

AFTER THE CRISIS: THE RUSSIAN ECONOMY IN 1999

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Russian Reform: What Went Wrong?

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Among recent transition performers, Russia stands out as an exception. Its August 17, 1998 debacle of a unilateral domestic debt default and subsequent ruble collapse followed by the installation of a Duma-approved, Soviet-era team of policy makers under Prime Minister Evgeny Primakov raise the possibility of a reversal of market reforms.

In the wake of the August trauma, the debates surrounding Russia's turbulent transition have acquired renewed vigor. Were not transitologists, seized with the fervor of a universal answer in the wake of capitalist triumphalism, mistaken in imposing a high-speed solution on an alien Russian situation? This view not only rejects the speed of the process but the underlying recipe itself. The opposite view, opting for market reforms for Russia, attributes the transition costs and chaos to the past burden of a planned economy marked by heavy industry, the military sector and socialized agriculture, and institutional shortcomings.

The current polarization extends from future recommendations for Russia to past actions in Russia. The irrational exuberance of the early phase—with some reform enthusiasts telling us that markets had come to Russia—has switched to dire predictions by habitual doubters warning us of a Russian apocalypse. The scale and complexity of the changes, continuously buffeted by presidential illnesses and governmental changes amidst frequent scandals and widespread corruption, provide little hope for their continued survival along a well-defined track.

From the perspective of these grand issues, an inquiry into the policy package of the past six years seems limited, even unexciting. It is, however, most relevant. Historians and political scientists may continue arguing over the likelihood of Russia ever belonging to the traditions of Western liberal democracies and the problems of describing current political arrangements as genuinely democratic, but economists and policy makers must devise policies, watch their implementation, and be held responsible for the consequences. The former can steer clear of the nuances of economic policymaking in their sweeping assessments;

by contrast, the latter ignore the weight of history and institutions in policymaking only at their peril.

In Russia's case, more than anywhere else, the policy agenda had been constrained by an institutional vacuum and contentious politics from day one. With respect to the former, it was hoped that market economy institutions ranging from a central bank, a banking system, and a tax regime to the legal guarantees of property rights would develop *in response to* appropriate policies. The actual record in this regard has turned out to be so poor as to threaten the continuing adoption of correct policies. As for the political underpinning of the process, the tensions between successive reform-oriented governments and left-leaning lawmakers have been exacerbated by a domineering and unpredictable President given to frequent and meddlesome governmental changes. Given these dual constraints, the "window of opportunity," to borrow a phrase from the heady reform days, turned out to be a treacherous trap.

Despite the narrow opening, several policies were pushed through. Prices were freed from their administered levels. Foreign trade was liberalized: by early 1998, import duties averaged 14 percent, export quotas had been largely removed, and export taxes lowered. Inflation had come down to single-digit levels by late 1997. Finally, most assets including farms were converted into joint stock companies with diversified stock ownership. Small businesses, shops and trading outlets were sold off or auctioned.

Coming on top of the breakdown of the Soviet Union and of the traditional links among enterprises within Russia, the policies had a severe impact. Russia's recession has been unprecedented in recorded history, the real economy having shrunk to half its pre-reform level in a massive deindustrialization. The share of the poor in the population jumped to nearly 40 percent by September 1998.

While output decline, significant unemployment and impoverishment have featured in every transition economy, their impact has been extreme in Russia. Could these costs have been minimized? In particular,

which policies can be held responsible for the severe drop in output?

Price Decontrol, Trade Liberalization, and Deindustrialization

Consider first the impact of price decontrol and trade liberalization on Russian industry. The economy was opened up swiftly in 1992, the average import duty having been fixed at a low 5 percent and rising to 14 percent in early 1998. Soviet-era import controls were abolished. At the same time, relative prices had been moving against manufactured goods, processed foods and the farm sector and in favor of (the monopoly producers of) raw materials, including energy and freight charges for Russian industry. The appreciating real exchange rate favoring imports of consumer goods and processed foods added to the woes of domestic producers battling huge price and quality disadvantages. Nowhere in a transition economy has import penetration reaching 60 percent of domestic consumption been so rapid and extensive as in the case of Russia.

