

Strengthening Western Support for Russia

by Jeffrey Sachs

The West has not offered sufficient help to support Russia's reform. As the IMF is not equipped for the enormity of the tasks, a special agency should be established in Moscow to ensure that reform continues. An army of technical experts on the ground is urgently needed.

Western neglect of Russia's reforms has left the reformer struggling for survival and the economy teetering on the brink of hyperinflation, with inflation running at about 30 percent per month and rising. But while the situation is dangerous, it is far from hopeless. Russia is making startling and successful advances in creating a market economy, with a dramatic commercialization

of society; broad progress on privatization; and a significant opening to market-based international trade and investment. Early actions by the Clinton Administration in putting forward a well-designed program of conditional financial assistance could be the stimulus needed to bring Russia back from the brink of financial chaos and give the reforms the crucial time that they need to take root.

The risk of hyperinflation now facing Russia could have been eliminated in early 1992. Russia's economic reforms started to work in the first six months of the year in the same general way as in Eastern Europe. Inflation was coming under control; shortages were being eliminated; markets were starting to function; the currency was stabilizing; the service sector was starting. But, as in Eastern Europe, reforms were also starting to squeeze heavy industry, including the politically powerful military-industrial complex, which began to struggle against them. Under intense po-

litical pressures and with little real backing from the West, the reformers started to acquiesce to large and highly inflationary subsidies to industry.

With a vigorous Western presence, the roll-back of stabilization policies would probably never have taken place. In turn, the success of stabilization would have greatly bolstered the political stability of the reformers, just as the growing inflation has undermined their hold on power. But as it turned out, the Western role in Russia since the start of the Gaidar cabinet in November 1991 has been totally insufficient.

Western governments made the fateful choice to duck any direct responsibility vis-a-vis Russian reforms by vesting key authority in the IMF. This was an enormous mistake for several reasons. First, the IMF was completely understaffed for the task. Hundreds of technical experts are needed *on the ground* in Moscow to help with reforms in banking, budgeting, management, trade and fi-

nance. As an institution of around 1,000 staffers, however, the IMF was simply unequipped to provide the needed assistance from in-house resources. As a result and as incredible as it now seems, the IMF did not have a single monetary specialist on the ground in Moscow during the first ten months of 1992. It relied totally on fly-in

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missions to try to cover the workload and thereby greatly weakened its capacity to help.

Second, it is necessarily a political task of the first order to mobilize tens of billions of dollars of Western support for Russia and to link the support to fundamental changes in the Russian economy in a systematic way. The IMF was not equipped to carry out these functions. It did not succeed in mobilizing funds; in designing an aid program in cooperation with the Russians; nor in carrying out conditionality. The \$24 billion aid package announced on April 1, 1992 simply vanished. Russia received approximately \$9 billion of trade credits last year, but none of these loans has been linked to the reform program. New trade credits slowed to a trickle after July. In fact, not one dollar of usable conditional assistance flowed to Russia during the first ten months of the year! The only conditional aid has been \$1 billion of IMF money and \$600 million of World Bank funds, but even these paltry sums exaggerate the actual resource flows. The IMF money was given under the amazing condition that Russia not use the money and most of the World Bank credit will be distributed only in 1993.

The Western effort on debt rescheduling has been equally inexplicable, being directed at getting the Yeltsin-Gaidar government to accept responsibility for the entire debt of the former Soviet Union. This has led, predictably, to a legal mess in subsequent negotiations. Moreover, the

West continued to press Russia for interest servicing of the debt even when Russia was completely out of foreign reserves. The pressures contributed to Russia's macroeconomic instability. Most importantly, after a year of radical reforms, Russia has still not received any formal debt rescheduling and the balance of payments pressures arising from Russia's debt overhang continue to weigh heavily on the economy.

While the IMF has been overwhelmed with its assigned task, Western governments have simply stood and done virtually nothing. The US role has been minimal. There has been little strategic thinking in the Administration and there has been no single senior official whose main responsibility was the design and coordination of the US response to Russian economic and political reforms. The role of the other G-7 countries has been similarly problematic. The German financial role has been large in recent years, but even German credits have largely been cut off. At this point, support in Germany for further financial assistance to Russia is slight. The EC has provided a modest amount of aid, but its role has hardly been decisive. Other individual European countries have also contributed moderately to Russian assistance, but again without a decisive role.

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turned. This policy finally backfired in September, when President Yeltsin canceled his trip to Japan at the last minute. But the costs have been high and mutual antagonisms have grown. Russian hardliners have seized on the Kurile issue to fight against the reforms with great effect, claiming that the West has again been proved to be hostile to Russia's interests in demanding the return of islands won during the Patriotic War. US policymakers were silent as Japan pursued this

mutually destructive approach; we share a complicity in the downward spiral of Russian-Japan relations, through our inaction.

