

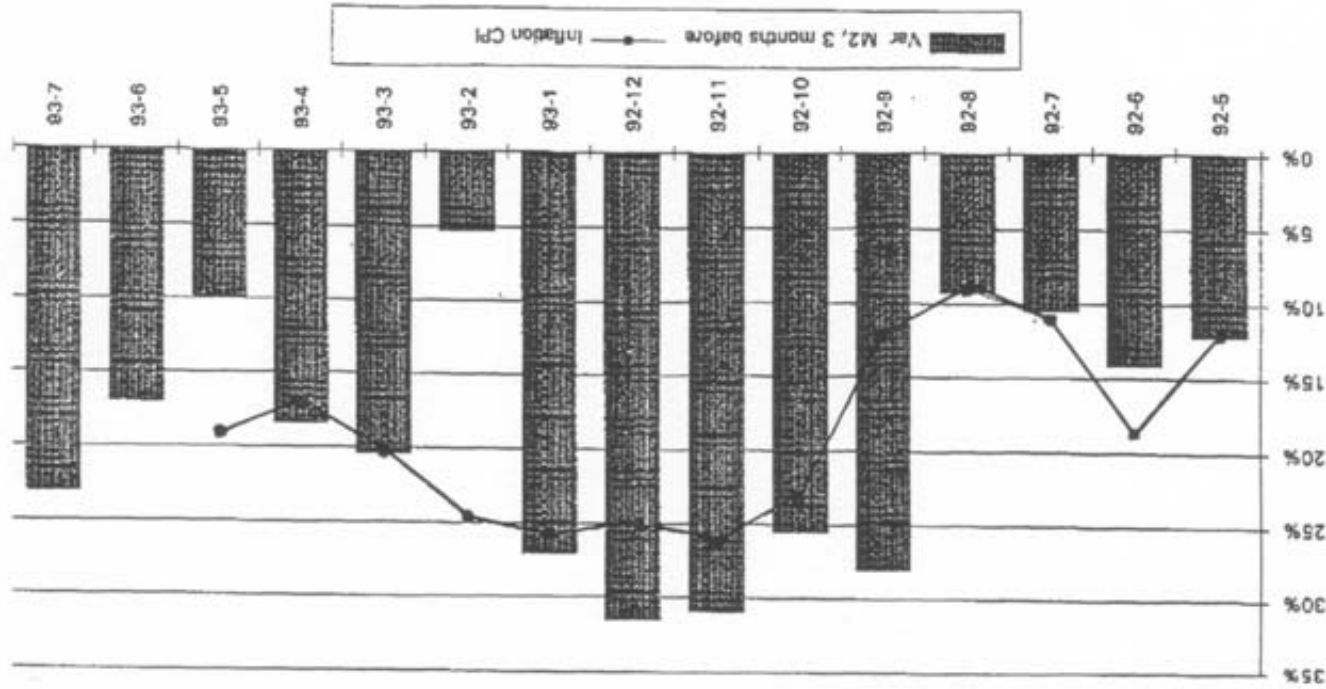
3 Prospects for Monetary Stabilization in Russia

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After 18 months of radical economic reforms, Russia continues to suffer from high inflation. Contrary to the intentions of the Russian Government at the start of 1992, and the experience of several Eastern European countries in recent years, Russia's price liberalization was followed by a sustained period of rapid inflation. One year after price liberalization, at the start of 1993, Russia appeared to be headed for hyperinflation, with monthly inflation rates at 30 percent and rising. A tightening of monetary and fiscal policies in the first half of 1993, under the vigorous leadership of Deputy Prime Minister Boris Fedorov, pulled Russia back from the brink of hyperinflation, but the policies have not yet been sufficient to establish price stability.

In May 1993, the Government and Central Bank of Russia (CBR) reached agreement on a goal of cutting the monthly rate of inflation from around 20 percent per month to around 5 percent per month inflation by the end of the year. This agreement (henceforward referred to as the May Agreement) provides the basis for a \$3 billion loan from the IMF under the new Structural Transformation Facility.¹ This paper discusses the prospects for achieving this target and the more ambitious target of a stable, convertible exchange rate. The discussion is based on the analytical work carried out by the author and his associates at the Macroeconomic and Finance Unit of the Ministry of Finance.

The proximate cause of the high inflation is clear. As shown in Figure 3.1, and well known to the Russian reformers, monthly inflation has tended to follow monthly increases in the money supply (M2) with a lag of approximately 3 months. There is little doubt that the growth of the money supply has been the proximate cause of Russia's ongoing high inflation, though the precise timing of month-to-month inflation is also related to the timing of administrative price changes (e.g. for energy,



Source: calculations of Jochem Wermuth, Peter Orszag, Jacques Delpla, MFU
Figure 3.1 Russia 1992-3: monthly inflation (CPI) and growth of the money supply 3 months before

public transport, and utilities). The real problems in slowing inflation thereby revolve around the problems of slowing the growth of the money supply.

As in any case of high inflation, the problems of reducing money growth are economic, political, and institutional in character. Some issues are unique to the former Soviet Union, such as the problem of several countries in the "ruble zone" all simultaneously using the same currency. Other problems are common to countries in transition from socialism, including the countries of Eastern Europe, such as the difficulty of weaning state-owned enterprises from cheap credits. And some problems are emblematic of virtually all countries battling high inflation, such as the political difficulty of ending consumer and producer subsidies that undermine budgetary balance. None of these problems is insurmountable in Russia. Stabilization is within Russia's reach in 1993, if realistic but consistent policies are pursued.

Russia's reformers should seek new ways to intensify the political and institutional forces behind stabilization. In other areas of successful reform — price liberalization, unification of the exchange rate, voucher privatization — bold executive actions were taken rapidly, often in the face of strong initial opposition which then diminished over time. In the area of stabilization, by contrast, even the goals have typically been stated in gradual terms (for example, the May agreement states that "Our ultimate objective is to stabilize the exchange rate" but that "in the meantime, the ruble will continue to float. . ."). International experience and Russia's own recent experience strongly suggest that a bold package of actions should be undertaken to peg the currency and bring the high inflation to a decisive end. This paper discusses the possible contours of such a package.