Indeed, the economy was opened up with such dizzying speed, that, in early 1998, Russia's Acting Trade Minister Georgy Gabounia was proposing a *rise* in duties ranging from 45 to 75 percent on a variety of imports, among them U.S. frozen beef, poultry, fish and processed foods, as part of Russia's possible entry into the World Trade Organization (WTO). Normally, potential WTO entrants promise to commit themselves to a *lowering* of bounded tariffs! Recently, with the ruble having tumbled from 6 rubles to a dollar in the first half of 1998 to 24-26 rubles, parts of Russian industry have begun reviving. Rendered noncompetitive by massive price disadvantages vis-à-vis imported items in the old days, some "virtual" producers may, provided domestic inflation is held at bay, turn out to be "real" performers, laying to rest the blanket notion of a virtual economy.

Macroeconomic Stabilization Struggles with No Growth Turnaround in Sight

Let us turn next to macroeconomic stabilization policies and their role in eventually reviving economic activity under a stable inflation regime. Inflation was brought down to a single-digit level in Russia by the end of 1997 via a slowing down of money supply growth rates from quarter to quarter rather than sound fiscal management which continued to be fragile. The

budget deficit was more or less stuck at 7 percent of GDP with consolidated government expenditures continuing at around 44 percent of GDP from 1995 to 1997. Unable to raise adequate taxes and prohibited by the International Monetary Fund (IMF) from borrowing from the Central Bank of Russia (CBR), the government turned to borrowing from the market, increasingly relying on foreigners investing in government short-term bills (GKOs) and long-term bonds (OFZs).

At their lowest levels in the final quarter of 1997, the annualized yields on government securities averaged 25 to 30 percent, far higher than comparable rates abroad. The restrictions on foreign capital flows taking advantage of these differentials were removed far more readily than could be sustained by shaky government finances. That was a mistake. By the end of 1996, the earlier requirement limiting purchases of government securities to domestic investors was lifted, allowing foreign creditors easy access. By the end of 1997, foreign investors in Russian government securities no longer required forward contracts tying them to the eventual remittance of their foreign exchange earnings at an exchange rate specified in the contract. As a result, a foreign speculator could walk into Russia with a sack full of foreign exchange, buy government short-term paper, and walk out the next day by selling it and converting the rubles back into foreign exchange. Russia was poised for a financial crisis at the slightest indication of a weakening ruble. Not to be left out from gainful speculative transactions in government securities, Russian banks borrowed heavily in foreign markets. The default on domestic government debt of August 17, 1998 amounted to \$40 billion.

The Privatization Program: Its Political and Social Fallout

Finally, consider the role of the privatization program in the continuing economic downturn. The program was spearheaded by the ideological motivation to banish the state from asset ownership and by the tactical necessity to keep the reform momentum alive rather than as a calculated device to boost instantly the efficiency of industrial enterprises. As macroeconomic stabilization faltered by mid-1992, a new reform front was opened up. The plan to sell vouchers to every Russian man, woman and child was brought forward in October 1992 enticing one and all to asset ownership and instant wealth. In effect a boondoggle, the voucher program gave a resounding "yes" to Boris Yeltsin and his reforms in the subsequent April 1993 referendum.

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While ordinary Russians played lotto with their vouchers, the big-time players, cash in hand, began acquiring stakes in Russian industry valued at throw-away prices. The emerging financiers had cornered resources in a variety of ways—by capturing precious metals and minerals at fixed prices at home and exporting them at higher prices abroad; by setting up banks and turning around funds, the process facilitated by the massive liquidity that the Central Bank of Russia had been pouring into the economy before inflation control took hold; by managing treasury deposits until 1997 when their management was turned over to special agents.

