

US Policy and Russia's Economic Plight: Lessons from the Meltdown

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This policy memo discusses economic reform in Russia and the role of the US government between 1992 and 1998. It begins by reviewing the general strategy of shock therapy in Eastern Europe, comparing it with what actually happened in Russia. It then highlights the shortcomings of US support for specific economic policies in Russia and the pressure exerted by the United States on the International Monetary Fund (IMF) when the Fund was reluctant to provide new disbursements to Russia. The final section draws conclusions about US policy and offers recommendations for the future.

Shock Therapy versus Aborted Reform

Approaches to economic reform in Central and Eastern Europe have varied markedly over the past eight years. The results suggest that shock therapy is the best way to move from a centrally planned economy to a free-market system. The countries that have adopted the boldest reforms, with a strong emphasis on macroeconomic stabilization, are all faring better--in most cases much better--than the countries that opted for a go-slow approach. The fast reformers include Poland, Slovenia, Hungary, Estonia, the Czech Republic, and (to some extent) Slovakia. Overall, the more slowly that countries have gone, the worse their performance has been.

The shock therapy programs adopted by Poland and other reforming countries have encompassed four types of policies:

- macroeconomic stabilization;
- liberalization of prices and commercial transactions;
- small-scale privatization and removal of barriers to small-business formation; and
- restructuring and liquidation (or privatization where feasible) of large enterprises.

Of these, the first three types of policies are crucial to implement at the very start. Countries that delay in implementing them pay a severe long-term price. The vibrancy of Poland, Hungary, Slovenia, and other reforming countries is due largely to their prompt adoption of these three types of policies, which laid a solid basis for sustained growth.

Policies in the fourth category are necessarily more prolonged. The record in Central and Eastern Europe leaves no doubt that large state-owned enterprises (SOEs) are extremely difficult to bring under control. The experience of these countries also indicates that mass large-scale privatization

programs, if adopted early on, can actually make things worse rather than better. The cases of Hungary, Poland, and the Czech Republic are illustrative in this regard:

- Hungary is the only country that has had an effective bankruptcy regime, which was firmly in place even before Lajos Bokros (then finance minister) imposed a sweeping austerity program in February 1995. Hungary deserves a good deal of credit for showing how large-scale industry can be reformed. The Hungarian government eschewed proposals for mass large-scale privatization and chose instead to privatize large firms on a case-by-case basis. The government eagerly permitted strategic foreign investors to buy controlling stakes in viable companies, something that no other government in East-Central Europe has been as willing to do. It is hardly surprising that half of all foreign direct investment in the former Communist world has gone to Hungary.
- In Poland, bankruptcies of large firms have been much less common than in Hungary, but considerable restructuring has taken place. This is true even though very few of the largest enterprises had been privatized until very recently. In 1990 the Polish government had intended to implement a mass large-scale privatization program, but it fortunately got derailed. The scheme is being implemented (on a reduced scale) in 1998, but the chances for success now, nearly a decade into the transition, are greater than they would have been if the scheme had been implemented at the beginning of the transition.
- The Czech Republic encountered serious problems in 1997 and 1998 primarily because the Czechs, unlike the Hungarians and Poles, implemented a mass large-scale privatization program early in the transition. Most of the Czech Republic's problems stemmed from financial burdens and microeconomic inefficiencies that the mass privatization program not only failed to eliminate, but actually exacerbated. (This is ironic because proponents of mass large-scale privatization argued that only private owners would be able to impose the necessary discipline on firms. The reality in most cases has been very different, not least because of the state's continuing role vis-à-vis nominally private firms.) Because the Czech Republic did enough other things right (e.g., macroeconomic stabilization, liberalization, etc.), the country should soon be able to recover from the stagnation of 1997-98. The odds are, however, that the Czech Republic would be in much better shape if it had deferred mass large-scale privatization and concentrated instead on stringent microeconomic reform.