The economic underpinnings of high inflation

To understand the prospects for ending the high inflation, it is important to have clearly in mind the recent chronology of monetary and fiscal policy. There are four phases to keep in view: 1) pre-1992, characterized by highly inflationary monetary and fiscal policies, combined with administrative price controls; 2) January–June 1992, in which the monetary overhang was ended by price liberalization, and inflation was falling to single-digit-per-month rates as the result of moderately restrictive CBR and budgetary policies; 3) June–December 1992, involving a strong acceleration of the money supply and increase of the budget deficit; and 4) January–June 1993, involving a modest tightening of monetary and fiscal

policies, with the announced intention to tighten further throughout 1993. Even in the fourth phase, however, the budget deficit remains large, especially as a result of continuing subsidies on consumer and producer goods. Let us consider each of these phases in turn.

Pre-1992 monetary and fiscal policy

In 1990 and 1991, there was a substantial buildup of excess aggregate demand, leading to intensified shortages and black-market inflation. The Soviet budget deficit was enormous (around 20 percent of GNP in 1991), and was financed by credit creation. The money supply (M2) relative to GNP rose significantly, reaching 85 percent of GNP at the end of 1991.² Also, wages rose sharply while prices remained constrained by official price controls, so that the measured real wage shot up far above historical norms. Of course, the real wage could not be converted into real purchasing power given the increasing intensity of shortages at official prices. Monetary policy was gravely complicated by the emergence in 1991 of 15 independent central banks, one in each of the republics, in addition to Gosbank (which was closed only after the dissolution of the Soviet Union in December 1991). Each republican central bank assumed the authority to issue ruble credits without aggregate limits or even rudimentary cooperation. The printing of ruble banknotes remained in the preserve of the Soviet Government and then the Russian Government, though several other republics introduced parallel banknotes, which in most cases eventually became the basis of distinct national currencies.

January–May, 1992

The monetary overhang was eliminated in January 1992 by the liberalization and resulting large jump in prices, estimated at 245 percent in the month. During February–June 1992, monetary and fiscal policies were moderately restrictive (at least in comparison with the preceding price jump), with M2 growing at an average of 10 percent per month, in the face of much larger price increases following liberalization. Monthly inflation rates fell to around 10 percent by mid-year, reaching the low point of 9 percent in August 1992.

June-December, 1992

The increasing tightening of monetary and fiscal conditions prompted both political and economic reactions. The industrial and agricultural lobbies pressed for increased credits, as did the other states in the ruble zone. Many of the CIS states, most importantly Ukraine, introduced substitutes for ruble banknotes (even before formally creating a new currency), thereby increasing the cash money supply in the remaining part of the ruble area. Large inter-enterprise arrears appeared, adding to the pressures for new credit increases. These pressures led to a change in Central Bank leadership, with Viktor Gerashchenko replacing Georgii Matyukhin. The new CBR leadership sharply increased the growth of the money supply, to around 30 percent per month on average during July-December. Various budgetary subsidies, and especially implicit subsidies on imported items (in the so-called centralized imports scheme, discussed below), were large and rising.

January-June, 1993

The acceleration of the money supply led to near-hyperinflationary conditions by the end of 1992, with inflation rising from its low in August to 27 percent in December, with a clear upward trend. After the change in Government in December 1992, the new cabinet declared the intention to avert hyperinflation by tightening macroeconomic conditions. The money supply growth moderated, and inflation fell to around 20 percent by mid-year. Modest budgetary tightening was pursued, although campaign promises by the President and Supreme Soviet made during the April referendum drive threatened to destabilize fiscal policy. The Government reiterated its intention to tighten fiscal policy in the May agreement with the CBR and the IMF. The agreement established tighter limits on central bank financing of the budget, and a target of monthly inflation of 5 percent by December 1993.

To judge the feasibility of the targets, it is important to gauge more carefully the reasons behind the money supply increases in 1992, as well as the situation with the budget as of mid-1993. Turning first to monetary policy, is the CBR correct to argue that the rapid money supply was inevitable, in effect a "lesser evil" in the face of falling output and rising inter-enterprise arrears? Will similar problems plague the renewed attempt to tighten credit in 1993?

Table 3.1 shows the distribution of CBR credits to the economy in 1992. We see that about half of the credit expansion was destined for industrial enterprises.³ One-third was destined for budgetary financing, and fully one-fourth was destined for other republics. Since total credits were about 40 percent of Russian GNP in 1992, around 10 percent of GNP actually was lent (in effect given) to the neighboring states. Let us turn first to consider the CBR's motivations for the large expansion of credit to industry, and then consider the credits to the "ruble zone" and to the budget.

Table 3.1 Central Bank credits in 1992 (bn rubles)

| | Total increase (rubles) | Total increase (percent) | Percent of GDP |
|-------------------------|----------------------------|-----------------------------|----------------|
| Total | 6,099 | 100 | 40 |
| Budget | 1,263 | 21 | 8 |
| Enterprises: | 3,306 | 54 | 22 |
| via banks | 2,524 | 41 | 16 |
| via Ministry of Finance | 782 | 13 | 6 |
| Other republics | 1,532 | 25 | 10 |

Note: credits to enterprises includes all central bank credits to commercial banks, plus several credit lines via the Ministry of Finance, including credits for working capital indexation (600 billion rubles), and various sectoral loans. There are several off-budget governmental accounts that ran surpluses in 1992, so that net central bank credit to the consolidated government sector is less than shown.

Credits to the enterprise sector

The Central Bank (and parts of the Russian Government opposed to restrictive monetary policy) gave several reasons for the inflationary financing of industry in 1992. In mid-1992, at the start of the acceleration of money growth, CBR Chairman Viktor V. Gerashchenko asserted that the money supply had to "catch up" with the price increases at the start of 1992. Since prices had risen several-fold, while the money supply had been held in check (at least relative to prices), the CBR claimed that real money balances were now inadequate for the productive sector of the economy. The alleged shortage of real money balances was said to

be an important factor in the falling production and in the rise of inter-enterprise arrears. In fact, the Central Bank argued explicitly that it would be possible to increase production and reduce arrears by increasing the money supply, without an increase in inflation.