The process reached its climax in the spring of 1996 when the “semibankiri” floated the “loans for shares” scheme with a promise to manage government stock in some of Russia’s lucrative companies in exchange for credits to the cash-strapped treasury. In the process, the government budget got support, the Yeltsin election campaign got a financial boost, and the oligarchs eventually seized government stock in the “commanding heights” of privatized industry.

In the meantime, little has changed in the running of companies as the oligarchs have played fast and loose with minority shareholders, transferred funds abroad, and concentrated on speculative activity in which returns have been higher. In general, the real sector has been largely bypassed, managers having also successfully avoided bankruptcies that would be inevitable under the efficient norms of private business activity. From that perspective, Russian privatization and its aftermath cannot be argued to have contributed to Russian deindustrialization.

Its impact, however, has been politically destabilizing and socially devastating. The short-lived, reformist government of Sergei Kiriyenko found itself battling the Communist-dominated Duma on the left and the overarching band of oligarchs on the right. At the same time, privatization has been seen as enriching a few at the expense of the many, while depriving the masses of their legitimate share in assets created collectively in Soviet days. In the end, the people got potato patches to subsist on.

Thus fast-paced trade liberalization accompanied by haphazard price decontrol aggravated domestic output decline; unsustainable macroeconomic stabilization mounted on fragile budgetary management and hasty removal of exchange controls failed to quickly turn around the economy onto a growth path. Russia’s deindustrialization arose from undue haste on these

policy fronts. On the other hand, privatization leading to the rise of oligarchs and contributing to public alienation in market reforms turned out to be politically risky and socially corrosive.

Which Way Now?

The August default has put the economy back to the start of 1995 with little hope for sustained economic revival in the face of uncertain macroeconomic stabilization, a heavier debt burden, a banking system in disarray, and shattered investor confidence. The battle on inflation control has been halted, 1998 inflation having jumped to 100 percent. Nor have the prospects for tax collection improved. With respect to macroeconomic management, the lessons of the recent past are writ large. Russia resembles an obese patient whose weight loss can be guaranteed only with a gradual but firm and feasible diet program under meticulous monitoring. From that perspective, the 1999 budget numbers worked up by the Russian government and approved by the IMF constitute an old ritual with few chances of fulfillment.

At the same time, Russian politics continues to be ominous. The political peace crafted by Prime Minister Primakov with the left-wing lawmakers in the Duma and the regional governors in the Federation Council (the upper house of the parliament) is threatened by President Yeltsin via manipulative signals of government changes. The composition of the Duma emerging from the December 1999 elections will, in all likelihood, continue to be left of center, more so if the NATO-led bombing of Yugoslavia damages the election prospects of reformist groups identified as pro-American. The outcome of the June 2000 presidential elections must in turn await the electorate’s verdict in the Duma elections.

The reform pace, constrained by political uncertainties and the left-leaning outcome of the forthcoming parliamentary elections, is therefore bound to be slowed as the international financial institutions move from the misplaced enforcement of the old days to the selective engagement of the new phase. The IMF’s recent accounting maneuver to lend Russia \$4.5 billion over the next eighteen months, just enough to cover Russia’s repayment liabilities to the Fund over the period, is tied to the Duma’s adoption of legislation aimed at streamlining the current bankruptcy laws, firming the tax collection arrangements, and overhauling the banking system. Unlike in the past, the IMF has decided to engage Russia’s lawmakers in the

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reform process. The World Bank will resume its lending after the IMF board of directors formally approve IMF credits that are contingent on the Duma's legislative actions. The Paris Club sovereign creditors and the London Club commercial lenders will thereafter begin negotiations on rescheduling Russia's massive debts. The big ticket items on the agenda, among them cutting back the massive subsidies to the public, restructuring the monopolies, and privatizing land, have disappeared from the drawing board. Hopefully, the process will continue moving along a market-defined route.

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