In Russia, the situation has been very different from the experiences of Poland, Hungary, and the Czech Republic. Shock therapy was never implemented in Russia. The first of the four components listed above was not achieved in Russia until several years into the transition, by which time the country had experienced a prolonged bout of ravaging inflation, which destabilized the economy, impoverished millions of people (especially pensioners and others on fixed incomes), and discredited the whole notion of reform (since the rhetoric of reform was being bandied about, even if the reality was quite different). The second and third components of shock therapy were only partly, and very imperfectly, implemented in Russia, where barriers to small business formation are still enormous. The Russian government did pursue a mass large-scale privatization program early on, but no viable bankruptcy regime was in place. Direct subsidies to large enterprises in Russia (including nominally private firms) continued and even increased in the first half of the 1990s, in contrast to the situation in Poland and Hungary, where hard budget constraints were imposed at the outset and large SOEs were forced to adjust or

languish. Subsidies to Russia's large enterprises have continued at a high level in the latter half of the 1990s, albeit in indirect form (tax writeoffs, payment arrears, etc.). As a result, microeconomic inefficiencies in the newly "privatized" economy not only remain as glaring as ever, but, ironically, have become even more entrenched.

To be sure, the obstacles to drastic reform in Russia when the transition began were enormous. The Soviet Communists had left a horrendous economic situation in their wake, which would have been extraordinarily difficult for any government to fix. The effects of so many decades of central planning weighed heavily on the new Russian government.

In view of this onerous legacy, some observers have claimed that shock therapy, including early macroeconomic stabilization, would not have worked in Russia. But is that really the case? Consider what happened in Poland. In late 1989 and early 1990, when Poland was embarking on its program of shock therapy, many observers were convinced that the program would never work. At the time, Poland was plagued by hyperinflation, sharp economic decline, and a crippling foreign debt. Predictions of failure abounded, and many observers warned of dire political consequences. Experts cited in *The New York Times* and other leading newspapers said they were "deeply worried about an explosion of malcontent" and "strong social protest" that "could threaten Polish democracy" and even inspire "the Communists and military to seize power." Poland, it was alleged, would be wracked by a series of debilitating strikes and unrest because of its well-organized labor force and history of labor militancy in the face of economic hardship.

Yet, as it turned out, shock therapy in Poland worked remarkably well. The experience of Poland confirms that a Communist country in dire economic straits (as Poland was in 1989) can achieve prosperity if it has competent and courageous leaders who are willing to implement drastic reforms. To be sure, there was an extraordinary national consensus in Poland in late 1989 and early 1990 in favor of abandoning Communism. This gave Tadeusz Mazowiecki's government a crucial boost at the start, and Mazowiecki and his finance minister, Leszek Balcerowicz, took full advantage of it. Nevertheless, that consensus soon dissipated, and Mazowiecki's government was gone by the end of the year. Over the next few years, Poland experienced numerous changes of government. The crucial thing, however, was that all those governments stuck to the drastic reforms that were enacted in early 1990.

Russian president Boris Yeltsin had a similar window of opportunity in the wake of the failed coup attempt in August 1991 and the collapse of the Soviet Union in December 1991. Yeltsin's first prime minister, Yegor Gaidar, wanted to take advantage of this opportunity. Unfortunately, Yeltsin chose not to seize it. In early 1992, Yeltsin made a crucial decision to undercut Gaidar and give carte blanche to the free-spending head of the Central Bank, Viktor Gerashchenko. By the time Gaidar left office in October 1992, the economy was in turmoil and hopes of real reform in Russia were doomed. Almost everything that went wrong afterwards was caused, at least to some degree, by these crucial early decisions.

The primary blame for Russia's failure to pursue shock therapy lies with the Russian government itself, and specifically with Yeltsin. Difficult though it would have been to undo the perverse effects of Soviet central planning, a more courageous and far-sighted leader might well have

succeeded. Yeltsin was not such a leader, and despite the credit he deserves for having led Russia into the post-Soviet era, he will also long be remembered for the economic plight in which Russia now finds itself.

The Role of US Policy

Even though the Russian government bears dominant responsibility for the failure of economic reform in Russia, the US government deserves part of the blame for its skewed priorities and misguided advice. To the extent that Russian leaders were inclined to eschew shock therapy, the US government greatly reinforced those inclinations. US officials had a disproportionate say in the many billions of dollars that were provided to Russia via the International Monetary Fund without an adequate quid pro quo. In some cases the IMF itself squandered funds, but the real problem most of the time was the US government, which repeatedly pressured the IMF to transfer money to Russia even when it was obvious that the Russian government would not come close to meeting the IMF's conditions.

This remarkably indulgent policy was driven mainly by the US government's preoccupation with Russia's nuclear weapons. US officials seemed to believe that a failure to turn over money to Russia would risk social instability, which in turn would endanger control of Russia's nuclear arsenal. From the US government's perspective, it was worth overlooking the misuse and waste of certain funds so long as the money was presumed necessary to avert social unrest.

