beginning of the stabilization /liberalization programme should not have been delayed well past January 1, 1992. The argument from failure is always strong. However, the reasons for not delaying the programme were also convincing. It was generally known that the

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[9] If the exchange rate regime chosen had been a floating one in the initial period, the value of the ruble would probably have soared, either as a result of intervention by the authorities, or as a result of an understanding by the markets of the strength of the ruble given the available backing.

[10] This is very similar to current account convertibility. The failure to do this was an important reason for the failure of the stabilization [Section 3].

[11] It is therefore not unimportant to know where the fault lies for the failure of Russia and the IMF to reach agreement. For if Russia is "lost to democracy" one will be able to trace the causes back to this very moment. My own belief is that the smallest amount of blame attaches to the Russian government, which was in the midst of a political and economic hurricane. There was, however, a tendency to underestimate the usefulness of an IMF agreement. The IMF itself is to blame on two main counts: first, that it wasted much of the early months of the Gaidar period on negotiating on debt on behalf of its Western members, and second, its attempt throughout 1992 to keep the ruble area in existence. But most of the blame attaches to the G7 governments, which failed to understand that the USSR was finished and which, once they did understand this, were more concerned with safeguarding their loans than with supporting radical reform - which would have been in any case the best way of ensuring that their loans would ultimately be repaid. The decision to leave the organizing of Western support for democracy and reform in Russia to the IMF was similar to leaving peacemaking in the former Yugoslavia to the UN and the EC, and with similar results.

main plank of the new government's economic policy was the freeing of almost all prices in Russia. As a result, the degree of repressed inflation increased sharply, in anticipation of high inflation after liberalization. There was a massive flight from money by households and enterprises: everyone wanted to buy, no one wanted to sell at the fixed prices. Furthermore, massive repressed inflation was causing the economic disintegration of Russia, as "oblast'i" and even cities introduced "export" bans on the transfer of goods - particularly consumer goods - outside their region. Such policies resulted in retaliation by other regions, and a spiral of "export protectionism" seemed to threaten the dissolution of the state[12].

Given the absence of sufficient state power to impose physical output and delivery orders, and the failure of the market mechanism to function because of fixed prices and generalised excess demand, most of the economy had shifted into barter already in 1991. By the end of the year a very large proportion of government time was taken up with organising barter agreements between various sectors of the economy[13]. The only way for the government to avoid being bogged down indefinitely in such crisis management of a barter economy was to liberate prices immediately. The original intention was to free prices on 15 December 1991. The two week delay which occurred (with price liberation delayed until January 2 1992) resulted in the almost complete emptying of all shops - particularly in the politically vital cities of Moscow and St.Petersburg[14].

Price liberalization required stabilization, both for economic and political reasons. As we have seen, rapid inflation can become self accelerating. The Tanzi effect reduces the real value of tax revenues, increasing the real budget deficit. The increasing inflation tax on holding money reduces the demand for real money

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[12] Export bans had popular support in the regions. They were also contributing to declining output.

[13] On finally getting to see Gaidar, after having waited for 12 hours one Sunday in December 1991, while the government arranged an exchange of clothes and diesel for grain from the kolkhozy, the he said to me: "You see before you the Walrasian auctioneer of Russia".

[14] It was these two cities which were the main targets of export bans by neighbouring agricultural regions.

balances, increasing any given budget deficit as a proportion of the real money supply, and therefore increasing inflation [Rostowski 1994b and 1993a]. If a significant part of government expenditures result from subsidies to the production of goods whose prices are fixed, then inflation increases the costs of production of these goods, requiring increased subsidies, as was the experience of Poland in 1989[15]. In order to limit the increase in the deficit resulting from this source, administered prices have to be increased from time to time, and if inflation is rapid, these increases must be by large amounts. As a result, relative prices become highly variable, causing severe disruption to economic activity. Last but not least, high inflation makes it hard for market participants to know whether any given price change is the result of an increase in the relative price of the good concerned or in the average price level. As a result, the price elasticities of supply and demand decrease, reducing the efficiency of resource allocation and output. In Figure 1 an external shock which increases demand by AB, causes output to increase only to Q_1 (the intersection of S_0' and D_1'), instead of to Q_2, which is what the non-inflationary supply and demand curves (S_0 and D_1) would indicate.

