The Prospects for Reform in Russia

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I'm frequently asked a basic question: "Can Russia make it?" Can it achieve a market economy and democracy? Russia, of course, is not alone in trying economic reform, so before I speculate on its prospects, let me offer some broader global perspectives.

Over the last 15 years, we've seen a global economic revolution of unprecedented speed. This change was fuelled partly by ideas but mostly by the economic disaster large parts of the Second and Third World experienced in the late '70s and early '80s. This was when we saw the failure of both Stalinist-style central planning and the more muted form of government interventionism, the so-called "import substitution" strategy, in Latin America. As these development strategies came grinding to a halt, we had the emergence of an international debt crisis in most of the developing world.

The one part of the world that escaped the crisis was East Asia, which had tried a very different kind of development, based on an outward-oriented, so-called "export promotion" strategy of developing the manufacturing sector by promoting participation in the world economy.

For much of the world, the debt crisis was the starting point on the path to a market economy. One by one, all of Latin America (save Brazil) has now undertaken fundamental economic reform. While this has been difficult politically (and we see that in Mexico), the economic results are clear. Growth has returned to most of Latin America. Hyperinflation has been brought under control everywhere except Brazil. And we see a return of large-scale investment and capital inflows into Latin America and at least the hope for a period of more sustained growth.

I mention Latin America before turning to the former Soviet Union because it holds an important lesson. The reform process has been difficult in Latin America and politically tumultuous. Yet one sees that the reforms have an almost magnetic grip, which seems to transcend politics. Even as governments get elected on platforms opposing reforms, as soon as they come into office they are almost inevitably pulled into supporting and furthering them.

The durability of the reform process, once started, is based on the fact that in the world today there is no viable alternative. Countries must participate in the world production system. They must be in joint ventures. They depend ever more on being able to attract international capital. The example of Latin America then helps us understand the changes under way in Eastern Europe and the former Soviet Union.

**THREE CRISES IN ONE**

While the import substitution strategy of Latin America was unwise and unsuccessful, the Stalinist model was nothing short of disastrous. It closed the economies not only to international trade but also to the flow of ideas, people, culture, politics and spiritual concerns. And it systematically destroyed all the institutions of a market economy, replacing them with the remarkably crude but powerful institutions of central planning. Today, Russia, along with most
of the countries of central and Eastern Europe, faces not simply one economic crisis as it attempts to move away from central planning but three simultaneous ones.

**INSTITUTIONAL TRANSFORMATION**

The first crisis is systemic. It's what we think of when we ask the question: "Can Russia become a market economy?" It involves the huge difficulties of dismantling central planning and all the corrupt and inefficient apparatus that surrounds it; it also involves moving to private property ownership, a law-based society, a judicial system that can enforce contracts, open international trade, and the free play of supply and demand in markets.

**STATE BANKRUPTCY**

The second and not so coincidental crisis facing Russia arises from the fact that by the end of the Communist era the Soviet government had gone bankrupt. In a sense, this is what had happened in Latin America 10 years before. The economic model had failed, and the failure had caused the regime to start to totter. Tottering regimes generally don't like to simply say goodbye; rather, they like to spend down the family fortune in order to hang on to power. And if possible, they like to borrow heavily to keep the economy afloat in the hope some miracle will come along.

Just as Latin America borrowed tens of billions of dollars in the 1970s and then ended up being unable to pay, so too Poland and then Russia joined the international debt club. In Russia, $50 billion of foreign borrowing failed to stave off state bankruptcy. It is hard enough for a state to make fundamental economic change when it is financially healthy, but when it is bankrupt, the task is overwhelming, as the state must struggle to meet the bills, carry on basic government programs, and avoid hyperinflation, while at the same time introducing deep reforms.

**DEEP STRUCTURAL ADJUSTMENT**

If that weren't enough, there is a third crisis. Central planners were planning for a purpose: to create a military superpower. From the first Five-Year Plan in 1928 onwards, the military-industrial complex got the best brains, the best resources, the best technology, the access to hard currency. Just about all the resources in the society went to building a major military power as opposed to building a normal economy.

What resulted is an extraordinarily lopsided economy: a military superpower, together with the living standard of a developing country. The service sector lacked resources and productivity, agriculture was in disastrous shape, and the consumer goods industry was nowhere to be found. This situation is captured well in the remarkable fact that at the end of the Communist period the Soviet Union was producing 160 million tonnes of steel while the United States was producing about 80 million. When you take into account that the U.S. economy was seven to eight times larger than the Soviet in terms of purchasing power, you see that, per dollar of GNP, Russia's economy was about 16 times more steel-intensive than that of the United States.

The counterpart to all the steel production is the absence of shops. Not only are the shops empty, there are very few shops. The number that captures this comes from the International Monetary
Fund, which studied the number of shops per 10,000 population at the end of the 1980s. In the Soviet Union there were 20 retail outlets per 10,000 population, in the United States there were 60 and in Italy there were 175!

Now that Russia has cut back on producing MiGs, aircraft carriers, submarines and tanks, the uses for steel are plummeting. And that points to the third crisis--what economists call "the crisis of structural adjustment." This crisis demands an enormous amount of change--in jobs, in production patterns, in the lives of individuals. The entire country must change what it has been doing for the last 50 years and move out of heavy industry and into services and consumer goods.