The CBR also maintained that, in any event, price stabilization was premature since Russian enterprises and the Russian Government were not yet equipped to deal with a truly competitive economic environment, complete with bankruptcies and high unemployment. According to the CBR, enterprises should first be given time to raise their efficiency through increased investments, in order to lower the eventual costs of stabilization. Moreover, the CBR maintained that Russia was unequipped to handle rising unemployment, so that it had no choice but to maintain rapid credit growth to preserve jobs.

These positions have in fact been widely held among Russian political elites and state managers. They reflect various confusions that have hindered adequate monetary policies. The first confusion is that money should have "caught up" with prices after the price liberalization at the start of 1992. Russia began the price liberalization in a condition of extreme excess demand and shortages, so that the average market-clearing price level was much higher than the official price level for the level of the money supply in the economy as of January 1992. It was therefore to be expected (as had occurred in Poland, for example), that price liberalization would not only change relative prices, but would raise the average price level, even with no further changes in the money supply. In other words, it was to be expected that prices would rise sharply relative to the money supply. Once macroeconomic balance was reestablished after the jump in prices following price liberalization, *further* money supply increases should have been expected to raise prices yet again. This is of course what happened.

The second mistake was to view the decline in industrial production as a result of monetary policy, rather than structural adjustment. One of the striking lessons of Eastern Europe's adjustment has been that *every* country in the region has experienced a sharp initial drop in production irrespective of the tightness or looseness of monetary policy, as shown in Table 3.2. In fact, the "shock therapy" of Poland has resulted in the smallest drop of production, while the supposed "gradualist" cases of Bulgaria and Romania have had far larger drops.⁴ In the FSU, Ukraine's highly inflationary policies have certainly not saved Ukraine's industrial sector from large decline. Evidently, something is going on much deeper than monetary policy. The socialist economies were heavily distorted in the sectoral

distribution of resources and output, with heavy industry built up at the expense of light industry and services. In the Soviet Union, the buildup was concentrated especially in the military-industrial sector. After price liberalization and a sharp cutback in state orders in each of the economies in transition, the heavy industry simply lacks customers. Even with cheap credits to maintain production, the enterprises cannot find customers to buy the output.⁵

Table 3.2 Industrial production in Eastern Europe, 1989-92 (change in %)

| | 1990 | 1991 | 1992 | 1989-92 (cumulative change) |
|----------------|-------|-------|-------|--------------------------------|
| Poland | -24.2 | -11.9 | +3.5 | -30.1 |
| Bulgaria | -12.6 | -23.3 | -15.0 | -43.0 |
| Czechoslovakia | -3.5 | -21.2 | -10.6 | -32.0 |
| Hungary | -4.5 | -19.1 | -9.8 | -30.3 |
| Romania | -19.0 | -22.7 | -22.0 | -51.2 |

Source: United Nations, Economic Commission for Europe, *Economic Bulletin for Europe*, 1992.

The third error was to view the inter-enterprise arrears as a sign of overly tight monetary policy. In fact, several related characteristics of the Russian economy seem to have contributed to the problem, as stressed by Jacek Rostowski and others: 1) enterprises were not used to demanding payment from their customers, since they had previously been guaranteed payments by the state following shipments according to the state-order system; 2) enterprises expected that the CBR or the Government would continue to guarantee such payments; 3) there were virtually no penalties for late payments; 4) enterprises continued to ship to customers even when they *knew* that the customer could not pay, because of their expectation of a bailout combined with a lack of alternative customers in any case; 5) the breakdown of the settlements process among the banks, including very long delays in the clearing of payments, led to unpredictability in receipt of payments and a spread of illiquidity even to otherwise healthy enterprises; and 6) standard payments mechanisms such as letters of credit, to guarantee the customer's ability to pay his bills, were underdeveloped or completely non-existent. These issues needed to be addressed directly, not through a return to inflationary financing, which simply added to the high costs of transactions in the economy.

The fourth error was to believe that inflationary financing would actually spur investments and structural change in the economy. Of course, the CBR's view of structural change was enormously constricted, as it viewed the economy almost entirely from the vantage point of the *existing state firms*. It had no conception that expansionary credits to these enterprises actually denied resources to the competing private enterprises trying to get established. It believed that adjustment could and should take place only through existing firms privileged with access to the CBR credits. Moreover, the CBR failed to understand that real adjustment within the enterprises would take place only after a hard budget constraint pressed the enterprises to make changes, and only after a stable monetary environment created the conditions for long-term financing and meaningful long-term expectations.

The irony is that the high-inflation policies of the central bank probably did more to damage the enterprise sector than to help, even putting aside the damage imposed indirectly on the rest of the economy by the inflation tax and the instability in the society. In total, the enterprises received about 20 percent of GNP in credits from the banking system in 1992, but the enterprises also had to build up increased bank balances throughout the year in order to offset the effects of inflation on the enterprises' own working capital. Thus, the net addition to ruble bank balances by enterprises was on the order of 10 percent of GNP, while the increase in dollar balances held in Russian banks was approximately 6–8 percent of GNP (not to mention the billions built up in foreign banks as a result of hidden capital flight). Overall, the enterprise sector used most of the credits merely to build money balances; rather than to fund production or restructuring. The inflationary financing was, to a significant extent, like a dog chasing its own tail: enterprises were loaned money by the CBR and the Ministry of Finance to replenish working capital that was being depleted by the inflation tax!

But as we have stressed, the overall effect was hardly benign. The high inflation lowered the capital flight and a drop in investment by both Russian and foreign investors. The high inflation stifled the development of a long-term capital market. Bank loans are almost entirely less than one year, and overwhelmingly three months or less, as a result of the highly unpredictable monetary environment. The combination of high inflation and slow settlements on inter-enterprise payments further undermined normal business life. Since payments were routinely delayed by as much as one month, the real value of payments could easily vary by 25 percent as a result of the unpredictability of the payments process. In sum, the high inflation sapped the strength of the supply response of the economy, by raising

transactions costs, imposing a high inflation-tax on enterprises, encouraging capital flight, and undermining the development of a long-term financial market.

