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Abstract: Describes key trends and developments concerning the economic conditions in Russia from the perspective of Jeffrey Sachs of Harvard University and economic adviser to the Russian government. Effects of political developments on the economy; Industrial development and performance; Policies that rely on humanitarian and technical aid; Efforts of the government towards economic stabilization and market reform.

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Section: HELPING RUSSIA

Goodwill is not enough

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What should Russia do about its sick economy, and what help, if any, does it need from the West? We asked Jeffrey Sachs, of Harvard University, the leading western economic adviser to the Russian government. Here he gives his answer

"URGENT" western action is needed, declared the American secretary of state, James Baker, recently, to support the political and economic reforms in Russia, Ukraine and the other republics of the former Soviet Union's new "commonwealth

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of independent states". "The remnants of Stalinism or the birth of nationalist extremism or even fascism", he warned the West, may stand ready to "exploit the frustrations of a proud but exhausted people in their hour of despair." Yes indeed. So how is the West to respond?

To work out a co-ordinated answer, Mr Baker has invited western governments and international financial institutions to a conference in Washington in early January. None of them has yet offered a coherent plan of action. On present form, the conference will not produce one either.

Russia and the other republics bear the deep economic cancer of seven decades of communism: over-extended heavy industry; bloated, bureaucratic enterprises; a starved service sector; and the absence of market institutions, in law, finance and administration. Now, on top of this systemic disease, the republics face a financial crisis.

Inflation has become hyperinflation. The foreign-exchange coffers are empty. The old administrative structures have collapsed. Only if hyperinflation is stopped and rudimentary market forces introduced through price and trade liberalisation can the new commonwealth start a decisive breakthrough towards long-term, market-led restructuring. Short- and long-term steps alike will require extraordinary efforts of governance and political fortitude.

In these circumstances, Mr Baker and his Group of Seven counterparts must recognise at once that their current policy of relying mainly on humanitarian and technical aid will fall woefully short of answering the "summons of history" invoked by Mr Baker. The conference must go far beyond his declared agenda of focusing on "food, medicine, fuel, shelter". The G7 countries must turn up ready to offer massive financial aid to those states of the new commonwealth that are moving forward with decisive programmes of macroeconomic stabilisation and market reform.

The collapse

The vertiginous collapse of the Soviet economy in 1991 has been a remarkable spectacle, fed by a combination of factors: communist ineptitude and corruption, the utter degradation of the old administrative structures, and the thoughtless reaction of the G7 finance ministers to the growing financial plight of the republics.

The main points of the story are well known. Under Mikhail Gorbachev's piecemeal reforms, communist terror was removed, but market discipline was not established. Workers and managers raked off enterprise income that used to go to government, while the authorities tried to buy social peace through bigger consumer subsidies and welfare spending. Budget deficits soared, and were covered by printing roubles. Meanwhile enterprises were given access to cheap bank credits, with little overall control. The money supply expanded relentlessly, accelerating sharply in 1991.

With prices administratively controlled, but the rouble mountain soaring, demand outstripped supplies. Goods were diverted into black or free markets. The shelves of state shops emptied, and inter-enterprise trade increasingly became a mix of illegal black-market transactions and barter.

The commodity in shortest supply of all was the dollar. Its "official" price was 1.8 roubles. Its market price this autumn reached 100 roubles. Would-be importers inevitably could no more find dollars at the official price than Muscovite housewives could find meat. Exporters too suffered, since they had to return part of every dollar earned abroad, at the official rate. No wonder that in 1990 and 1991 Soviet hard-currency earnings from manufactured exports fell short of Poland's, which have boomed under the convertible-currency system introduced at the start of 1990.

As the regime collapsed, the monetary situation became desperate. Tax flows from the republics to the centre ceased, while expenditures continued, leading to a consolidated budget deficit, centre and republics together, that exceeded 20% of GNP. Administrative price changes and a panicky confiscation of 50-rouble notes proved more farcical than effective.

