

3 Why Russia Has Failed to Stabilize

Jeffrey D. Sachs

Russian stabilization has been a continuing story of missed chances, by the Russians and the West. As the saying goes, Russia and the West have never missed an opportunity to miss an opportunity. The good news is that Russia has so far avoided hyperinflation. The bad news is that the climate of Russian public opinion *via-à-vis* market reforms has continued to deteriorate; most reformers have left the government; political extremism and criminality seem to be on the rise; relations are cooling with the West; there are signs of increasing militarization of Russian politics; and inflation remains high and unstable. In short, Russia remains adrift, and still vulnerable to political upheaval.

The sad part about Russian stabilization is that the underlying precepts of a good stabilization program were discernible at the outstart of reforms in 1992. Unfortunately, the West failed miserably to speed the needed reforms. The G-7 never got deeply involved in the reform process, and certainly never provided vital financial backing at the key moments. Technical IMF advice was highly flawed. The World Bank moved at a glacial pace, probably to avoid getting caught in the Russian thicket. At the same time, the Russians were chronically divided as to what to do. Long-standing patterns of Russian politics - intrigue, chronic lying to the public, improvisation rather than serious administration - all gravely undermined the stabilization effort. Despite the all of the uproar in recent years about "shock therapy" in Russia, knowledgeable observers understand that it simply never occurred, an obvious point when one compares Russia's disorganized and partial stabilization efforts with the decisive actions in the Czech Republic, Estonia, or Poland.

What would shock therapy have entailed in 1992?

The Russian stabilization program that was launched early in 1992 should have included: 1) a *quick* introduction of national currencies for the successor states of the Soviet Union; 2) a budget deficit of between 5 and 10 percent of GDP, financed by non-monetary means; 3) Western financial support for the Russian budget, on the order of 5 percent of GDP; 4) a pegged exchange rate of the new Russian currency as a nominal anchor for Russian monetary stability early in the reform period, backed by a restrictive credit policy and a Western-financed stabilization program; 5) the early introduction of non-monetary instruments of deficit financing, such as Treasury bills and bonds; and 6) a comprehensive rescheduling of Russia's debts. See Sachs (1993, 1994a, 1994b), Sachs and Lipton (1993), and Fischer (1994) for earlier discussions of the basic components of a stabilization package.

These six points have finally become the foundations of negotiations between the IMF and the Russian Government at the end of 1994, but fully *three years* after they should have been put on the table. These basic points were not promoted by the West, nor accepted by the Russian Government, in the early stages of reform. The delay in arriving at this basic stabilization strategy has been as unnecessary as it has been costly.

Consider the evolution of thinking on these points. The IMF opposed the early introduction of national currencies during 1992, and instead promoted the "coordination" of monetary policies under IMF auspices. Among other things, the IMF asserted that the non-Russian republics were not ready to manage their own currencies. In saying this, the IMF failed to recognize that the continued use of the Soviet ruble as a common currency virtually guaranteed highly inflationary policies in the non-Russian republics, and therefore the failure of stabilization during 1992. As a direct result of the use of a common currency among the CIS states, Russia ended up extending credits to the other republics of around 10 percent of GDP during 1992 (see Sachs, 1994a).¹

It is certainly true that Russian attitudes towards a separate national currency were divided. In general, there was support for a separate national currency among the reformers, even if they lacked a clear technical understanding of how to proceed. On the other side, the hard-line opposition generally opposed a separate national currency, as they

still dreamed of a reunification of the Soviet Union. Nonetheless, an early move on a national currency, backed by the West (and the IMF in particular) could have caught the anti-reform opposition off guard. In any event, a separate national currency proved to be the only feasible course of action in any event, as many of us had predicted in the face of IMF resistance early in 1992.

As for the budget deficit, the IMF position at the start was that Russia should aim for a balanced budget, without the need for Western financing of the Russian budget deficit. This was typical "wholesome" but naive IMF advice. The Russian fiscal crisis was deep, and there should have been little expectation that Russia could reduce the budget deficit as a percent of GDP below levels achieved in almost all of the OECD!

Western financing for the Russian budget - that is, loans and grants to help cover the budget deficit in a non-inflationary way - was simply not part of the West's real policy discussion with Russia until 1994, and the possibility of large-scale budgetary financing was not discussed with Russia until late in 1994. The two aid packages announced for Russia, \$24 bn announced in May 1992 and \$28 bn announced in July 1993, were never properly elaborated or delivered. These packages were failures even at the conceptual level, since the G-7 and IMF failed to understand that Western support for Russia's budgetary financing was necessary for Russia to achieve financial stabilization.