The final error was to believe that the cheap credits were an effective "jobs program" for the economy, and therefore necessary to avoid high unemployment. The economics are rather straightforward. Labour costs are a small proportion of total costs of production, perhaps 20 percent in the military-industrial sector. It is vastly more efficient to subsidize job losers through unemployment compensation than it is to maintain production of unwanted products. Moreover, the Government had established already in 1992 a Federal Employment Service (FES) to provide unemployment benefits. The institutional mechanisms were being set in place. It is of course vital to fund the FES adequately, and it will be much easier to do so with a cutback in other CBR credits.

The ruble zone

The Russian Government and the CBR failed to come to grips with the problem of the ruble area in 1992. Ironically, part of the difficulty lay in encouragement from the IMF and the EC to maintain a ruble zone despite the obvious inability of the participating countries to manage such a zone in a responsible, non-inflationary manner. The IMF and EC views were not the decisive factors, but they gave confidence to politicians in the CIS that wanted to maintain the ruble area for other reasons. The result was a substantial inflationary impulse that was probably even more important in fact than its one-fourth share of total credit expansion shown in Table 3.1.⁶

The economic problem of the ruble area at the start of 1992 should have been clear. Fifteen central banks were simultaneously issuing ruble credits to the governments and commercial banks of the respective states. No single central bank outside of Russia had the incentive to maintain tight monetary policies in the face of this collective non-system. Nor were there any real prospects for active coordination in an environment of great pressures within each state for inflationary finance and no institutional mechanisms for enforcement of monetary rules across the fifteen states. In fact, on the grounds of trade, public finance, politics, and labour mobility, there was simply no reason to suppose that the FSU constituted an optimal currency area, and in fact every reason to believe the contrary. The strong logic of the situation suggests that each of the new sovereign states should

manage their own national money, and that these distinct currencies should trade freely against each other with floating exchange rates.⁷

Unfortunately, despite many CIS meetings and supposed deadlines for action (including mid-1992 and end-1992), there was little orderly progress on these problems. Russia failed to adopt a coherent strategy. A few states adopted their own currencies, while others issued currency notes alongside ruble bank deposits, thereby subjecting Russia to a significant inflow of banknotes, (incidentally, without a murmur from the IMF). In June 1992, the CBR created the foundation for a distinct Russian bank ruble, by ending the automatic clearing of bank deposits in other republics into bank deposits in Russian banks. Up until June, a Kazakhstan enterprise could automatically pay a Russian enterprise with rubles held in a Kazakhstan commercial bank. After June, the Kazakhstan rubles would be settled in Russian rubles only if the Central Bank of Kazakhstan (CBK) held adequate deposits at the CBR, or if the CBR explicitly granted the CBK credit or an overdraft for the settlement.

To be specific, the Kazakhstan enterprise would transfer rubles to the CBK; the CBK would transfer rubles to the CBR, assuming that it held adequate balances; and the CBR would credit the account of the Russian enterprise. If the CBK did not hold adequate balances (and could not get an overdraft from the CBR), then the transaction would not be cleared. Alternatively, the Kazakhstan enterprise could simply hold a ruble account in a Russian bank, and then use the Russian bank balance directly to make the payment to the Russian enterprise.

The new CBR policy had one advantage; other republics could no longer *automatically* issue ruble credits for use in purchasing Russian goods. But it was also seriously deficient, since it left the ruble area with an ostensible common currency that in fact was composed of distinct and mutually inconvertible national currencies! Even if the Kazakhstan enterprise held adequate ruble deposits, there was no guarantee that it could use them to buy Russian goods. In fact, if Kazakhstan as a whole was in deficit to Russia (as evidenced by a negative CBK balance at the CBR), then the Kazakhstan enterprise could not rely on using its domestic bank balances for a purchase in Russia.

One important step was taken towards the solution of the ruble area problem by the June action of the CBR, and another by the withdrawal of Ukraine and the Baltic states from the ruble area in the summer and fall of 1992. Nonetheless, the problem continued in another guise in mid-1992, when Russia began issuing large amounts of new credits (essentially overdraft facilities) to the other republics,

including Ukraine, in order to maintain their purchases of Russian goods. This policy resulted from a powerful alliance of the industrial lobby with the Russian foreign policy community interested in smooth relations with the neighbours. The result was that, in fact, Kazakhstan and the other CIS states never really ran out of rubles at the CBR: their accounts were continuously, and almost automatically, replenished.

The pressures for credits were most readily fulfilled for the countries that stayed in the ruble area. Credits to Ukraine and the Baltic states have been sharply curtailed in 1993 (though Ukraine continues to receive credit in the form of late, or non, payments for oil and gas shipments). For the states still in the ruble area, a shortage of credits leads automatically to inconvertibility of one ruble to another, and this makes it extremely difficult for the CBR and the Russian Government to resist demands for new credits. If new currencies were introduced by these states, then convertibility could be maintained by the fluctuations in the market exchange rate between these currencies and the Russian ruble.

To this date, there has been no definitive solution to the ruble area, even though more and more of the CIS states are leaving on their own accord. Certain Central Asian states, particularly Kazakhstan and Uzbekistan, want to remain inside the ruble area, almost surely because they recognize that this is the clearest route to the continued flow of cheap credits. Russia has set more stringent targets for providing credit to the other republics, but in fact only separate national currencies will overcome the problem of currency inconvertibility. We return to this issue below.

Fiscal policy and inflationary finance

In addition to CBR loans to enterprises and to the CIS states, credits to finance the budget deficit are the third major source of inflationary pressure in the economy. In 1992, CBR financing of the general government was approximately 8 percent of GNP. The overall government budget deficit was approximately 20 percent of GNP, with the balance (12 percent of GNP) representing subsidies on imported items financed by external sources. (The exact nature of these subsidies is described later.)

All countries in transition face severe fiscal problems, as government budgets are caught between declining tax collections from the state-enterprise sector, com-

bined with rising social demands. Russia's fiscal crisis is compounded by the political weakness of the federal government in the face of rising demands from Russia's 88 regional governments. The regions have been able to secure massive tax exemptions, particularly from export and raw materials taxes, as well as special transfers, both of which have seriously weakened the federal budget. On top of this are serious administrative problems in tax collection and enforcement.