These then are the three fundamental crises, and they are of a virulence and complexity that, in my opinion, makes the overall crisis in Russia unmatched in history. All of this would be cause for enormous pessimism but for two factors. First, there is a real sense that there aren't many viable alternatives other than a market economy. Second, there are a number of countries in Eastern and central Europe and the Baltic region that are clearly succeeding in economic reforms. These are countries where the politics and perhaps the ferocity of the crisis were less intense, but by moving quickly and effectively on all three fronts, they are turning around.

GOOD NEWS IN EASTERN EUROPE

Poland is in the lead in this. It moved fastest and hardest at the start of 1990 to introduce what has become known as "shock therapy." Poland rapidly introduced market institutions and cut the budget deficit. For two years things looked bleak, but to an economist's eye many good things were happening. The service sector started to develop, private business to grow and the state sector to shrink. Poland went through political hell. Each government came in attacking the previous one but then carried the policy forward until it was thrown out itself in the next election.

After three years of this, Poland's economy started to grow rapidly. In 1993 it grew 4 per cent, the fastest growth in Europe in a year of recession, and this year it will grow about 5 per cent. Industrial production is up year-over-year 12.5 per cent from March 1993 to March 1994. Poland is sitting on a real boom in many sectors. The private economy now represents about 70 per cent of the total economy, so it has now become almost a normal market economy, with over 2 million private businesses, overwhelming private ownership, a convertible currency, market institutions and a growing economy.

We're seeing good news in other countries, too. The economy in the Czech Republic will grow this year. We also see incredible dynamism in a very small country--Estonia. It carried out the toughest and best monetary reform of all the former Soviet republics. It introduced a new currency, followed a relentlessly tough monetary policy and kept its exchange rate absolutely fixed to the Deutschmark. Estonia's heavy industry collapsed, but then it experienced a boom in light industry. The Swedes and Finns and others came pouring in with highly mobile capital to start producing ski boots, cross-country skis, IKEA furniture . . . just about anything where a factory could be put in place very quickly and assembly operations used. Now, Estonia has low unemployment and a booming economy. Their big problem is how to avoid overheating.
All of this shows that market reforms can succeed, but they have to be pursued very aggressively. The hardest part for people to understand is that the old industry must come down—it is impossible to keep the old structures in place and have rising living standards—and this means real job loss, real anxiety and a real loss of power for the old nomenklatura, which was at the core of the Communist system.

THE IMPORTANCE OF AID

The role of foreign aid is not to make a country rich or even to make it grow; foreign aid can't do that. What it can do is help provide enough political stability to give reforms time to move forward. What the Marshall Plan did was give democratic, market-oriented regimes enough staying power to wait for markets to pull Europe out of the catastrophe of World War II. What aid could do now for Russia is help the government through this difficult period help it to meet the social needs, pay the bills without printing roubles and finance some restructuring of industry.

Unfortunately, the West has provided little real aid to Russia. Big numbers have been floated around, but real support to the Russian government has been negligible.

CAN RUSSIA MAKE IT?

What are the possibilities that Russia can carry off the reforms? I think there is a better than even chance it can plough through and get to the other side, as so many other countries have done. But Russia faces two great risks. The first is that the government may simply lose its authority to manage the affairs of the state: to collect enough taxes, govern effectively, keep the regions in line, enforce the laws, and overcome criminality and corruption. You get a sense that the country could descend into a Yugoslavia or a form of warlordism. That this is a possibility is most evident in the fact that the central government is now collecting very little in tax revenues, which makes for extremely fragile political and financial circumstances.

The second risk I fear is that if the reforms succeed in stabilizing the economy, there will be a lot of unemployment and empty factories. That is the nature of the reform in the early period. It will be fertile ground for demagogy and a fascist kind of appeal that will say: "Five years ago we were strong and respected, and you all had jobs. Now our steel production has been decimated and we have empty factories. We are the laughingstock of the world. Let's put our people back to work in the armaments factories. Let's make Russia powerful again."

In a peculiar way, such a fascist economic program would work in the short run. It could get the factories going; it could get the armaments going. What it couldn't do is raise living standards. Russia would be stuck in the same desperate dead end it was in five years ago. But there could be the feeling of short-term uplift and pride of the same sort that one saw in Germany in the 1930s. I find this prospect real and extremely worrisome—and again, an overwhelming reason why the U.S. government ought to be extending more aid to Russia.

These then are the risks Russia faces. Russia can make it, but it is in a precarious condition. It has great potential; in fact, there is tremendous upside after decades and even centuries of
disaster. On the other hand, there are great political and social risks. Russia could certainly find itself drown towards a new style of fascism. In the end, Russia's outcome may depend on the amount of care and attention it receives from the West. What is worrying here is that the West has so far not risen to the occasion. The G-7 governments have faced up to neither the potential for success nor the very grave security risks. Our governments have so far failed to deliver meaningful aid.

But I don't want to end on a pessimistic note. Around the world we see examples of economic and market reforms working, and we see that the reforms have surprising durability and staying power. In the end, this may provide the answer to the question about prospects for reform in Russia.

This article is adapted from a presentation made in Toronto on May 3, 1994, at "An Evening with Jeffrey D. Sachs." The lecture was the fourth in a series jointly sponsored by Pratt & Whitney Canada and The Conference Board of Canada and designed to enhance business leaders' understanding of critical issues. Previously featured speakers in this lecture series have been Lester Thurow, Rupert Pennant-Rae, and Michael Boskin.

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