The notion of relying on the nominal exchange rate as an anchor to stabilization was also strongly rejected by the IMF until late in 1994, when the institution abruptly reversed position. The IMF's advocacy of a floating exchange rate during 1991-93 flew in the face of stabilization experience, including the successful stabilizations in Eastern Europe in the Czech Republic (1991), Estonia (1992), and Poland (1990), and the major recent stabilization successes in other parts of the world, including Argentina (1991), Bolivia (1986), Israel (1985), and Mexico (1987).

Since almost all the official Western advice regarding Russia's budget deficit focused on deficit cutting, rather than non-inflationary deficit financing, there was little attempt among the Western institutions to help spur the issuance of Russian treasury bills as an alternative to central bank financing. Moreover, the chances for successful stabilization would be enhanced by the use of *indexed* or *dollar-linked* treasury bills,

but once again, there has been little effort or advice in this direction.

Finally, a comprehensive debt settlement, both conditional and delivered in tranches (as in Poland's two-stage debt cancellation) is a necessary feature of Russian stabilization, given the heavy burden of debt servicing on the budget. But, as is well known, the negotiations over the debt have dragged on for years without being adequately integrated into Russia's stabilization efforts. This was especially true during the first two years of reform, when the debt burden loomed large in the Russian thinking, and with actual negotiations tied up in knots over Western insistence on the "joint and several responsibility" for the Soviet debt among the successor states. The legal fiction of "several responsibility" (making each individual state, such as Moldova, legally responsible for the entire debt of the Soviet Union) was hastily forced upon the republics in late 1991 by the G-7. This clause then delayed a satisfactory negotiation over the Russian foreign debt burden until late 1993.

A comprehensive and rapid effort towards stabilization along the six dimensions just indicated - in short, "shock therapy" stabilization - could have succeeded in 1992. Such an effort was politically and financially feasible if the Russian reformers and the Western governments had been alert to the opportunities at hand. Of course, it was a difficult course of action, since it called for a set of sophisticated and consistent policy measures at a time of extreme confusion and upheaval. Active Western involvement and financial backing was needed to provide vital impetus for the overall package. Both Russia and the West would have had to choose, rapidly and unswervingly, to follow the policy prescription.

The basic need for speed should have been clear. The small team of reformers, led by Yegor Gaidar and Anatoly Chubais, needed to lock in certain basic rules of behavior early in the reforms - such as the introduction of a national currency, deep subsidy cuts, a clear rule limiting credit expansion by the central bank, and private ownership of industry - in order to cut through the political turmoil, corruption, and often ineptitude that afflicted the ruling elites of the Russian bureaucracy, the Russian Central Bank, and the Supreme Soviet. Necessary breakthroughs were indeed achieved in a few areas of reform, most notably privatization and the liberalization of international trade (in sectors other than raw materials), but no breakthrough was achieved

in the area of the public finances. At the same time, Russia's underlying financial conditions were deteriorating rapidly during 1992 and 1993, as a result of enormous inherited instabilities and political tensions (foreign debt, declining tax revenues, the increasing confrontation between the President and the Parliament, and so on).

There are in fact many reasons to believe that stabilization could have been achieved in 1992. President Yeltsin was at the peak of his popularity, a true national hero with unquestioned moral authority throughout Russia. Moreover, the Russian Parliament had bestowed Yeltsin with emergency powers for one year to enable the new Government to stabilize the economy. Public opinion was highly supportive of market reforms and democratization. And despite fears of massive social turmoil, there were almost no strikes or demonstrations against the reforms. Of course, as in Poland a few years earlier, this kind of unity and support for reforms could not be expected to last. But as in Poland, it could have been used to achieve implementation of the basic measures needed for stabilization.

By acting indecisively with regard to the public finances, the Russian reformers and their supporters in Western governments and the international institutions gave time for the anti-reform backlash to take hold. Corruption in the bureaucracy quickly multiplied, and at a very high cost to the budget (this has been especially the case in the areas of agricultural subsidies and energy export quotas). The reformers inexplicably failed to block the return of Mr. Viktor Gerashchenko to the leadership of the Russian Central Bank in July 1992, from which position he engineered a highly inflationary policy to support his political patrons in key state sectors. The Russian Central Bank was almost surely home to enormous corruption under Gerashchenko's leadership.