[INSERT FIGURE 1]

Politically, inflation undermines the authority of government, which is seen as incapable of fulfilling one of its basic functions, while the various actions which are necessary to manage inflation at a very high level (and prevent an exponential increase in prices), will repeatedly bring government into conflict with various powerful groups in society[16].

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[15] If such subsidies are not increased, shortages of the goods will increase.

[16] Members of the Gaidar team expected an "industrialist" government headed by A.Volsky to precede their own. They expected such a government to pave the way for transformation and stabilization by freeing many prices and most entrepreneurial activity, in much the same way that the last Communist government, headed by M.Rakowski had done in Poland. Possibly unfortunately from the viewpoint of the success of transformation in Russia, the August 1991 coup

3. The Implementation of the Programme.

As a result of the situation described in the previous section, the liberalization/stabilization programme introduced in Russia on January 1 1992 was very rudimentary. There was a budget for the first quarter of 1992, a commitment by the CBR not to increase the quantity of its refinancing credit by more than 15% per month during the first quarter, and a commitment to the freeing of most prices. There was also a desire to see the ruble appreciate significantly, or at the very least to maintain its international value. However, there were practically no reserves available for this purpose.

In general outline, and in its intentions, the Gaidar "programme" was very similar to the Polish and Czecho-Slovak programmes which had preceded it. However, in its details the Russian plan was far less thorough in its implementation of the principles it espoused. This could be seen quite clearly from the very beginning in the systemic changes relating to liberalization. Later it also became evident in the implementation of stabilization policy.

Price liberalization was "contaminated" to a large degree from the start. Thus, the drafting of the decree liberalizing prices was entrusted to the old Price Commission! The result was a law of such complexity that it was quite some time before it became clear which prices had been liberalized and to what extent. Furthermore, retail margins in state shops were not to exceed 25% over wholesale prices. This meant that often shortages actually had to appear (or inventories decline) causing retailers to increase orders, before suppliers would increase their prices, making it possible for the retailers to raise their prices in turn[17]. Finally, the prices of many basic food products were centrally administered until March 1992, after which

"accelerated history", causing the reformist team to come to power "too early", so that it had to be responsible for both the first price liberalization in Russia and to attempt stabilization. In an irony of fate, it may be that the "industrialist" government of Viktor Chernomyrdin will succeed in implementing the stabilization which the reformists have not been able to.

local authorities often continued to fix their prices, and state retail chains found it easier to set a single price in all their shops. Price control was in the interest of shop staff, who in its absence would be unable to sell "deficit" products "under the counter". The control of profit margins of so-called monopolistic producers was also very widespread, and was only given up at the end of 1993.

The result was that while liberalization led to a definite improvement in supply, the situation on the market continued to be one of "semi-shortage", with many consumer goods completely or mostly unavailable. Thus the Russian Government’s Centre for Economic Reform’s index of availability of goods stood at between 60 and 65 as late as the last quarter of 1992[18]. The result was that the political benefits to the government of the improvement in the supply of consumer goods were limited. This may have been one reason the conservative counter-attack against government economic policies started in April 1992, far earlier relative to the beginning of the programme than in either Poland or Czecho-Slovakia.

Formally, a significant degree of quantitative planning remained, with the maintenance of "state purchase orders" (goszakazy) in the energy sector, and particularly in the oil industry[19]. The government argued privately that these orders would have no effect, as to become enforceable they required the delivery of inputs to the energy producers which the Ministry of Economy (the old Gosplan) was incapable of effecting. At the very least they caused confusion for actors as to whether they were operating under a centralized barter system or under a market system. The "goszakazy" also encouraged the central bureaucracy to believe that it could maintain its traditional directive power, at least in some areas of the economy.

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[17] The justification was originally that the 25% margin would not apply to those shops which left the state-owned retail monopolies. It was thus supposed to induce the break-up of these monopolies. As it turned out, no exception was in fact made for the "leavers" in the decree.

[18] The index measures the availability of 70 food items and 28 non-food items in 132 cities in Russia. 0 indicates that none of the items are available anywhere, while 100 means that all are available everywhere. As can be seen, it is not a very demanding measure of market saturation!

[19] Coal prices were only freed in July 1993.