This line of reasoning was enormously counterproductive. The billions that were transferred to Russia became a lubricant that allowed the Russian government to avoid real reform. The IMF loans gave the Russians every excuse they needed to defer long-overdue reforms. The US government did itself and Russia a disservice by insisting in the early to mid-1990s that funds be transferred to Russia even when the Russian government was engaging in irresponsible economic policies. US tolerance of Russia's unsound policies was compounded by the misguided program of mass large-scale privatization that US officials, working via the United States Agency for International Development (USAID), helped set up and implement in Russia in the early and mid-1990s. (This policy, it should be emphasized, was the administration's policy, not USAID's per se. Some experienced personnel at USAID were skeptical about the merits of the mass privatization program, but were obliged to follow through on it.) Senior US officials gave such high priority to the large-scale privatization program that they were willing to overlook or tolerate a host of irresponsible policies. So long as large-scale privatization was moving ahead, that was deemed sufficient evidence of "reform." US priorities, unfortunately, became skewed.

Even if US officials had been less tolerant of Russia's macroeconomic transgressions, the high-level focus on mass large-scale privatization was misguided in itself. The transfer of ostensible ownership of a large number of value-destroying and worthless enterprises was counterproductive in the absence of an effective bankruptcy regime. Russia's microeconomic inefficiencies thwarted efforts in the mid-1990s to achieve sustained growth.

These microeconomic problems were aggravated by the IMF's loans, in much the same way that those loans permitted Russia to eschew early macroeconomic stabilization. The loans helped the

Russian government avoid selling controlling stakes in lucrative sectors (e.g., telecommunications, gas) to strategic foreign investors. Those sectors instead were reserved for cronies of the ruling elite. If the government had been forced to raise money by selling controlling stakes in lucrative companies to strategic investors and providing a clear ownership structure for those companies, the Russian economy today would be in significantly better shape.

The misguided advice that the US government provided about large-scale privatization was by no means the only issue on which the United States went astray. The Clinton administration was also instrumental in setting up the Russian short-term bond (GKO) market. Funding for this initiative was channeled through USAID and then through the Financial Services Volunteer Corps. Although the original aim of the policy--encouraging the Russian government to stop the endless printing of money --was eminently laudable, it was an inherently risky measure to propose when dealing with a Russian government that had proven so fiscally irresponsible. The GKO's ended up creating enormous debt and liquidity problems, the consequences of which became fully evident in 1998.

When it became clear in the spring of 1998 that the Russian currency was coming under severe challenge, the US government (and the IMF, with US encouragement) urged the Russian authorities to hang tough and defend the ruble. The United States persisted in this line even though the IMF's own data indicated that domestic inflation in Russia from 1995 to 1998 had outpaced the depreciation of the ruble by 35-40 percent. With full US approval, the Russian government continued to expend its dwindling foreign currency reserves in a vain attempt to stave off speculators. The entire \$4.8 billion loan that Russia received from the IMF in July 1998 (a loan that was provided only after US officials exerted enormous pressure on the IMF) was squandered on this futile cause. As a result, currency speculators earned huge profits at the expense of ordinary Russians.

It should have been abundantly clear by the spring of 1998 that a country like Russia was a prime candidate for continued challenges by currency speculators who were increasingly leery of emerging markets. Multi-country studies have shown that three key factors--a real exchange rate appreciation, a low level of foreign reserves relative to M2, and a weak banking system--can leave an emerging market highly vulnerable to speculative panics. All three of these factors were acute in Russia, reflecting the broader lack of systemic reform. It is not at all surprising, then, that serious financial pressures emerged in Russia.

What is surprising is that the IMF and US government not only went along with, but actively encouraged, the Russian government in its quixotic defense of the ruble. The recent experiences of Malaysia and Thailand should have underscored the folly of trying to fend off this sort of challenge in economies that are weak in the three areas mentioned in the previous paragraph. Those two East Asian countries squandered vast amounts of money in futile efforts to defend their currencies. (Both did so against the IMF's advice.) In 1995, Argentina was able to stave off devaluation, but Russia's situation in 1998 was very different. Without further enormous injections of outside funding, devaluation in Russia almost certainly was inevitable. The only real question was when it would occur. Had the currency devaluation been implemented early and the extra billions of IMF dollars not been wasted on a vain defense of the ruble, the problems that came to a head in August 1998 would have been less acute, and the government headed by

Sergei Kiriyenko would not have been thoroughly discredited. Kiriyenko could have rightly pointed out that he had inherited a disastrous situation from his predecessor, Viktor Chernomyrdin. An early, preemptive devaluation, coupled with the establishment of a currency board, would then have been seen not as an admission of failure, but as a sign of the need for drastic change. Such steps would have caused disruption, but they would have been far less debilitating than the belated devaluation in August proved to be.

