

Russia and the Rest: Economic Reform and Western Assistance

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What can we learn about Russia by comparing it to the other post-Communist countries? In particular, what can we learn about the wisdom of applying the brand of economic reform promoted by the International Monetary Fund, and supported by US foreign policy?

Shock Therapy is Painful, but Gradualism is Disastrous

Every one of the 28 post-Communist states to emerge from the former Soviet bloc has suffered a decrease in gross domestic product that makes the Great Depression in the United States appear tame by comparison. It was widely believed at the outset of this process that radical macroeconomic reforms would exacerbate the initial decline. In fact, however, countries that moved rapidly to tame inflation suffered less severe declines. Moreover, countries like Poland, the Czech Republic and Slovenia quickly began to grow again in 1992, while countries that tolerated higher levels of inflation, like Russia, have continued to decline throughout the decade.

The key variable is inflation. Inflation discourages investment and retards growth in any country, but in the post-Communist countries these effects were magnified by the fact that the transition from central planning to markets entailed the complete reallocation of resources in the economy. Restructuring the economy was essential because the existing pattern of production was irrational. As a result, delay could be much more costly than in countries like Brazil or Mexico, where inefficient industries were highly protected in the 1980s, but a domestic market nonetheless allocated resources. The policies that create inflation--cheap credits and generous state subsidies to loss-making enterprises--delayed restructuring by creating incentives to continue inefficient patterns of production. Inflation itself delayed restructuring because it increased the risk of investment, siphoned capital away from the real sector into speculation on the volatile capital and exchange markets, and encouraged massive capital flight.

In addition, high inflation combined with rapid mass privatization, as in Russia, led to a surge of inequality. Inflationary times are characterized by great uncertainty for consumers coupled with lax monetary policies that give enterprise managers access to very cheap capital. Privatization under these circumstances gives the managers a much stronger bargaining position than the citizens and workers who hold the coupons to privatize their factories. Managers can afford to take a long view because they have

access to cheap credit; consumers do not have access to credit, and they somehow have to put food on the table. Under the circumstances, giving the shares to the workers really meant giving them to the managers--at fire-sale prices. Russia is now the most unequal of the post-Communist countries, which is the major reason for the prevalence of extremist political parties there. Countries that dealt firmly with inflation maintained a much more egalitarian division of property.

The conclusion is that the basic strategy behind IMF advice to Russia was sound: bring inflation under control rapidly by employing a tight monetary policy and balancing the state budget. The problem is that after the first four months of 1992, these policy recommendations were never implemented.

Russia is an Ordinary Country

On most indicators of economic reform and economic performance, Russia is a roughly average post-Communist country. The problems it has faced over the last decade are not in any sense sui generis. All of the post-Communist countries have faced surging violent and white-collar crime, widespread corruption, recalcitrant banking sectors, loss-making state enterprises that are too big to bankrupt, and the erosion of traditional sources of state revenue. Some have seen the emergence of widespread barter, the dollarization of the economy, and the explosive growth of uncollectable interenterprise debt. Comparison with other post-Communist countries shows that similar policies led to similar outcomes, but that different policies and outcomes were possible as well. States that rapidly contracted their intervention in the economy, set hard budget constraints for enterprises, and maintained a tight money supply suffered from all of these problems to a lesser degree.

All Economic Basket Cases are Not Created Equal

The biggest difference between Russia and the rest is that Russia is the only post-Communist country with great strategic importance to the United States. This is an important economic variable because Russia's international standing makes it impossible for the International Monetary Fund and the World Bank to credibly commit to holding Russia accountable when it breaks its promises. Unfavorable decisions are routinely appealed to the president of the country with the largest voting bloc. This problem is by no means unique to Russia. Indonesia and Brazil have recently shown that they are too important to be allowed to fail, and during the Cold War even a country like Zaire was able to flout the IMF's conditions because of its importance to US strategic policy.

Of the eight agreements negotiated with the Fund since 1992, Russia has only fully implemented the conditions attached to one. Recent research demonstrates that in most other post-Communist countries, the IMF has much more influence. When it is able to act independently and discipline countries' monetary and fiscal policies, the Fund can have a dramatic, quantifiable effect in reducing inflation and stabilizing exchange rates. Unfortunately, the IMF is unable to exercise decisive influence in the country where we

would most like to see results--and this is a direct consequence of how important Russia is to US interests. It is useless to blame the IMF for this, since it is only the agent of the foreign policy of the major donor countries. In order for the IMF to be truly effective in important countries, it would be necessary for the donors to insulate the Fund from their own abilities to exercise influence. In effect, the IMF would have to become an independent central bank.

In the meantime, we should not expect spectacular results from IMF intervention in Russia, but that does not mean that this involvement is not constructive. Even in Russia, the IMF is able to exercise a degree of influence during the brief window of opportunity while it is negotiating the terms of a new loan. Consequently, the IMF should focus its efforts in Russia on negotiating institutional changes that will have a lasting impact. For example, in 1993 the Fund helped to broker the deal that imposed the first meaningful constraints on the credit policy of the Central Bank of Russia. Later that summer, Russia violated many of the other conditions of its agreement, but the institutional changes persisted.

Russia Probably Won't Collapse, But It Will Be in a State of Collapse for a Long Time

By any measure, the collapse of the Russian state is catastrophic. Federalism as practiced in Russia is equivalent to incipient anarchy, governed by a patchwork quilt of ad hoc treaties with various regions whose conditions are not really observed. The Federal government exercises power in certain issue areas and in certain regions, but its public policy is not consistently implemented across the country in any sphere. The dramatic decline in the government's ability to raise tax revenues has led to the deterioration of public goods across the board: medicine, education, social security, criminal justice and defense. Demonitization of the economy and the expansion of barter have put much of the economy beyond the reach of the state, frustrating efforts to collect taxes or impose hard budget constraints. To anyone familiar with the powerful state apparatus of the Soviet period, this looks like total collapse.

In comparative perspective, however, the Russian state is not so weak after all. It actually governs its territory more effectively and provides more public goods than most governments around the world. Other states, such as Argentina in the 1980s, have recovered from more dramatic declines in tax revenues. Moreover, the experience of developing countries shows that states do not have to be very effective to persist for a long time. Russia probably will not dissolve, as all of the other post-Communist federations have done. Eventually, Russia's human and natural resources will guarantee its place as a resurgent world power, so US policymakers would do well to avoid alienating it in the meantime. However, the mistakes of the Yeltsin era will haunt Russia well into the next century, providing a grim backdrop of inequality, poor economic performance and human misery.