The disaster culminated with a cut off of money from abroad. For years Mr Gorbachev had been sustained by huge inflows from European banks and governments. In the winter of 1990-91 private creditors at last smelled the rot of the regime and pulled out whatever they could, especially short-term credits. This autumn the post coup leaders of the republics found themselves heirs to large foreign debts, but without financial reserves or access to new credits on reasonable terms. The cut-off also speeded up the collapse of imports, already under way as exports fell. Imports in 1991 have been about half those of 1990, which in turn has intensified the slump in production. When the grain harvest fell sharply, reserves were not enough to pay for needed imports.

Yet as late as mid-November the G7 stood calmly by as Russia's last reserves were depleted by private creditors fleeing the scene. The G7 finance ministers issued grave warnings that the Soviet Union's "creditworthiness" would be harmed by any debt arrears or rescheduling, unaware, apparently, that the Soviet Union and its creditworthiness had already ceased to exist. They threatened Boris Yeltsin's new economic team that emergency food shipments would be halted if Russia took any unilateral action to stop the rundown of what was left of its reserves. Repayments of principal on medium- and long-term debt could be postponed, said the West, but payments of interest and of short-term debts must continue. In the end, Russia had to default anyway. Its official reserves are closer to three days of import coverage than to the three months generally seen as a minimum.

The Russian response

It is clear that the West has so far responded inappropriately to the engulfing financial crisis. Food shortages are not, as it imagines, proof of a need for technical aid in how to grow wheat, or harvest it, or transport it or bake it, but just one of many symptoms of financial collapse.

In contrast, President Yeltsin and his remarkable team of young, radical reformers understand the basic economic truths. The team is headed by the deputy prime minister, Yegor Gaidar, respected by western experts as one of Russia's ablest young macroeconomists. He has appointed several other leading young reformers to key ministerial posts. In one month they have prepared a comprehensive package of measures, which follows the pattern of the radical reforms under way in Eastern Europe.

The broad idea is to start by creating a stable, market-based monetary system, the base for all other reforms, including free trade and rapid privatisation. The shortages and the overhang of roubles are to be ended by allowing prices, wages and the exchange rate to rise to market-clearing levels. Overall, prices are expected to rise more than threefold. By allowing the rouble to float freely, at least at the start of the programme, currency convertibility will be achieved instantly. Given that budget and credit policies thereafter are rigorously tightened, the result should be a one-of jump in prices, spread over two or three months, followed by an abrupt stop to further inflation and acute shortages.

Since the current market rate of 100 roubles to the dollar reflects, in part, fears of a continuing explosion of prices, the tightening of macroeconomic policies should produce a sudden strengthening of the rouble, to perhaps fewer than 50 to the dollar (as in Poland, in late 1989, when credit conditions were tightened). After a few months of floating, the rouble should reach a fairly stable rate. Assuming the Russian government has sufficient foreign exchange reserves, it would then undertake to peg the rouble at that level.

This quest for monetary stabilization will begin on January 1st, when the government will end almost all price controls, float the rouble, and start trying to slash the budget deficit by some 20% of GNP and staunch the flood of credits still being extended to enterprises. Trade barriers will be lifted, and various laws strengthening private property and business introduced. At about the same time sweeping measures will be brought in by the bright new privatization minister, Anatoly Chubais. These will require thousands of manufacturing enterprises to be converted to joint-stock companies, some shares being distributed at once, free of charge, to workers and managers, so as to create some real ownership as swiftly as possible. Small shops will be auctioned rapidly by local governments.

Mr Gaidar's team, however, know all too well that the financial chaos could easily engulf them before their reforms take hold. Isolated violence related to food shortages has already begun to break out, and

political demagoguery is on the rise. So the Russians have appealed urgently to the international Monetary Fund to help them design the reform programme and at the same time to help mobilise international financial backing for it. And they have explicitly welcomed the IMF'S traditional conditionality, to bolster self-discipline, to help ward off populist excesses in the Russian parliament, and, most important, to demonstrate to the world that they mean what they say.