Other fissiparous trends took hold within Russian politics and society at large as it became clear in mid-1992 that the reformers had failed to slay the inflationary beast. Several regions successfully campaigned to withhold or to reduce their tax payments owed to the federal government. Tax evasion and lobbying for tax exemptions by individual enterprises and sectors (e.g. energy) soared. Capital flight increased markedly in step with the Gerashchenko-led flood of new credits to Russian industry, and in response to the failure of the Russian Government to introduce a national currency (leaving Russia exposed to imported inflation from the rest of the CIS).

The eventual political failure of the Gaidar Government came for a straightforward reason: the government had promised a quick stabilization, à la Poland, but did not deliver. In his recent autobiography, *The Struggle for Russia*, Yeltsin (1994) depicts the unravelling of support for radical reforms as a result of the government's failures to deliver on its promises. Yeltsin notes ruefully that in the spring of 1992, "Yegor Gaidar kept giving assurances that stabilization was just around the corner. I was forced to mimic his confidence" (p. 165). Discussing events in the ensuing months, Yeltsin notes:

By the end of the summer [of 1992], the economy was obviously cracking along two fault lines. It was impossible to attempt any economic measures or plan an economy when the prices on everything were constantly jumping.² (p. 174)

Then, in advance of the Seventh People's Congress in December 1992, in which Gaidar was dismissed, Yeltsin worried that:

The opposition's gloating over the Gaidar government's unfulfilled promises threatened to escalate at the Congress into the usual harassment campaign, which would destabilize the country and undermine the authority of our policy and our ideas. (p. 176)

What should the Russian Government and the West do now?

Russian governments, since the start of reforms, have failed to deliver on their promises of stabilization. Rather than sticking to clear and transparent rules of actions, backed by the West, these governments have relied on an unending series of improvisations and often deceptions of the public, with little real Western support and a heavy dose of bad IMF advice. Though 1994 was another year of official pronouncements regarding the urgency of monetary stabilization, little progress was actually recorded. The inflation at the end of 1994 was *higher* than at the end of 1993, as December 1994 inflation soared to 16 percent for the month, compared with 13 percent in December 1993.³ The amount of central bank credits to the budget (as a percent of GDP) during 1994 was probably higher than in 1993, though central bank credits to the commercial banking sector were successfully

restrained in 1994, a very important and positive point for a future stabilization attempt. In the meantime, the public's confidence was further sapped by the October ruble crisis (in which the currency lost 27 percent of its value in one day), and then by the outbreak of war in Chechnya in December 1994.

Delay in stabilization till now has had several adverse financial effects, which make future stabilization attempts more difficult and probably more costly (see Sachs, 1994b, for further analytical and quantitative details on these points). First, the Russian public now places extremely low credibility in the Russian ruble, and thus has engaged in a massive flight of capital, and an unwillingness to buy Russian treasury bills except at enormously high interest rates. As a result of the decline in the ratio M2/GDP, the inflationary consequences have increased for any given level of central bank financing of the Russian budget deficit. Second, tax evasion and tax exemptions have grown enormously, so that tax collections have consistently declined as a percent of GDP, contributing to the chronic budget deficit. Third, the regional governments have successfully claimed an ever-growing share of total revenues, beyond the shift in expenditure functions to the local level. On the positive side, though, we should note the following: Russia now has its own currency; credits to the other republics have stopped; and most credits to the banking system have also been brought under control. Finally, there is certainly increased understanding, both in the Russian Government and in the West, as to what is needed to succeed in stabilization.

As of the start of 1995, the greatest single challenge for the Russian Government is to win back the confidence and support of the Russian people, a challenge that may prove to be impossible before new elections in 1995 or 1996, or even after. A successful stabilization effort in 1995 will require renewed confidence among several key groups: *domestic money holders*, who must trust the ruble enough to stop the flight of capital, who must buy large quantities of T-bills at interest rates that are manageable for the budget; *foreign creditors*, who must grant another round of debt-service relief; *foreign lenders*, mainly foreign governments, the IMF and the World Bank, who should agree to a large-scale foreign loans, on the order of 3-5 percent of Russian GDP (around \$12 billion), to support rapid stabilization; *the Duma*, which has a keen political interest in overseeing the government, and passing

a budget that is actually implemented.