Nonetheless, Russia's fiscal problems could be substantially meliorated in straightforward ways. The main source of Russia's ongoing fiscal crisis lies in extensive price controls with various direct and indirect budgetary costs. Elimination of these price controls would also end Russia's budgetary crisis, or at least reduce it to levels consistent with the low inflation rates achieved in Eastern Europe. In this sense, Russia's continuing inflation is characteristic of the high inflation experiences of the populist episodes in Latin America, where misguided governments attempted to provide "cheap goods" to the public via budget subsidies, and ended up imposing much heavier costs on the public in the form of a burdensome inflation tax.

The major continuing price controls are in the following areas:

1. grain prices, which are held at approximately 30 percent of world levels;
2. energy prices, which vary between 5 percent (for coal and gas) and 20 percent (for oil) of world levels;
3. other import items subject to import subsidies;
4. infrastructure prices (internal transport, communications, housing rents, utilities prices);
5. general profitability margins for some sectors and for firms deemed (rather arbitrarily) to be monopolies.

In all of these areas, the government attempts to provide low prices to the population or to other enterprises that use the subsidized or controlled commodities as inputs, and then ends up paying a heavy budgetary cost to sustain the low prices. In the case of grain, for example, domestic grain prices are held at about 30 percent of world prices through a system of import subsidies for wheat, as well as direct subsidies to producers at various production stages (e.g. cheap energy inputs for state farms, and substantial subsidized credits that are, in effect, grants given the high rate of inflation). As a result of these actions, a loaf of bread in Moscow in June 1993 costs approximately 3.7 U.S. cents. The budgetary costs of these subsidies is probably around \$3 billion, or roughly 3 percent of GNP.

Enormous direct and indirect subsidies exist for coal, gas, and oil. In the case of coal, price controls are combined with direct subsidies to coal enterprises, in an amount estimated at 1.5 trillion rubles in 1993, approximately 1.5 percent of GNP. The domestic price of coal in June 1993 is \$1 per metric ton, or approximately 3.4 percent of the world price. For gas, domestic prices are simply regulated by the government, and as of June 1993 are set at approximately 5 percent of the world price. In the case of oil, domestic oil prices are kept at around 20 percent of world prices through a system of export quotas. Later on, we will provide estimates of the increase in budgetary revenues that could be achieved by a move towards world prices in energy.

Various import items are also subject to budgetary subsidization, through a system known as "centralized imports". In this arrangement, the government imports a commodity using an international line of credit (e.g. a three-year U.S. credit to import grain). The commodity is then sold to domestic trading companies, typically at a small fraction of the world price. The trading company then markets it on the domestic market. In many cases, such as for sugar, tea, dry milk, meat products, and cocoa, the government actually sells the commodity to the trading company at a price even below the *domestic* market price. The trading company then earns a pure rent by buying the commodity from the government and reselling it in the domestic market. This rent, clearly, is a pure transfer from the budget, without benefit to final consumers. The overall budgetary subsidy under the centralized import system was around \$10-12 billion in 1992, and is targeted to be \$4-5 billion during 1993. The direct annual costs of the pure rent component are approximately one-third of the total subsidy.

In addition to the various subsidy schemes, the government budget also loses large amounts of revenues as a result of the policy of setting export barriers in the form of administratively distributed quotas, rather than auctioned quota rights or export taxes. Export quotas exist on energy, base metals, various wood products, and some chemical products. Estimates of the budgetary consequences of completely converting the export quotas on energy to export taxes suggest that the revenue gains would be as much as 8 percent of GNP. The MFU does not yet have estimates for most of the other commodities. In the recent agreement between the Government and the CBR on the direction of economic policy, the Government announced the intention to eliminate all non-energy export quotas by end-1993, and to phase out the energy export quotas by end-1994.

Progress has been promised in each of these main fiscal areas in the potentially

of the problem was the absence of a meaningful offer of Western foreign assistance during 1992. To paraphrase the old Russian joke, the relationship of Russia and the West in the first year of reform was "you pretend to aid us, and we pretend to stabilize". (Of course, the Gaidar-led reforms in 1992 made historic and often spectacular progress in areas other than stabilization, including privatization, liberalization, and creation of public and private market-based institutions).

Many of the basic procedures for crediting and budgeting were carried out without attention to their macroeconomic consequences. Credits to the other republics were routinely approved by the CBR without much governmental scrutiny. Similarly, credits to commercial banks from the CBR were granted without overall macroeconomic targeting or limits. There have been widespread media reports of kickbacks on CBR credits to commercial banks and other republics. Until the spring of 1993, individual ministers, key members of Parliamentary commissions, powerful industrial enterprises, and influential regional authorities, all have had substantial sway on credit policy without any overall macroeconomic constraints. Only with the emergence of the operations of the Credit Commission is there the prospect of limiting credits to meaningful macroeconomic guidelines.

The situation has been greatly complicated by the Presidential authority to issue decrees. While this power has very often been beneficial to the reforms by speeding the process of executive action, it has also been frequently the source of increased deficits. The President has routinely granted tax exemptions to and subsidized credits to key regions and sectors. Also Presidential decrees on price controls have been issued without regard to their budgetary or macroeconomic consequences.

Various other aspects of governmental policy – centralized imports, debt servicing, export quotas, energy pricing, Russian sovereign guarantees given on loans to Russian enterprises – have been made by various committees within the Governmental structure without macroeconomic oversight or considerations of the effects on the budget and money supply. Thus, the Russian Government distributed several billion dollars of foreign credits in 1992 through the centralized import scheme without regard to the enormously serious macroeconomic consequences of the policy.

The situation has begun to improve in 1993, with the activation of the Government Commission on Credit Policy, under the prodding and chairmanship of Deputy Prime Minister Boris Fedorov. The CBR and relevant ministries (among others, the ministries of economy, privatization, foreign economic relations, and the state committee on CIS relations) are represented on the commission. Since

important May agreement. The main policy commitments include: across-the-board cuts in expenditures; reductions in coal subsidies; increased excise taxes on oil and gas; reductions in grain subsidies; reduction in centralized import subsidies; reduction in interest rate subsidies; and a rather rapid phase-out of export quotas and centralized exports by the government. Nonetheless, even *after* the promised adjustments, the budget deficit remains at around 10 percent of GDP, and there is not yet the intention to stabilize the exchange rate.