An opportunity for the IMF

The IMF can play a vital role in this emergency, overcoming the naivety and lack of vision in the West. In professionalism, experience and institutional mandate, it has no rival. Its conditionality can help to assure sceptics that financial aid is being used to support real reforms (as recently in many countries, including Bolivia, Mexico, Poland and Venezuela). The question is whether the IMF will rise to the occasion, or simply take directions from western governments. It sat on its hands last month as the G7 hassled the Russians over their debt, though it knew very well that Russia's cupboard of reserves was bare. When the Washington conference begins, all eyes should be on Michel Camdessus, the IMF managing director.

What he should propose, and offer to help co-ordinate, is the following: * Economic reform. First, and most important, the IMF should seek to negotiate a for real macroeconomic programme with every ex Soviet republic prepared to make the radical reforms needed. In effect, it should treat the republics as member countries, their programmes being subject to approval by the IMF executive board and to standard IMF monitoring and conditionality.

The IMF could not handle negotiations with all the republics simultaneously, unless the small ones essentially agree to do as Russia does. In practice, it should throw its limited resources into dealing with Russia and Ukraine. Since Russia is already far ahead of Ukraine in planning its reform, its programme could be negotiated by February, and ratified by March. For Ukraine, approval in April or May is a realistic target.

- The money. Since the republics are not in fact members, the IMF will not be able to lend directly to them. Instead, it must rely on western governments to do so. At the same time, preparations for full membership should move forward, to be completed by mid-1992, at least for Russia and Ukraine, and soon thereafter for other republics.

A plausible financial package to back the Russian programme should be set as follows (packages for other republics could be similar, but smaller). Russia will need a stabilisation fund of around \$5 billion to help peg the newly convertible rouble, after an initial period of floating has produced a reasonable market rate. The fund would go into operation once the programme was approved, and Russia's access to it would be linked to compliance with the programme.

In addition, Russia should receive in 1992 around \$6 billion of general balance-of-payments support, and another \$6 billion of food aid. These should begin immediately, to help the initial measures of price liberalisation and meet shortages of food and other essential imports. Even these forms of assistance should ideally be tied to the IMF programme; but time is too short. Of course, disbursements after the programme is agreed could be made conditional on compliance with it.

Balance-of-payments funds are needed both to help reverse the disastrous fall in non-food imports this year and to support the rouble at the start of its float. As with food aid, they should be allocated on a market basis, by selling the reserves into the newly free foreign-exchange market.

During the early months, Russia should receive about \$500m a month for this purpose. Later support could be linked to formal structural-adjustment loans negotiated with the World Bank, but financed by western governments rather than the Bank itself. The Bank's programmes should most urgently focus on the establishment of a social safety net (including unemployment benefits and cash payments to low-income households) and on the introduction of market forces at all levels of the food sector.

The food aid--other republics would need about \$5 billion between them--would serve several purposes. It would compensate for this year's bad harvest and get food quickly to urban areas. It would also greatly

facilitate the freeing of food prices, by encouraging expectations that they will settle at reasonable levels. As in Poland in mid-1989, price decontrol can decrease market supplies in the first few days or weeks, if soaring prices lead producers to expect they will soar higher still. If a government commands large stocks of food that it can sell into the wholesale market, such destabilising expectations can be reversed.

Some western food donors have proposed highly administrative methods for distributing their aid, supposedly to avoid it being "diverted" from the intended recipients; some people have even talked of enlisting the Red Army to deliver supplies. If the goal is to feed the poor, however, there is a much simpler, market-oriented way: the republics' governments should simply sell wholesale and then direct the proceeds toward the poor. Distributing cash is much easier than distributing food.

- Technical assistance. The IMR should urgently sponsor technical-aid missions to the Russian central bank and finance ministry (and soon to the other republics). To staff these missions, it should start working more closely with private law firms, investment banks, accounting firms and management advisory firms. Japan could provide the funds needed.

