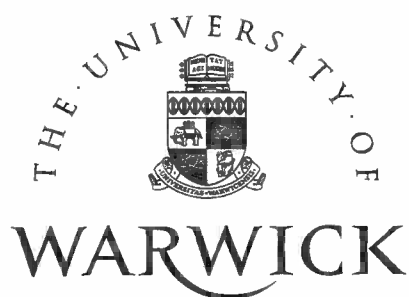


**MACROECONOMIC STABILIZATION IN RUSSIA: LESSONS OF
REFORM, 1992-1995**

Robert Skidelsky & Liam Halligan

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This paper is circulated for discussion purposes only and its contents should be considered preliminary.

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The Social Market Foundation
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EDITOR'S NOTE

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I Introduction

It has never been possible to learn the truth about anything in our country.

Alexander Solzhenitsyn

Seventy-six per cent of all Russians agree that inflation is the country's most pressing problem.¹ Similarly, all mainstream parties in Russia agree on the need to lower inflation. The question is how. In this Paper, we outline the main theories of persisting high inflation and test them informally by reference to the three main attempts to stabilise the Russian macroeconomy between 1992-4. We then assess the prospects for the success of the fourth and current effort. Our main conclusion is that the political and financial preconditions for a rapid reduction of inflation to low levels — to below the 40 per cent a year achieved by the successful post-Communist economies — were not in place at the start of the reforms in 1992 and have only slowly and painfully been assembled from repeated experience of failure or partial success.

This does not mean that the reformers were wrong to try. It is sometimes necessary to act even if the prospects for success are poor on a cool estimate of probabilities. A degree of illusion is probably a necessary prerequisite for action, since too vivid a conception of the difficulties in store can paralyse the will. This is not to deny that technical mistakes were made. But it seems to us that most of them were avoidable only with hindsight. Yegor Gaidar has offered the most telling insight into the state of mind of the first post-Communist reformers:

I myself could have given a perfect explanation of why in 1992 the reforms should not have been launched. There was no stable support in parliament; there were no functioning institutions of governance. There were sixteen central banks instead of one; there was no strong private sector as in Poland. There wasn't a kopeck to be had of hard currency or gold reserves, nor the opportunity to attract free investment from the international financial market. But ... we couldn't wait any longer. We couldn't just keep doing nothing, or keep explaining why it was impossible to do anything.²

The question which needs to be asked is: what would have happened to the Russian state, economy and democracy, as well as to international relations, had the reformers not tried? The likeliest answer is that, had the Gorbachev drift been allowed to continue, a serious attempt would have been made to recreate the Soviet Union and remilitarise Soviet society. This in turn might have broken down — sooner rather than later for the old system was unviable — but the intervening repercussions would have

been horrendous. Whatever their errors of timing, sequencing, tactics — the categories beloved of academic analysts — Boris Yeltsin, Yegor Gaidar, Boris Fedorov, Anatoly Chubais and many others in the first wave of reformers were heroic figures who never lost sight of the main strategic objective: to transform Russia into a capitalist market economy and a 'normal' member of the international community, putting the nightmare of Communism and state planning finally behind them.

Most of the preconditions for the rapid fall in inflation and resumption of economic growth are now in place, and it is likely that the fruits of the long struggle to stabilise the economy will start to be realised this year. In particular we highlight the success of the constitution established at the end of 1993, the emergence of a market for government debt, the belated establishment of the IMF budget stabilisation fund, and the consolidation of a low inflation coalition. Further external financial assistance in the form of a ruble stabilisation fund would both strengthen anti-inflationary expectations and be a fitting reward for the progress in stabilisation already achieved.

II The Inflation Problem

Since the start of the post-communist reforms in January 1992, Russia has made impressive progress from a state-owned centrally planned economy to a privately-owned economy based on market forces. By the end of 1994, the private sector accounted for 60 per cent of total output, up from 12 per cent in 1993: Russian privatisation has outpaced that of all the countries of Eastern Europe and has involved a higher proportion of asset acquisition by foreigners than sell-offs in any of the Visegrad countries. Russia has also liberalised most of its prices, although the trade and foreign exchange system is being deregulated only in fits and starts.

The biggest failure has been to reduce inflation to a low level, conventionally defined as less than 40 per cent a year. There have been three major attempts to conquer inflation, each of which broke down after some initial success. A fourth attempt is now in progress. Failure on the inflation front has damaged all the other reforms. Our purpose is to explain why inflation has remained so high for so long. This explanation will at the same time show how most of the barriers to inflation reduction have now been overcome.

Table 1: Post-Communist Russia's Inflation Record (average monthly increases in the CPI)

1992				1993				1994				1995			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
150	17.4	10.2	24.8	23.5	18.9	23.7	16.1	12.0	7.1	5.8	15.5	12.6	7.7	4.8	4.0

Post-Communist Russia's inflation record is set out in Table 1 above. The essence of the problem facing the post-Communist reformers is that Gorbachev's Russia was already on the verge of hyperinflation (defined as an inflation rate of 50 per cent a month) though this was being suppressed by administrative control of prices. A wages explosion coupled with an acute shortage of consumer goods offered for sale at official prices had led to a large 'monetary overhang', some of which spilled out into the black market, but most of which was hoarded — equivalent to the suppressed demand which builds up during a major war. Official retail prices in the Russian Federation rose by 93 per cent in 1991; but black market prices on

basic consumer goods were often more than five times the official price. By November 1991, the black market exchange rate for dollars was over forty times the official price of 1.7 rubles to the dollar. As Soviet enterprises became less and less profitable, tax revenues fell, while employment subsidies increased. In 1991 real GDP fell by 15 per cent, and the state budget deficit rose to 16 per cent of GDP, largely financed by government borrowing from the Central Bank of Russia (CBR).