Administrative factors in the high inflation

The inflationary policies should also be understood in the administrative and political context in which the CBR and the Russian Government operated in 1992 and the first part of 1993. Most fundamentally, the Russian Federation emerged from the Soviet Union as a sovereign state only in December 1991, so that the period of economic reform has coincided with a critical and complex period of creating state institutions. This state-building has been characterized by an inadequate constitution carried over from the communist regime, and intense political struggles among rival branches of government, both with the federal and the regional levels, and at times between the federal and regional levels. This struggle has been complicated by the absence of free elections for legislative and executive bodies at the federal, regional, and local levels since the end of the communist regime, thus undermining the clear political legitimacy of the rival governmental institutions.

The specific administrative structures for economic decision making have also been highly inadequate. The dependence of the CBR on the Supreme Soviet is notorious. Not only is there no central bank independence, but the CBR dependence is in fact with the branch of government most hostile to the reforms and to macroeconomic stabilization. But the organizational problems go far deeper.

Until spring 1993, there was virtually no overall macroeconomic policy control or analysis within the Government or the CBR. The Ministry of Finance and the CBR were not seriously engaged in setting or monitoring aggregate credit targets. There were rhetorical bows towards a credit policy, as early as January 1992 when the Central Bank announced that aggregate credit would grow by 15 percent in the first quarter of 1992, a target that was almost immediately exceeded. In practice, the relevant governmental authorities gave far too little attention to overall targets, and made little effort to monitor or fulfill them. As I have stressed many times, part

April, the credit commission has been establishing monetary and credit targets for overall macroeconomic policy. A breakthrough occurred in late April when the Government and the CBR negotiated a program of credit limits for the second quarter of 1993. The following month, these credit limits became the basis of the May agreement. The readiness and ability of the Government and the CBR to live within these credit targets will be tested during the remainder of 1993.

Achieving macroeconomic stabilization

It is evident that there are several important factors involved in the ongoing high inflation in Russia. Pressures for large credits to enterprises continue to arise from concerns over declines in production and rising unemployment, as well as the intensive lobbying by politically powerful industrial enterprises. Pressures to maintain the ruble area, and the accompanying subsidies to the other republics, emanate from domestic exporters as well as foreign policy leaders. Nonetheless, these subsidies have been cut sharply compared with 1992. Credits to the budget overwhelmingly reflect misguided attempts to provide "cheap" goods to the public through subsidy schemes that indirectly tax the public via inflation. All of these pressures are exacerbated by inadequate administrative and political institutions, and widespread inexperience with monetary policy.

Can these pressures be overcome to achieve effective stabilization along the lines that the Government and CBR announced in May 1993? The answer, I strongly believe, is yes. Despite all of the difficulties, Russia is actually closer to stabilization than is commonly believed (the same was true of Poland, Estonia, and several other countries in transition that have succeeded in ending high inflations in recent years). Stabilization can be achieved by a limited number of actions, all administratively feasible, though no doubt politically controversial. These actions would have a very good chance of slowing inflation to low single-digit levels if carried out consistently and vigorously.

Many of the needed actions have already been started in the May agreement. In each area, I believe that stronger actions should now be taken to make a decisive breakthrough on stabilization. I will summarize the main directions of changes that are needed, in my view, to achieve a success in stabilization.

1. *End of the Ruble Area.* The May agreement calls for a significant cutback in credit to the other CIS states, and new procedures to put these credits through

the regular budgetary mechanism. In my view the Government should go further, by explicitly ending the quest for a ruble area, and delinking from the other CIS states. This should be done in a firm, though non-confrontational way, as suggested in Appendix A.

2. *Tighter administrative control on budgeting and crediting.* All budgetary and credit measures proposed within the Government, or in discussions between the Government and the Parliament, or by Presidential decree, should be referred to the Credit Commission for vetting, to determine whether the expenditure proposals are within the macroeconomic limits established by the Government and the CBR.
3. *End of subsidized credits on imports for all goods except grain.* The May agreement calls for a cutback in centralized imports. The policy should be fortified, by eliminating forthwith all centralized import subsidies other than for grain and fodder, particularly since a large part of the non-grain import subsidies constitute a pure rent to state trading organizations.
4. *Raise grain prices to around 50 percent of world levels.* The May agreement calls for a partial cut in grain subsidies, but again the measures can and should go further. Higher grain prices should be passed through into final prices of bread and other foodstuffs, and the extensive subsidies to the grain producing sector should be cut commensurately.
5. *Raise energy prices substantially.* The May agreement calls for modest cuts in energy subsidies (particularly to the coal sector), and modest increases in prices. Energy prices should be increased more sharply, through a combination of excise taxes, price decontrol, and increased exports of coal and oil. Special social groups (e.g. schools, hospitals, etc.) should be partially compensated to cushion the higher energy prices. The specific recommendations are contained in Appendix B, and are designed to raise at least 5 percent of GNP, net of the subsidies for social groups.
6. *Peg the exchange rate in conjunction with these actions.* The May agreement calls for a continuation of a floating exchange rate, "until financial policies have been tightened and inflation has been substantially reduced". However, as in virtually every successful stabilization in the past decade, a pegged exchange rate at the start of stabilization would provide a crucial "nominal anchor" to the stabilization process, not only through its direct effects on the goods market prices, but also through its disciplining effect on the Government's and CBR's macroeconomic policies.

7. *Fiscal federalism.* The central government can reduce some of the fiscal burdens arising from social spending by giving increased responsibility to regional and local governments, combined with increased authority at the regional and local levels to establish independent tax regimes. Currently, the Federal government sets all tax rates, and shares revenues with the region. The Federal Government should instead reserve particular taxes to itself (personal and corporate income tax; trade taxes; VAT; and national excise taxes, e.g. on energy), and then permit the regions to establish independent taxes on income, sales, property, and royalties.

8. *Mobilization of international financial support.* At the G-7 ministerial meeting in Tokyo in April, the leading industrial countries committed \$28 billion in international resources to Russia for 1993. This sum may be augmented at the Tokyo Summit in July with an additional \$4 billion Privatization Fund, supported by the U.S. Government, and designed for use by newly-privatized enterprises for restructuring and by oblasts burdened with increased social costs as a result of restructuring. The key point of international assistance is that it can directly substitute for CBR financing to the government, the enterprises, and the other republics. Each \$1 of financing of the budget, for example, directly reduces the CBR financing by 1,100 rubles.