The IMF could also act as an information clearing-house between the reformers in the various republics. After decades of institutionalised lying and phoney data, the republican authorities do not trust each other, but would trust the IMF as an honest broker. For example, it could help Russia and Ukraine co-operate in the introduction of the new Ukrainian currency, the grivna, due early in 1992. At present, Russia is afraid that Ukraine, once it has its new currency, will flood the Russian market with roubles. Ukraine is terrified of being cheated by a monetary policy under Russian control. The key will be to withdraw the roubles now circulating in Ukraine, most directly by swapping the old money for the new.

- Foreign debt. The IMF should call on western creditors--governments, suppliers and banks--to forgo all debt service, interest and principal alike, in 1992. As in any virulent financial collapse, a standstill is needed while the bankrupt party puts its house in order under new management. The debts would still remain payable, in full, eventually.

More steps for the West

There are many other steps that the West should take. The European Bank for Re construction and Development should set up funds in each of the reforming republics to lend money to new private enterprises, as America has done in Eastern Europe. The West should put up another \$1 billion for technical assistance not covered directly by the IMF or World Bank: things like management consultancy for newly privatised firms, establishment of business schools and economics faculties to teach market economics, scholarships for thousands of Russian students in the West. West European lawyers should team up with the American Bar Association, which has agreed to send a team of specialists to advise on reform of the law and the judicial system.

Special attention should be given to saving the significant, high-technology enterprises that were formerly part of the military-industrial complex. There are, for example, about 50 "closed cities", each with a population of around 40,000, set up to produce military goods. Many face a bleak future, unless they can reshape themselves for civilian production. The Russians are keen to throw these cities open, to attract joint-venture partners for that restructuring.

The World Bank and EBRD can help here. The West, notably the European Community and Japan, should open its markets to Russian goods not least because Russia itself will have unilaterally introduced one of the freest trading systems in the world. A good starting-point would be to copy the market-opening measures extended to Poland, Hungary and Czechoslovakia in 1989 and 1990.

The costs

What would all this cost? An overall figure is tricky to estimate, since it is not clear how many republics will truly qualify for aid and at what levels. Moreover, the finance will depend on the date when Russia and the other republics are admitted to the IMR and the World Bank. Until then, support must come from

western governments. Later, these institutions can provide some.

At a rough estimate, a comprehensive package for Russia, including a stabilisation fund, balance-of-payments support and food aid, should cost \$15 billion-20 billion in 1992. Help for other republics would add \$10 billion-15 billion more, if they can get reforms moving rapidly. The total would come to around \$30 billion in 1992. Similar sums would probably be needed for three or four years of reforms, though their use would change over time, from balance-of payments support and stabilisation to loans for investment.

Assuming that Russia, Ukraine and some other republics are admitted quickly to the IMF and World Bank as full members, yearly budgeting might be roughly as follows: \$5 billion from the IMF; \$4 billion from the World Bank; \$3 billion from the EBRD (together with co-financing from private investors); plus \$18 billion from western governments--say, \$10 billion from Europe, \$3 billion each from America and Japan, \$2 billion from other sources such as Korea and Saudi Arabia.

The best hope

Such a package of radical economic reforms and emergency financial aid would not produce miracles. But it represents the best hope for democracy and economic recovery in the new commonwealth. To judge from Eastern Europe's experience, it should be possible in 1992 to end hyperinflation and shortages, encourage the development of hundreds of thousands of new small, private businesses, and establish the basis for rapid export growth based on currency convertibility. A deeper need for industrial retrenchment and restructuring will remain for years, even decades, as the former Soviet Union scales back its old heavy industry, not least its arms factories. Patience and steadfastness will be needed, in East and West alike, to maintain the market reforms in the face of intense pressure for protection of the status quo. As post war Germany and Japan, and more recently Chile and Mexico, have shown, the big pay-offs come after five years of steady reform.

Mr Baker's belief that we can "prevail over the tyranny of the spirit that might threaten reform and democracy, and that might bring darkness to our lives as well" is stirring. His call to action is a service to the West and to the peoples of the new commonwealth. But now both must move on to match words with deeds.

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