Finally, the whole area of foreign trade was riddled with price and quantitative controls. On the export side a part of export earnings had to be sold to the authorities at half the market exchange rate, with the proportion varying from 80% for oil and gas to 40% for manufactures in the first half of 1992[20]. This was the equivalent of a variable export tax. More seriously, there were also dozens of export ceilings, affecting almost all of Russia's exportables. The most important single item here was oil. The controlled domestic price was so low, at about 5-15% of the world price[21], that even the very high export tax on this commodity (equivalent to 40% of the world price) would have been insufficient to prevent a surge in exports, and massive domestic shortages[22]. Instead of raising the domestic price closer to world levels, the Russian authorities tried to restrict oil exports through export quotas (additional to the export tax). In the case of many goods the agency granting the export quota was also the main domestic purchaser of the product: thus exports of medicines had to be approved by the Ministry of Health! These export barriers made it harder for Russian enterprises to respond to the fall in domestic demand accompanying the stabilization by increasing their exports, as Polish, Czecho-Slovak and Hungarian enterprises did under similar circumstances. A key safety valve present in well designed stabilization programmes was effectively shut off. This in turn made it harder for the Russian authorities to resist the political pressure to increase domestic demand; and indeed they gave way to it in June 1992.

In the Central European countries increased export earnings increased the supply of foreign currency and thus strengthened demand for the domestic currency, while at the same time financing increased imports from the West, improving consumer goods supply and variety with positive political effects, and also reducing or eliminating monopoly power in the traded goods sector. Freedom to import resulting

[20] This was made uniform in the second half of the year.

[21] This varied with oil price and exchange rate changes.

[22] This did not prevent export smuggling of oil from taking place on a very large scale (see Section 4).

from internal convertibility facilitated the growth of the private sector [Rostowski 1993b] and increased efficiency as a result of imports of western capital goods. All of these benefits were available to Russia in far smaller degree because of its export and import controls.

In Russia on the other hand, in the first half of 1992 40% of all imports were centrally administered, the foreign currency being provided to the importer initially at a rate of 5 rubles/US dollar (at a time when the market rate fluctuated between 110 and 230 rubles). As a result of inflationary expectations the ruble was so massively undervalued in real terms, that in the first quarter of 1992 imports were the equivalent of about 135% of national income (NMP)[23] at the market rate of exchange for non-cash rubles. In the second quarter, when the ruble had appreciated very significantly in real terms this share was 60 percent[24]. Thus, centralised imports were equivalent in value to about 65% of NMP in the first quarter and 30% of NMP in the second quarter, if one priced them at the market rate of exchange, which is what purchasers would have had to pay if they had proved unable to obtain the foreign currency at massively favourable rates from the government. These figures give us some idea of the degree of resource misallocation resulting from the controls, but also of the degree of micro-economic power retained by the central bureaucracy[25].

In one respect, moreover, the Russian programme differed fundamentally from its Polish and Czecho-Slovak predecessors: wage controls were very weak[26]. In spite of this, statistical real wages crashed in January 1992 and then increased slowly during

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[23] Net Material Product (NMP), see Russian Economic Trends Vol.1.

[24] The figures for exports are very similar: about 110% and 60% of NMP in quarters 1 and 2 of 1992.

[25] In the second half of 1992 the share of imports to which a preferential exchange rate was applied fell from 40% to 10%. The implicit subsidy was supposed to be funded by the budget, but this did not in fact apply to imports financed by foreign credits.

[26] Wages above 3 times the minimum wage are not counted as costs, and cannot therefore be set against enterprise income tax. Effectively this means that they attracted a further 30% tax, on top of the payroll tax paid on all wages. This was a very mild regime compared with the Polish one, where wage increases which were more than 5% above the permitted threshold increase (itself generally considerably less than inflation) attracted 500% tax on top of the payroll tax [Chapter 7].

the rest of the year, very much as in Poland and Czecho-Slovakia during the analogous periods in their programmes [Figure 2]. This close similarity is the more surprising as unlike the Central European countries (including Hungary) which formally had tight wage controls, unemployment remained vestigial in Russia. What is more, wages are not generally believed to have been the direct motor of inflation in Russia, particularly in the first quarter of 1992 when the ratio of profits to wages increased by 22%[27]. Such cost-push pressures as existed seem to have been mainly initiated by enterprise managements aggressively pushing up prices, with wages largely following somewhat passively. This is reflected in the inter-enterprise debt explosion [Rostowski 1993c] and the far faster growth in producer prices than in consumer prices [Figure 3]. Thus, paradoxically, the point on which the Russian programme seems to have differed most in principle from its Central European predecessors, seems to have been the one which was least important in practice for its divergent outcome.