A new Western response is needed. There should be an urgent rethinking of the Western response to Russia by the incoming US Administration. The nature of the response must be carefully modulated to the events in Russia. If the reformers are able to survive the current political onslaught, then the West should aim to reinforce the reforms with considerable urgency. If the reformers are routed, then the West must respond in a clear way, holding back on most aid until political and economic reforms get back on track. If the situation remains muddled, then a nuanced carrot-and-stick approach would have to be used.

Financial assistance should be re-designed to give the maximum political and economic backing to the reforms. The assistance should come in forms that are easily understood by the Russian people and Russia's political leadership, so that the assistance is (correctly) viewed as vital and much too important to abandon. The money should also come largely in ways that help to finance Russia's budget deficit, so as to substitute for direct inflationary finance.

The specific types of aid will have to be determined in the course of negotiations between the Russian government and the G-7 partners. The following kind of package makes sense, in terms of the political and economic support that it would offer to the reforms:

An **Emergency Social Fund**, to help pay for unemployment compensation, emergency medical

support and supplements for pensioners. The fund would be supported by direct grants from Western countries. All Russians would understand that if the aid were cut off, it would mean risking the key social safety net for the country. The money would obviously help to cover direct budgetary expenditures in Russia in a non-inflationary way.



An **Industrial Restructuring Fund**, to help pay for military conversion and other industrial restructuring operations. This money would be in the form of loans from export credit agencies and the international financial institutions. Part of the fund would be for military conversion and part for energy and agricultural investments.

A **Small-Business Loan Program**, modeled on the Polish-American Enterprise Fund, which would make loans to small and medium-sized enterprises. This fund would be managed by the European Bank for Reconstruction and Development (EBRD).

Balance of Payments Support, including an IMF standby loan to help cover the foreign exchange requirements for basic imports, a stabilization fund to help stabilize the ruble and the rescheduling of the debt that was taken on by the Soviet Union before December 1991.

The key strategy in such a program is simple, but it was basically neglected in 1992. The aid package should be spelled out in *political* terms, so that everybody in Russia understands the value of the international assistance and the high cost of losing that support. The general public should understand that Western support funds emer-

gency social protection; industrialists should understand clearly that Western support funds their access to restructuring money; small businesses should see that Western support actually provides credit to them; and everybody should understand that international support is the key to making the Russian currency stable in value via a stabilization fund.

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The funding would be strictly multilateral in character, involving funds from government budgets, export credit agencies, the IMF, World Bank, EBRD and the EC. The US budgetary contributions would have to rise, as would contributions from the Export-Import Bank (EXIM). Perhaps most importantly, the US should insist that Japan step up its contributions, in view of Japan's financial resources, its minimal contributions to date and its enormous stake in the success of Russia's democratic and economic reforms. The sums involved should be determined in the course of detailed negotiations, the sort of dialogue between the Russian reformers and the G-7 that was needed but did not take place last year. Nevertheless we can sketch roughly the sums that might be involved. The emergency social fund should be of the order of \$8 billion *in grants* from the industrial democracies. The US share would be around \$2.5 billion. The industrial restructuring fund would be of the same size, but in the form of loans from the export credit agencies, the World Bank and the EBRD. The small business fund should start at around \$1 billion, to be covered by funds from the EBRD and private investors. The balance of payments support should include a \$4 billion IMF loan and a stabilization fund of around \$6 billion.

The total direct budgetary costs to the United States would come to around \$3 billion per year, approximately one percent of US defense spending.

The West would also need new institutional means to deliver such a program. The G-7 should establish a political-economic umbrella, under which the IMF, World Bank and EBRD would act. In effect, the G-7 would establish an administrator for Western assistance, with a substantial presence in Moscow, that would be similar to the Economic Cooperation Administration (ECA) of the Marshall Plan. Unlike the IMF, the new G-7 office would have an *on-the-ground* team of businessmen, bankers and economists, helping the Russian government implement practical reforms in key areas. Within the US government, there should be a new senior position to coordinate US policies in support of economic and political reforms in Eastern Europe and the former Soviet Union. This person must clearly be the "President's person."

The greatest mistake would be to lose heart with Russia's reforms. Throughout history, successful reform programs have been heatedly attacked and even written off just as they were starting to prove their worth. Chancellor Adenauer and his Economy Minister Ludwig Erhard barely survived in Germany in the late 1940s, the very period in which they were putting in place

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Germany's economic miracle. After three years of tough politics, the reforms in Poland are only now becoming self sustaining, based on the remarkable economic turnaround that the reforms have ushered in. All reformers, from Erhard to Balcerowicz, have required international financial support to help the reforms take root. With the enormous stakes in Russia, this is the least that we can do for President Yeltsin.

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Professor Sachs is Galen L. Stone professor of international trade at Harvard University.