A shocking answer to inflation: Jeffrey Sachs argues that the West must now back Yeltsin with real financial aid - Opinion

But could a slower move to the market by itself ease Russia's travails? We have to ask what 'slower' might mean. If it means continued large subsidies for Russia's state industry and agriculture, the answer is almost certainly that slow reform will be far more painful than decisive measures. The past week's events and the preceding political paralysis, were not the result of a social upheaval against economic reform. Rather, they were the last desperate gasps of hardline and violent Communists trying to hold on to power despite the absence of public support.

While Russia's hardliners and many Sovietologists have long bemoaned Russia's 'shock therapy', the country's reformers have instead bemoaned the absence of strong measures during the past two years. Shocktherapy was the plan on paper, but the reality has been a fitful, at times incoherent, set of economic actions, reflecting the paralysis of Russia's politics.

Much progress has been made in the area of privatisation, where the government's voucher programme has been popular and effective. Great advances have also been made in dismantling price controls and abolishing the planning system. Yet the reformers have been completely stymied in macroeconomic stabilisation, and have been unable to abolish highly corrupted and inefficient controls on international and internal trade.

The main idea of 'shock therapy' is to end inflation rapidly, through tough monetary and fiscal policies to produce a sound and stable currency, and open trade policies to introduce competition in the economy. Monetary and fiscal discipline and market competition lead to an initial sharp decline in output, as uncompetitive industry is forced to close, but then to a rapid recovery as a new, competitive private sector takes hold. The countries that have followed this course most consistently - the Czech Republic, Estonia and Poland - have had the strongest recoveries. By contrast, Ukraine, which early on proclaimed its faith in 'gradualism', is collapsing under an inflation even more extreme than Russia's.

Explosive inflation poses the greatest risk to social stability. As Meynard Keynes observed in 1919: 'There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.'

Russia's financial emergency calls for three measures, just the sort that one would see in a company financial restructuring: a standstill on debt payments; new cash infusions from outside creditors (for example the IMF and G-7) to help Russia pay its bills without the need to resort to the rouble printing press; and a sharp internal reorganisation, cutting out subsidies that are fuelling the high inflation.

The G-7 governments were extremely slow off the mark when Boris Yeltsin came to power. As a standard of comparison, Macy's, New York's famous department store, filed for bankruptcy in January 1992, the same month that Russia started its reforms in dire financial conditions. Immediately, Macy's was protected by a court-ordered standstill on debt payments, and by mid-February, had received dollars 600m in emergency credits. It took the West nearly 18 months to grant
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Russia a debt standstill in the Paris Club and to grant it its first dollars 600m from the World Bank.

The long delay of the G-7 was nearly fatal. By failing to move early on, the West left the Russian reformers confused and anxious to find political allies among the old guard. In the middle of 1992, they vainly tried to compromise with so-called centrist forces representing parts of the old nomenklatura. The reforms lost coherence and momentum, especially as the hardline Parliament and Central Bank forced the Government to adopt highly inflationary budget and credit policies. Since mid-1992, inflation has persisted at debilitating rates of nearly 30 per cent per month. Just as Keynes predicted, few could work out why.

Mr Yeltsin probably missed another chance for a breakthrough after April’s referendum, when he probably could have forced through new elections for the Parliament. Instead, he got trapped in complex negotiations over the new constitution during the summer months, while the hardliners regained their footing. In July, the reckless Central Bank further undermined confidence in the reforms by the ridiculous confiscation of rouble banknotes.

Russia now has the chance to put its explosive instability behind it. It would be a tragic mistake for the West to counsel that Russia should slow down now, just as the hardline Parliament has been pushed aside and the Central Bank has been brought under Mr Yeltsin’s control. At last Russia can take real actions, especially if they are backed up by real Western help. These should include cutting back on agricultural and industrial subsidies, and an elimination of remaining controls on international and domestic trade. These controls, such as export licences, are not only economically unjustified but are also the seedbed of Russia’s extraordinary corruption.

The IMF and the World Bank should be on the alert, ready to release more than dollars 2bn of pending loans in the next month if Russia now carries out the necessary steps on its side. The G-7 governments should augment their aid effort by coming up with fresh funds to help support Russia’s social safety net, especially to help fund job dislocation and the cash-starved clinics. To date, the Western world in its entirety has provided less grant aid to Russia in two years than the US alone provides to Egypt each year.

Could anti-inflation policies go forward but without the dislocations to the state sector? This is the popular image of China, a country that is growing rapidly while at the same time protecting its inefficient state industries. In China, there is very little social protection. Its growth is fuelled by tens of millions of peasant farmers who are willing to work for subsistence wages in new private factories to escape even more dismal conditions in the countryside. China’s state enterprises lose money at an extraordinary rate, but fortunately account for less than 20 per cent of the workforce. In Russia, more than 80 per cent of workers were in the state sector at the start of reforms in 1992.

Even now, the political management of Russia’s reforms will not be easy. In Poland, rapid overall growth did little to mollify unemployed workers from state industries, who helped to vote out the government in last month’s election. But although they fight fiercely over the details, even Poland’s left-of-centre parties agree that the future lies in continued macroeconomic stability, privatisation and integration with the world economy, although they fight fiercely over the details. A similar political base for real reform can probably be achieved in Russia through adequate Western aid, a decisive victory against high inflation, and new elections in the coming months.
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(Photograph omitted)