[INSERT FIGURES 2 AND 3]

The main outlines of macroeconomic policy and performance are given in Figure 3 and Tables 1 - 4, which trace the evolution of producer and consumer prices, high powered money, M2, the budget deficit and nominal and real exchange rates. Essentially, the year can be divided into two periods, corresponding roughly to January-May and June-December of that year. Until June, monetary policy was relatively restrictive [Table 1], and the consolidated general government's budget was actually in surplus in the first quarter [Table 2][28]. In May the budget began to

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[27] This does not mean that the NAIRU analysis does not hold for Russia. If financial policies had been sufficiently tight in Russia, the policy of aggressive price increases practised by enterprise managers in the initial months of the reform would have lead to large scale unemployment, and forced the enterprise managers to desist.

[28] This was according to Russian methodology, which counted foreign loans as income.

deteriorate, and in June high powered money grew by 68% and M2 grew 28% (compared to an average of 17% and 12% respectively during the first five months of the year). The change can be seen not only in policy, but also in economic outcomes, though with a slight delay. After the initial "price flare" following liberalization, inflation was on a downward trend which continued until August, but then it reignited rapidly, exceeding 20% in every month from October 1992 to April 1993. The nominal exchange rate for non-cash rubles appreciated from 230 rubles/US$1 on 28 January 1992 to 113 rubles/US$1 on 2 June 1992. After that the nominal exchange rate depreciated rapidly, reaching 309 rubles/US$ on 1 October and 416 in mid-December 1992. The real exchange rate appreciated from an index of 140 at the beginning of January to one of 25 at the beginning of June (i.e. a real appreciation of 460%)[29], after which it depreciated some 45% to mid-October.

[INSERT TABLES 1 AND 2]

The change in macro-economic policy has been explained in different ways. According to Gaidar[30] political pressure by the industrial lobby for a massive expansion of credit became irresistible in May. The source of this pressure was the vast amount of trade credit the SOEs had granted each other, and which they could not pay off because monetary policy, though in fact quite loose, was tighter than they had expected [Rostowski 1993c]. In order to save the general thrust of the reforms, Gaidar not only agreed to a change in the stance of macroeconomic policy but also accepted the appointment of four anti-reformist Deputy Prime Ministers and in July the

[29] April 1991 = 100.

[30] Lecture at the London School of Economics, 7 May 1993.

proposal for a multilateral clearing of inter-enterprise debts[31]. Anisimova, Sinelnikov and Titov [1993] draw attention to the massive increase in government expenditure which was one expression of this shift in policy. As a percentage of GDP expenditures of the consolidated budget (Federal and local) increased from 25.7% in the first quarter to 40.6% at the end of August[32]. By sector of expenditure the changes were as follows:

TABLE 3: Share of Federal expenditure in GDP in 1992

	1 April	1 September
National economy	7.9%	13.3%
Social safety net	6.8%	9.3%
Defence	4.2%	6.3%

Source: Anisimova, Sinelnikov and Titov 1993.

Revenues remained unchanged relative to GDP at about 28 percent, giving rise to a deficit of about 12 percent of GDP (compared to 2% of GDP in the first quarter)[33]. This corresponds to Gaidar's description of events: there was a conscious, if enforced, shift in budgetary and monetary policy, and the consequences for inflation and the exchange rate followed naturally.

TABLE 4: Nominal and real rates (R/US$)

	nominal	real
December 1991	144	275.6
January 1992	180	100,0
February	170	68.3
March	161	49.9
April	155	39.5
May	128	29.1
June	119	22.8

[31] The present author presented Gaidar with a proposal for a market based solution to the inter-enterprise debt problem - which would have avoided the need for additional money creation - in May 1992. It is contained in the last two sections of Chapter 8.

[32] In real terms this increase was about 60%.

[33] However, revenues were smaller than they might have been because of the difficulties the authorities had in properly indexing tax pre-payments (an example of the Tanzi effect).

July	136	23.5
August	163	25.8
September	204	28.9
October	338	38.9
November	448	40.9
December 1992	418	30.5

Source: *Russian Economic Trends*, nominal rates are for the middle of the month, real rates are deflated by the CPI.

4. Russia's Economic Structure.

A commonly held view before the beginning of the transition in Russia was that the highly monopolised nature of Russian industry made a stabilization of the Polish kind impossible. This is a version of the structuralist belief common throughout developing countries (but particularly in Latin America), that - whatever the case in the rest of the world - inflation in one's own country is a monopolistic phenomenon.