The May agreement provides an excellent starting point for a real and decisive stabilization. According to the benchmark data, agreed to with the IMF in May, the overall budget deficit for 1993 (after the measures agreed to in the May package) is targeted at 10 percent of GDP, of which 6.9 percent is to be foreign financed (mainly through commodity credits) and 3.0 is to be domestically financed. In fact, the gross domestic financing is 6.1 percent of GDP, combined with a scheduled net repayment of internal debt of around 3 percent of GDP. The internal debt repayment involves so-called internal "commodity loans" in which the Soviet government promised subsidized automobiles to certain groups. Honouring these commitments in 1993 would now cost around 3 percent of GDP. For purposes of increased clarity, let us consider the IMF-agreed baseline in the following terms:

| | <u>% of GDP</u> |
|-----------------------------|-----------------|
| Total to be financed: | |
| deficit | 10.0 |
| commodity loan amortization | 3.0 |
| Financing: | |
| domestic | 6.0 |
| foreign | 7.0 |

Now consider some adjustments to the baseline. First, the domestic commodity loans can likely be stretched out or even formally rescheduled over a number of years, rather than paid out this year. I would assume that at least 2.5 percent of GDP of the commodity loan amortization can be postponed this year.

Second, foreign financing can be increased by at least \$2.0 billion, or 2.0 percent of GDP, compared to the IMF baseline, with the adoption of an IMF standby agreement (not counted in the baseline) and a second World Bank rehabilitation loan.

Third, the IMF baseline probably overstates by at least \$0.5 billion (0.5 percent of GDP) the amount that will be paid on foreign debt service during 1993, in view of the substantial amount of negotiations that have yet to reach agreements with the various creditors.

Fourth, further steps on energy prices, compared with those announced in the May agreement, should recoup an additional 3.5 percent of GDP. Note that the May agreement calls for a 1.6 percent of GDP increase in net revenues as a result of energy measures (cuts in coal subsidies and higher excises on oil and gas), while Appendix B specifies an adjustment of at least 5 percent of GDP.

Fifth, further cuts in centralized imports could likely net another 1.5 percent of GDP in budgetary savings.

Sixth, further cuts in grain subsidies could likely net at least 0.5 percent of GDP, and probably twice that amount.

Adding up all of these further adjustments, we have additional budgetary savings or foreign financing of around 10.5 percent of GDP. Note that this would more than permit a *complete elimination of CBR financing of the budget deficit* according to the May baseline. Even if the baseline is too optimistic in certain areas, it is clear that the domestic financing by the CBR could be virtually eliminated.

Note that the pegging of the ruble exchange rate would not require a complete elimination of CBR financing. It is likely that the combination of administered price changes on energy and grains, inflationary inertia, and necessary real appreciation of the ruble would all mean that inflation will continue at a rate of a few percent per month (perhaps 3-5 percent per month) even after the exchange rate is stabilized. This continued modest inflation permits an increase in the nominal ruble money supply, which in turn allows for a limited amount of CBR financing of the budget.

The political base for monetary stabilization

The biggest potential obstacle to stabilization in Russia today is that the executive branch, including the President and the Government, might not have the political will to stand behind a rigorous stabilization program. In 1992, the obstacles were far more pervasive, including a renegade central bank, the active opposition of the Supreme Soviet, an uncontrolled ruble zone, and the lack of an overall monetary framework for government policy. The situation is vastly more favourable today, since the CBR is more or less in compliance with Government policies; the Supreme Soviet is greatly weakened as an opposition force; the ruble zone has been largely abandoned and could be eliminated completely in short order; and the Credit Commission has the *de facto* mandate to establish overall macroeconomic targets for the Government and the CBR.

Nonetheless, the Government itself remains divided between those who would go slowly and those who would act decisively now. The gradualists believe that stabilization is politically damaging, and thus must be pursued at the right moment, presumably after a new and supportive Parliament is elected. This idea is doubly wrong in my view. First, stabilization need not be politically damaging, at least not in an electoral sense. The public strongly desires an end to high inflation, and most of the stabilizing measures affect special interests rather than the broad population. Even though unemployment will rise with tight macroeconomic policies, the unemployment will affect only a small proportion of the labour force, while all social groups will benefit from the stabilization of the currency.

Second, there is likely to be no more fortuitous moment than the present to make the decisive breakthrough. The executive branch is unhampered by a *legitimate* parliamentary opposition, and CBR opposition has been checked. Also, summertime is traditionally the most favourable time to raise energy prices. It would be a mistake to squander the current moment on the hope that the future is even more amenable to strong stabilization measures.

Even the administrative and political disarray of the government could be overcome by a vigorous push of policies by the main reformers. History shows that successful stabilizations are made by a few individuals, typically over the vociferous objections of their political colleagues.⁸ Stabilizations therefore almost always require a *package* of measures, since the reformers must push through a number of controversial actions at once to have a chance of success. Piecemeal actions may be enough to forestall hyperinflation, but are rarely sufficient to win the psycho-

logical confidence of the people. The package of measures strongly raises the credibility of the government with the population, and raises the power of the stabilizers within the government by committing the government in a bold and explicit way to a program of action.

Appendix A Suggested Russian policy on currencies in the CIS

I. Overview

1. The current policy of trying to preserve the ruble area has been an expensive failure. Monetary policy is not under adequate control and payments problems on interstate trade have not been solved. A true currency area would require a single central bank, as opposed to a separate central bank in each CIS state. The CIS states are not willing to eliminate their central banks and to cede their sovereign control over monetary policy to a new centralized institution, and even if they were, the Russian Government lacks the political and administrative will to monitor banks and control monetary policy in other states. The only solution is the introduction of a separate national currency in each CIS state.
2. There are very high costs of any further delay in introducing separate currencies. In fact, the rubles of the various republics are already effectively separate currencies that have black-market exchange rates between them (the "Kazakhstan ruble", for example, trades at a discount vis-à-vis the "Russian ruble"). Nonetheless, there are no legal foreign exchange markets for the free exchange of these currencies, so that rubles of the various republics are *de facto* inconvertible. This accelerates the breakdown of trade among the republics. Contrary to some opinions, trade among the CIS states would be greatly strengthened, not reduced, by the swift introduction of national currencies in each of the CIS states.