Unfortunately, at the behest of US officials and the IMF, the Russian government chose not to pursue this course. The result was that a bad situation was made much worse.

Conclusion

The failure of economic reform in Russia ultimately must be blamed on the Russian government itself. For various reasons, Yeltsin chose not to embrace shock therapy. The strategy that Yeltsin did adopt may have been politically expedient, but it was damaging to Russia's long-term interests.

To the extent that US policy affected the Russian government's calculations, the impact was mainly a negative one. US objectives were sound, but the United States was consistently willing to sacrifice or step back from those objectives. By pretending that what was going on in Russia was radical market reform, the United States contributed to the widespread impression among ordinary Russians that the half-baked measures adopted by Yeltsin were in fact the painful "reforms" needed to create a market economy. As a result, the very notion of market reform has now been discredited in Russia.

What lessons does this hold for US policy in the future?

- US economic relations with Russia must be tied to economic fundamentals. In the absence of genuine reform in Russia, the United States should not have provided and condoned billions of dollars of loans. Nor should it have made unwarranted rhetorical claims about Russia's reforms and embraced the notion of a G-8. Latin American leaders are justified in complaining that their countries, with sounder economies than Russia's, have been treated much more stringently by the IMF than Russia ever was. Russia should never again be treated more leniently than other IMF recipients.
- No further money should be provided to Russia by the IMF or the World Bank unless the Russian government adopts appropriate policies. US officials must refrain from interfering with the IMF's judgment about when those policies are in place.
- The US government should let investment flows be determined by market forces. It is highly unlikely that private investors will want to reenter the Russian market anytime soon. In the event that Russia does again become attractive for Western investors, the US government should let those investors assume their own risks. The government should not be in the business of subsidizing or mitigating the risks of private investors who want to venture back into Russia.
- In particular, the government should not be cushioning private investors against the risks of investing in Russian bonds. US bankers and fund managers eagerly helped the Russian government bury itself under an ever larger mountain of debt. The investment bankers

received lucrative fees from each new issuance of bonds, and thus they sought to win over creditworthy debt issuers in Russia--oblast governments, companies, banks, and the like--while assiduously glossing over the problems that were emerging. Needless to say, the August 1998 crisis has induced much greater caution on the part of US investors. It is disconcerting to see that the US Overseas Private Investment Corporation (OPIC) is proposing to cover the political risks that bond investors incur in emerging markets. Even though the new OPIC insurance is not intended to apply to commercial risks, the potential for a bailout of private US investments in Russian bonds would work against the very market principles that the United States claims to be promoting. OPIC's programs should be scaled back and phased out, not expanded.

- The debacle with Russia also yields some more general lessons about the risks of IMF lending. As in Russia, IMF loans to other countries (e.g., Brazil) may encourage those countries to avoid or defer urgently needed reforms. That risk is likely to increase as a result of the G-7 countries' decision in late October 1998 to condone accelerated "precautionary" loans by the IMF. This expedited loan procedure goes in precisely the wrong direction. Rather than streamlining the conditions imposed by the IMF, the G-7 countries should be seeking to tighten those requirements.

The rationale behind the streamlined loans is that the IMF should be able to help emerging market countries act swiftly to stave off crippling speculative attacks. The drawbacks to this idea, however, are severe. Once a line of credit has been set up for anti-speculative purposes, the IMF will find it extremely difficult to cut off the loan without seeming to give a green light to the speculators. The risk, then, is that the Fund will compromise its standards to avoid being accused of having triggered a speculative panic. This is bound to deprive the IMF of crucial leverage.

If the United States truly wants to avoid a repetition of the dismal experience with Russia, the notion of giving greater "flexibility" to the IMF should be abandoned. A precautionary fund is likely to spur new abuses. The United States should instead be devising new guidelines for the IMF to ensure that all future recipients of the Fund's money, including Russia, will be held to strict requirements.