In considering this question we need to distinguish monopoly in the non-traded and the traded sectors. In the former, the high level of monopolization of wholesale trade in basic consumer goods was a serious problem which required forceful government intervention, which did not in fact materialize. In the retail sector, small privatization and private sector development resulted in far reaching demonopolization, but not until the second half of 1992 at the earliest. The decree on the freedom to trade of 28 January 1992 was an attempt by the authorities to weaken monopolistic trade and wholesale organizations by strengthening the rights of the ordinary people who were taking to street trading in their thousands[34]. However, the local authorities were powerful enough to largely ignore the decree if they wished, and maintain the position of the trade networks they owned.

As regards internationally traded goods, at the beginning of the transition Russia does not seem to have been potentially less open to international trade than

[34] This phenomenon had dramatically increased retail competition in Poland in 1990. The decree was the result of advice by a number of advisers who had been involved in the Polish programme (including the present authors).

Poland. The authors estimate that in 1992 exports outside the FSU were about 12.5% of GDP (at purchasing power parities) compared to 8% for Poland before the transition began[35]. The problem therefore lay with the host of export controls described in the previous Section. In fact, as we shall see below, Russia as an exporter mainly of raw materials, was likely to face very strong penetration of her manufactured goods markets by imports, providing strong competition for domestic producers. What we have little information about is the degree of concentration of domestic production of tradeable. Anecdotal evidence suggests it was higher than in Poland, where a degree of demonopolization of the state sector had been undertaken by reform Communists in the 1980s[36]. Certainly the Russian anti-monopoly office did little to split up producer cartels, or even to prevent their formation, concentrating instead on attempts at price control in cases in which it believed monopolistic behaviour had been identified [Fornalczyk and Hoffman, 1993].

More fundamentally, we need to consider why monopoly should inhibit anti-inflationary policy. Monopolists maximize profits by setting output at a level at which marginal cost = marginal revenue, but both of these are effectively **relative** prices, which should therefore have nothing to do with inflation. It is true that monopolists who have previously had their prices controlled may increase them sharply on liberalization, but this would be a once and for change [Berg and Blanchard, 1994]. Also, Soviet-type economies suffered from many sole purchasers as well as sole producers. Where these buy from sole producers you have a bilateral monopoly with no implication for the price level. Where they are monopsonists, they are actually likely to force prices down.

[35] Russia's per capita GDP at purchasing power parities (PPP) before the transition began is assumed to have been 2/3 of Poland's, giving a total GDP of $240 billion compared to $90 billion for Poland. Exports were respectively $30 billion and $7.5 billion.

[36] And where the revision of the law on state enterprises of March 1990 (as part of the Balcerowicz plan) gave component entities the right to leave SOEs without the agreement of the latter.

However, there is another way in which Russia's economic structure did indeed make the whole transformation process (and stabilization as part of that process) particularly difficult. Russia is suffering today from what was known in the 1970s as the "Dutch disease", but on a continental scale. This results from the way in which the Soviet economic system since Stalin was directed primarily at supplying the industrial base on which Soviet military power rested. Therefore, the economy was based on exploiting the vast of the north Eurasian landmass and transforming them into relatively efficient weapons and low quality machinery and consumer goods. The Soviet manufacturing sector was far too large, based as it was on underpriced raw materials (particularly energy), and almost completely protected from foreign competition by the planning system and the inconvertibility of the currency.

A significant part of Russian manufacturing was therefore bound to be uncompetitive when world prices for traded goods were introduced into the economy. The country as a whole would gain, exporting more raw materials than it otherwise could, and using the revenue to buy better and cheaper foreign manufactures. But the problem for manufacturing enterprises as purchasers of raw materials was bound to be severe.

One of the apparently paradoxical aspects of this issue was that the energy producing enterprises themselves were opposed to the freeing of the prices of their products. The reason for this was the property rights structure of these firms: the managements could make large amounts of money by exporting oil which they claimed had been sold domestically, and pocketing the difference[37]. Thus, a major problem with stabilization in Russia is that the basic mechanism of the Soviet economy was privatized **before** the end of the "perestroika" period and before the transition to capitalism began. With the collapse of the Soviet system this mechanism became one by which individuals and companies use their access to natural resources

[37] Viktor Chernomyrdin was brought into the government in May 1992 as Deputy Prime Minister in charge of energy production as a concession to this interest.

to transform them into private wealth. In the absence of legitimate private property rights to these natural resources, distorted prices are a key element in this process, but so is high inflation as it makes it easier to obtain cheap financing for such operations. Fraud is also made easier by the chaos which accompanies very high inflation, as is capital flight.