II. Policy actions

3. The Russian Government should explicitly declare the end of the attempt to create a single ruble area. Russia should seek to strengthen economic links within the CIS according to normal market conditions based on separate national

currencies in each of the republics. Separate national currencies will provide a key step towards macroeconomic stability within the CIS, and towards market-based trade within the CIS.

4. The Russian Government should call on each CIS state to establish the juridical basis of a separate national currency before July 1, and to begin operation of a separate national currency on or before July 1. Until then, the Russian Federation should treat ruble bank deposits in other CIS states as separate national currencies of those states (e.g. Kazakhstan rubles, Uzbekistan rubles, etc.). Each state should prepare for the replacement of ruble banknotes by banknotes of the new currency by no later than October 1. Russian rubles collected by the exchange of banknotes should be returned to the Russian Federation for removal from circulation.
5. The Russian Government should stop all credits (technical credits and inter-state loans) to CIS states that do not introduce their own national currencies. Moreover, the Russian Government should reschedule existing debts of CIS states (e.g. on "technical credits" from 1992) only after the introduction of new national currencies. The Russian Government should consider limited inter-state credits to other CIS states after the introduction of separate national currencies, but only after the introduction of those currencies.
6. The Russian Government and Central Bank should take necessary measures to preserve and strengthen the role of the Russian ruble as a currency for inter-state trade within the CIS. CIS residents and enterprises outside Russia may hold Russian ruble bank accounts in Russian banks, and may use those accounts for payments to Russian enterprises and households, and for participation in the Russian foreign exchange markets (consistent with the foreign exchange regulations of the Russian Federation).
7. The Russian Government and Central Bank should also work closely with cooperating states to encourage the development of foreign exchange markets for converting the new national currencies into Russian rubles and vice versa. Russian commercial banks should be licensed to hold correspondent accounts directly in the commercial banks of other states, while the commercial banks in the other states will be allowed to hold correspondent accounts in Russian banks. These correspondent accounts would provide the basis for the foreign exchange trading among national currencies, without a direct role of the central banks. Naturally, these off-shore correspondent accounts will be subjected to normal prudential requirements.

8. Russia should work closely with the cooperating states to speed up payments. The payments system under the arrangements suggested here would likely be much faster since it would be based on correspondent accounts of commercial banks, and would not require clearing through the Russian Central Bank.
9. At least at the inception, national currencies should float freely against the Russian ruble, to ensure convertibility of national currencies into Russian rubles and vice versa. After the establishment of a foreign exchange market, other states may choose to peg the value of their currency to the Russian ruble, and this would be acceptable to Russia assuming that the currency remains freely convertible into rubles.

Appendix B Suggested energy sector policies for Q3 and Q4, 1993

| Policy | Revenue gain (as % of GDP) |
|---|-------------------------------|
| 1. Impose a 22% excise tax on sales of natural gas and increase the state price to R.15,300, approximately 35% of the world price | 1.6 |
| 2. Subsidize households, hospitals and day-care centres for one-half of the real gas price increase | -1.0 |
| 3. Rescind the price regulation fund for oil and increase the mean effective oil excise tax to 25% | -0.4 |
| 4a. Variant A Remove all energy export restrictions and raise the export tariff on oil to 50% | 8.1 |
| 5a. Subsidize vulnerable consumers of oil | -2.0 |
| 6a. Savings on coal-subsidies after consumer subsidies | 0.0 |
| 7a. Net revenue gains from policy package A | 6.3 |
| 4b. Variant B Gradually abolish the export quota system and keep the export tariff at 30% | 1.9 |
| 5b. Auction 4 million tons of oil quotas each month | 3.5 |
| 6b. Subsidize vulnerable consumers of oil | -1.8 |
| 7b. Net revenue gain from policy package B | 3.8 |

Source: Calculations of Jochen Wermuth, Peter Orszag, Jacques Delpla, MFU

Notes

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1. "Economic Policy Statement of the Government of Russia and Central Bank of Russia," May 1993.
 2. For 1991, GNP was estimated at 1130 billion rubles, and end-of-year money supply at 938 billion [Note: a revised estimate will calculate annual GNP at December 1991 prices, rather than year-average prices].
 3. These credits came in several ways: CBR credits to commercial banks, onlent to enterprises at market rates; CBR credits to commercial banks onlent to enterprises at subsidized rates to be covered by the budget; and CBR credits lent to the Ministry of Finance for onlending to the enterprises. In the accounting in the table, this last kind of lending is considered as enterprise finance, rather than budgetary finance.
 4. Of course, the data are imprecise, so that a careful statement would say that Poland's fall was among the lowest, and that there is no evidence that Poland's tight stabilization measures added to the cumulative decline measured over a three-year period.
 5. A particularly graphic case is steel output. Soviet steel production in 1990 was 160 million metric tons, compared with 80 mmt in the U.S., despite a U.S. economy roughly 10 times the size. There is simply no demand for such large amounts of steel, particularly after the drastic cutbacks in tanks, MIGs, submarines, aircraft carriers, and other military output.
 6. Part of the enterprise credits were an attempt to replenish enterprise working balances that were depleted by the inflation tax. Thus, if there had been a smaller inflationary impulse coming from the non-enterprise credits (budget and other republics), there would have been fewer credits extended to the enterprises as well. For this reason, the credits to the budget and to the other republics probably account for well more than half of the underlying inflationary impulse in the economy.
 7. Another logical possibility would be to subordinate all monetary policy to a single monetary authority under Russian control. Even this alternative should be avoided. Russia does not have the ability to monitor the banking systems of the neighboring states (much less with Russia), nor probably to resist the political entreaties to fund deficit countries within the monetary system. In the end, a single, multi-state authority would have deficient monitoring of the banking system, and would naturally prey on Russia's political weaknesses to provoke excessive credit expansion.
 8. This is why stabilization programs are often known by the name of their authors, such as Erhard, Salinas, Balcerowicz, and Klaus.