For these reasons, stabilization will require an open, transparent, rule-based economic program, in order to reassure domestic creditors, to appeal to the Duma's stake in its own laws and oversight function, to protect the stabilization program from Presidential and Governmental improvisation, and to help to convince foreign creditors and lenders (a process made vastly harder if not impossible by the events in Chechnya). The core of the stabilization program should therefore be a prominent set of laws and principles, agreed among the Government, the Parliament and President. The laws should include concepts of the following sort (the list is obviously meant to be illustrative, and not exhaustive):

- 1) the Government can not spend any funds not appropriated by the Duma in the Budgetary Act;
- 2) the Government and the President cannot approve any tax exemptions not voted by the Duma (ending the practice of granting tax exemptions by decree);
- 3) all existing tax exemptions established by Presidential or Governmental decree rather than Parliamentary law will be ended, unless reauthorized by Law;
- 4) the Duma will set the limit on overall Treasury bills and bonds that may be borrowed on the market;
- 5) all treasury bills will be marketable securities. There will be no further issues of forced "promissory notes" or arrears on government payments, which have been a disguised method of financing (with the promissory notes even constituting a kind of money printed by the Treasury);
- 6) the Central Bank cannot extend any new net credits directly to the Government during 1995. The Central Bank cannot increase its net claims on the Government above a restrictive authorized limit, established by Law. (The most appropriate limit would be zero net credit in 1995);
- 7) the Duma and Government agree not to initiate any new spending proposals in 1995 after the Budget Act is adopted, except under extraordinary conditions and with a supermajority (e.g. two-thirds of the Duma);
- 8) the ruble will be maintained a stable, market exchange rate against

the dollar, based on the preceding principles, and backed by the stabilization fund provided by the IMF;

- 9) the Government, the Central Bank, and the Duma (e.g. via the Chairman of the Budget Committee) publicly commit to cooperate in order to enforce the Agreement on points 1-8. The Chairman of the Duma Budget Committee should be invited into a special oversight panel to verify that budgetary expenditures are carried out according to the Budget Act.

Proposals like these would help to establish the minimum of clarity, credibility, law and order, transparency, etc., necessary for successful stabilization. The public would have a much better idea of what stabilization is really trying to accomplish. Most important, there would be less chance that individual ministers, or the Presidential apparatus, or the Central Bank, could undermine the stabilization through new improvisation.

From a purely financial point of view, Russia is not that far from stabilization under the budgetary proposals presented by the Government to the Duma in December 1994, if the budget can be adopted and actually implemented; if the government can achieve sufficient credibility with the public; and if the war in Chechnya doesn't destroy all of the existing financial and political assumptions. Specifically, as I have argued on many occasions, it should prove to be possible to finance a budget deficit of 7-8 percent of GDP in a non-inflationary manner, based on:

- 2-3 percent of GDP in net sales of domestic T-bill financing
- 4 percent foreign financing (approximately \$12 billion)
- 1 percent of GDP in privatization revenues (approximately \$3 billion) from sales to foreign investors

An additional key step would be in the introduction of a \$6 billion ruble stabilization fund to allow the ruble to serve as a nominal anchor for the entire stabilization program, assuming that the rest of the package can also be put in place.

Conclusions

The technical conditions for stabilization are neither mysterious nor impossible to implement. This has been true from the start of Russia's reforms in 1992. Yet, each delay has brought greater political and financial risks. The souring of the public's support for reforms; the flight from the currency; the growing tax evasion; and the war in Chechnya, all add to the difficulties of stabilization in 1995. Perhaps the fragile democratic institutions will function effectively enough to achieve stabilization. Perhaps real stabilization will have to wait for another election. Or perhaps the opportunity for peaceful, democratic stabilization of the economy has been tragically squandered in the past three years.

Notes

1. Some recent estimates suggest that the credits might have been a bit smaller, perhaps 7 percent of GDP. Even this lower estimate is, of course, enormous, and makes Russia the largest "aid giver" in the world in 1992 as a proportion of GDP.
2. Ironically, Yeltsin goes on to attribute the stabilization shortcomings during that summer heavily to the absence of an appropriate wage freeze (p. 174), without apparently appreciating the much greater significance of monetary factors at that point.
3. Until mid-1994, the Government lived off of the tight monetary policies of the end of 1993. Inflation came down to around 6 percent per month in the summer of 1994. Then, in July-September, there was another enormous increase of Central Bank credits to the budget, to finance agricultural subsidies, the Northern regions, and many state enterprises in the military-industrial complex. The ruble collapsed in October, and inflation soared in November and December.

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