The raw materials pricing problem was compounded by the massive reduction in arms procurement which Gaidar implemented[38]. A democratic and peaceful Russia clearly did not need the level of weapons production of the USSR[39]. A similar situation held in some of the former Soviet satellites, but to a smaller degree, firstly because these countries were less well endowed in raw materials than was Russia, and secondly because their economies were generally less directed to weapons production[40].

With so many SOEs threatened by the introduction of world prices, a significant part of elite and public opinion was susceptible to claims that monetary policy had to be loose to make possible the provision of cheap credit to threatened enterprises (and that fiscal policy had to be loose so as to provide subsidies). Export taxes and quotas, and especially favourable exchange rates for imports were justified on the same grounds[41]. This does not, of course, mean that it was the most threatened or the most deserving of temporary support who actually got it. Moreover, instead of "maintaining production" as was intended, cheap credit was often used to buy foreign

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[38] Said to be 80% in 1992 alone.

[39] Gaidar was politically astute in cutting weapons procurement far more than the personnel budget of the army. One area where the generally pro-western stance of the government may have made things harder was the disapproval of the United States for Russian arms exports to certain countries. However, many of the more unpleasant customers of the former USSR were even more broke than Russia, and arms deliveries to them were more in the nature of gifts than sales.

[40] Part of the impact of the collapse of the Council for Mutual Economic Assistance (CMEA) was due to the cheap raw materials obtained by the Central and East European satellites, which helped to sustain their manufacturing industry (and in the case of some countries - such as Slovakia - into weapons for the Warsaw pact to a significant degree). Similar effects - but far stronger - were felt by the more industrialised of the newly independent states of the former USSR, such as Ukraine and Bielarus.

[41] Thus in the first half of 1992 Aeroflot was paying 25 roubles/US dollar, at a time when the market rate was 120 roubles/US dollar [Dabrowski 1993].

currency in order to avoid the inflation tax, and thus effectively to speculate against the rouble.

5. Russia's Political Structure

What made the Gaidar attempt at stabilization unique was that at the beginning of 1992 Russia was a state without frontiers, sharing a common currency with fourteen other countries - it was in fact a state in the process of being born from the ashes of the USSR. At the end of 1991 Russian leaders were faced with an insoluble dilemma. They could, as Grigorii Yavlinsky proposed[42], try to devise a stabilization programme which would have the support of at least the major post-Soviet states. The problem was that most of these (and in particular Ukraine) were not prepared to accept a general liberalization of prices, let alone the shock stabilization programme that had to accompany price liberalization. Alternatively, as Gaidar proposed, Russia could go it alone. This meant accepting that the USSR was an empty shell, its republics effectively independent states, and devising an economic policy for Russia alone, which would take into account only Russia's interests.

Gaidar's problem was that neither Russia's frontiers nor her currency were under the control of the state. There were few border and customs posts because these were on the external borders of the USSR, and were now mostly in the territory of foreign countries, so that the Russian government did not have any authority over them[43]. As a result it was difficult for the state to raise the export taxes which could have been an important part of its revenue[44]. Indeed, in the first two months of 1992

[42] At the time Deputy Prime Minister of the USSR.

[43] Some "internal border posts" had been established before the dissolution of the USSR (for instance on the frontiers with the Baltics) so as to "defend the domestic market" from the purchasing power of residents of these republics. But these frontiers remained highly porous.

[44] A very rough calculation shows just how large these revenues could have been. Exports in the first quarter were $7 billion. We assume that half the exports consisted in energy products, of which half was oil and half gas (these figures are taken from the actual shares in Q1 1993 quoted by *Russian Economic Trends*), and that the difference between the domestic and world prices was (1) 90% of the world price for oil, and (2) 50% of the world price for gas. If the whole of this difference had gone to the Federal budget, as should have been the case, then these two items alone should have brought in 288 billion roubles, i.e. over ten times as much as total "earnings from foreign economic activity" actually did,

export taxes were simply not levied. Furthermore, during the first nine months of 1992 the states of the FSU (excluding the Baltics) received Russian energy at domestic Russian prices. Since then these have been increased, but still not consistently to world levels.

As serious was the situation as regards money creation. The central banks of all fifteen successor states were able to create non-cash rubles without any restraint. In such a situation it is in the interest of each central bank to create as much money as possible, and in this way to give the residents of its state purchasing power over goods produced in other states. The only constraint was that only Russia had the printing presses. This has meant that if a non-Russian central bank created so much deposit money that the demand for cash exceeded the amount made available to it by Russia, a cash shortage would develop in that state. Most central banks were eager to avoid such a situation, and this imposed some restraint on their behaviour[45]. On the other hand they were also eager to prevent a differential in price levels between their country and others in the ruble area, so as to avoid a trade surplus which would represent the payment of seigniorage. This was in effect the exchange of goods and services for a book entry in the central bank of the importing country. Such a system inevitably led to an "inflation race" between the states of the FSU[46].

The only real solution was for Russia to "nationalise the rouble", i.e. to treat the non-cash roubles created by the central banks of the other states as foreign currencies, and effectively to force these states to introduce their own currencies and decide on an exchange rate regime **vis a vis** the Russian rouble and other currencies. Although this step was discussed within the Russian leadership from as early as October 1991, it

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and about 21% of GDP in that quarter! However, it needs to be noted that these difficulties were to some extent anticipated and the budget of 18.12.1991 left all such revenues out of account (one of the purposes being to prevent the populist parliament from spending this revenue).

[45] Some non-Russian central banks (in early 1992 particularly those of Lithuania and Ukraine) tried to escape from this dilemma by emitting "emergency cash" of their own. This had the additional advantage of limiting non-residents' access to consumer goods on the domestic market.

[46] A similar mechanism operated in 1991 Yugoslavia in the run up to the formal disintegration of that country, and indeed during the Serbo-Croat war which followed.

really happened only on 11 November 1992 when Ukraine finally left the rouble zone, and a system of **daily balancing of payments between the two countries** was made effective[47]. The automatic overdraft facilities which the non-Russian states had at the CBR until June 1992, and the massive "technical credits" supplied to them by the CBR under Gerashchenko's governorship from then until November cost Russia the equivalent of between 8.6% and 10.9% of GDP [Dabrowski 1993b][48]. Since the Russian state was unable to raise this money through taxation, it had to be paid by Russian savers through the inflation tax.

Why did nationalization of the rouble take so long to happen? Certainly the interests of those Russian firms whose main export markets were in the countries of the FSU played an important role. There was also the fear that, deprived of this massive subsidy (equivalent to 12-18% of the GDP of the recipients), the economies of the non-Russian states would collapse, with grave effects on the welfare of the 25 million ethnic Russians living there. The effect could then have been a massive emigration of these Russians to the Federation[49]. Ironically, Russia which had given up territory was in similar position to Germany which had gained the former GDR, and which was also spending very large sums to avoid mass migration into its heartlands. However, a major motive was also imperial - the desire, particularly by Gerashchenko, to hold the former Soviet Union together at least economically, if this could not be done politically[50]. Unlike Germany, Russia proved incapable of

47 This system had formally been introduced in July , but the automatic overdraft facilities and technical credits issued by Gerashchenko meant that it had little bite.

48 The last overdraft facilities and technical credits for FSU republics were only abolished by Finance Minister Boris Feodorov in May 1993.

49 This could have been either as a direct result of economic collapse in their countries, or because of a violent reaction against them by local inhabitants. This line was put forward to the authors by highly placed Russian officials.

50 A second irony of history is that it was only once the rouble was nationalised that the non-Russian states realised their true economic weakness, and the states of the FSU began to come under renewed Russian domination. The exception are the Baltics, which were prepared themselves to cut the umbilical cord of CBR transfers, and with it their economic dependence on Russia, by creating their own currencies on their own initiative and stabilizing inflation. The third, and final, irony is that Lithuania, the last of the Baltics to stabilize and thus to prove itself capable of independent statehood, did so under the auspices of the post-Communist (so-called Socialist Party) government, while the previous more nationalist Sajudis government had not had the courage, or maybe the understanding, to take this step.

sustaining the burden, and by the second half of 1993 the crediting of the non-Russian states had effectively ceased (and prices charged for Russia's raw materials were also sharply increased). Interestingly, the catastrophic effects for ethnic Russians outside the Federation failed to materialise.

6. The stabilization vs. privatization debate

As 1991 turned into 1992 and the Gaidar programme was being launched, one of the major criticisms levelled at it was that price liberalization and stabilization, which were based on the assumption that enterprises would respond to market forces[51], failed to take into account the nature of the SOE. It was therefore argued that privatization had to precede a liberalization/stabilization package. The Gaidar team, including those directly engaged in privatization, argued correctly that Polish experience showed this was not the case, and that a liberalization/stabilization package was feasible in an economy dominated by SOEs (though it is preferable to implement such a programme in an already predominantly private economy). It was felt, again probably correctly, that the majority of those arguing for privatization first did so because they knew that privatization would be a lengthy process, and hoped in this way to delay liberalization and stabilization.

The opponents of the Gaidar policy were unable to prevent price liberalization but, for the reasons described in the previous Sections, they were able to severely limit liberalization in the wider sense, and to prevent stabilization. They were not, however, able to prevent privatization[52]. The bulk of state assets outside the natural monopolies and the defence industry was privatized by the middle of 1994, i.e. within two and a half years of the beginning of the transition. No other post-communist country has achieved a comparable result in so short a time, not even the Czech Republic, and this in spite of the far greater organizational and political difficulties

[51] Both at the micro level (e.g. enterprises would respond to relative prices) and at the macro level (e.g. the money supply would affect the aggregate price level).

encountered in Russia. It happened because of the bold decision to base privatization in Russia on vouchers and auctions, and thanks to the enormously privileged position given to insiders within the privatized firms by Anatoli Chubais, the Deputy Prime Minister in charge of privatization [Frydman, Rapaczynski and Erle 1993].

Thus, despite the intentions of the Gaidar team, in Russia privatization has preceded stabilization[53]. The reason for this seems clear: unlike liberalization and stabilization, which required painful adjustment by the SOEs to changes in relative prices and to a reduction in liquidity, Chubais' privatization programme was in the interests of the most powerful groups in Russian society, i.e. the insiders in the SOEs, and in particular their managements (workers have been politically far weaker in Russia than in Central Europe). The result is that during 1992-4 Russia has experienced "transformation without stabilization", very much along the lines advocated by easy money populists. Few would dispute that this has happened at a particularly high cost in terms of capital flight, income inequality, criminality and general chaos, which has strengthened authoritarian and anti-democratic politicians.

7. Conclusion and Postscript

It is impossible to assess which of the four groups of causes for the failure of stabilization in 1992 were critical. Weakness in the implementation of the programme resulted from both the political pressures which emerged from the economic and political structure of Russia, and also from the lack of a clearly thought out programme well supported by Western finance. The counter-factual one will never be able to answer is whether such a programme could have developed enough economic and political momentum to make it effectively irreversible, as has happened for example in Poland. Unlike with privatization, however, it is difficult to imagine that it could have been possible to develop a liberalization-stabilization programme which

[52] Though the attempts to do so were on occasion desperate [Chubais 1993].

would have been in the interest of the dominant producer groups in Russia [Layard and Richter 1994 and Section 4]. Thus the only way to stabilize in Russia in 1992 was to take these groups by surprise by the speed of stabilization, as happened in Poland[54].

By 1994 this situation had changed somewhat because of the completion of mass privatization. Very high inflation reduced the price insiders had to pay for control of their SOEs to very low levels, and was thus in their interests. Now that the privatization programme has been completed, this reason for opposing stabilization has gone, and this (together with the nationalization of the ruble and the establishment of effective borders) may be one reason why stabilization has been somewhat more effective in 1994. On the other hand, as we noted in Section 4, a major problem is that the fundamental mechanism of the Soviet economy (the exploitation of natural resources) was privatized **before** the end of the "perestroika" period and before the transition to capitalism began. In the absence of legitimate private property rights, high inflation and distorted relative prices for raw materials facilitate the process of expropriation of the state which is at the base of much of the larger scale private sector activity in the country. At present there is little indication that this process is abating, or that the groups which benefit from it are loosing their power.

[53] Thus implementing the proposed sequencing of the 500 day plan, so heavily criticised by reformers for its lack of radicalism.

[54] An important element in Poland was that producers were profoundly divided, with power divided between workers councils, trade unions and the managements. This so-called "Bermuda triangle" was much lamented by Balcerowicz as a break on the restructuring of enterprises, and Gaidar said to one of the present authors that Russia's great advantage was that it did not have Solidarity. It seems to us that the case was quite the opposite: the internal conflicts within Polish SOEs played a vital role in inhibiting producer mobilization against stabilization. And, as is claimed in Chapter 1, little restructuring will happen in the absence of stabilization anyway.

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