When Yegor Gaidar liberalised prices in January 1992, a large jump in the official inflation rate was inevitable, and this duly occurred. Inflation rapidly came down, but annual inflation rates of 1354 per cent and 896 per cent were recorded in 1992 and 1993 respectively. In 1994, the inflation rate fell to 220 per cent. With inflation currently running at about 100 per cent a year, the Russian economy today is far from hyperinflation, but inflation is still too high for the fruits of economic reform to be realised. This goes some way towards explaining the poor showing of the reformist parties in the Duma elections of December 1995. However, there are good prospects for a substantial fall in inflation during 1996.

Why should low inflation be the only relevant measure of the success of Russian macrostabilisation? The quick answer is that in conditions of persisting high inflation the transition from a command to a market economy cannot be achieved without possibly irreparable damage, delay, and deformation. It has to be understood that 'transition' means not just the replacement of planning by the market as the organising principle of economic life, but the extensive restructuring of economic activity to meet the demands of private agents rather than those of central planners and bureaucrats. Macroeconomic imbalance has its roots in the breakdown of the command economy. The state can no longer enforce the behaviour required to validate the central plan. The quantity of resources being produced declines, and its power of appropriating them declines as well. The restoration of macroeconomic balance *requires* the restructuring of production for market demand. High inflation delays the restructuring and therefore delays the restoration of macroeconomic stability, quite apart from the other evils it inflicts on the way.

The basic reason is that the attempt to keep the existing state apparatus and industrial structure going by means of an 'inflation tax' hits the restructuring process from both the demand and the supply side: on the demand side by producing a collapse of real incomes, on the supply side through the continuing political allocation of capital to the industries favoured by the old command system. The majority suffers horrendously; the minority gains spectacularly; the welfare benefits of the market system

are unconscionably delayed; people's faith in the desirability of capitalism and markets wanes. The positive effects of the 'inflation tax' in promoting the capitalisation of the emerging banking system, for example, weigh little in the scale against the damage done to mass living standards, to the probity of administration, and to the credibility of capitalism as the organising principle of economic life.

Inflation reduction is not so much the condition of economic transformation as the mechanism for achieving it. What it means is turning off the monetary flow to firms which cannot sell their products on the market, forcing them to close down, slim down, or convert to supplying consumer demand, and *at the same time* halting the collapse of real incomes. That is why ending high inflation automatically stops the collapse of production and enables economic growth to resume along market-determined lines. No short-run trade-offs between desirable objectives (e.g. unemployment and inflation) are available till inflation has been reduced to much lower levels — comparable to those experienced in the West in the 1970s.

All these considerations were certainly in the minds of the early reformers. Why, then, did they fail to achieve their low inflation goals? In classic Western discussions, there are two main theories of inflation. For monetarists, inflation is exclusively a monetary phenomenon, caused by an excessive rate of growth of the money supply — 'too much money chasing too few goods'. In most circumstances, high rates of inflation result from the monetary financing of government budget deficits. Ending the excess production of money means primarily refusing to finance budget deficits by borrowing from the Central Bank. On this view, policies which result in persisting high inflation reflect analytic mistakes or a lack of political will.

For cost-push theorists, inflation is caused by an autonomous increase of factor input costs like raw material and energy prices or wages. Cost-push inflation can be transmitted either through an adverse balance of trade causing currency depreciation or through wage push. Such autonomous increases in costs cannot take place unless the economy is highly monopolised. With flexible markets, businesses cannot raise prices or unions raise wages. So an anti-inflation strategy has to embrace at the minimum a de-monopolisation of product and labour markets. Monetarists argue that, even if businessmen and workers had market power, a general rise in prices is impossible if the money supply is held steady. In such circumstances attempts to raise product prices or wages would simply induce unemployment which would halt the inflation. Our view is that monopolisation cannot be regarded as an independent cause of inflation,

but as a factor which increases the unemployment costs of reducing inflation. In that sense it is an obstacle to inflation reduction, by increasing its political costs.

Both theories have their supporters in Russia. Yegor Gaidar and the early reformers subscribe to the 'monetarist' theory of high inflation and bent their efforts in government to trying to achieve a reduction in the growth of the money supply. The economist-politician Grigori Yavlinsky, who has been out of government since 1990, seems to accept a cost-push explanation of Russian inflation (though it is not entirely clear whether he regards the existence of monopoly power an independent source of inflation or an obstacle to inflation reduction) and blames the reformers for not concentrating on de-monopolising and de-regulating the Russian economy.

In his discussion of the German hyperinflation of 1922-3, Charles Kindleberger has drawn attention to political and social barriers to the reduction of inflation, which he loosely labels 'structuralist'. This type of discussion goes beyond consideration of the technical or proximate causes of rising prices to the underlying structures of politics or society which prevent governments from reducing the rate of growth of the money supply. The 'structuralist' explanation starts, that is, where the technical (monetary) explanation leaves off. Inflation is, from this point of view, a 'vent' for political or social conflict, and particularly a device for allocating the costs of change, in lieu of domestic consensus or external help. Monetary authorities do not have a 'free choice' of policy: they are endogenous to the inflationary process. Optimal inflation-reduction policies will not be pursued if the costs they impose on politicians (removal from office) or on society (heavy unemployment, revolution) are too great. In such circumstances, rulers may have a choice only between third, fourth, and fifth best policies.³

Since the term 'structuralist' is apt to mislead, it may be better to recast Kindleberger's argument in the form of political and institutional constraints on macroeconomic stabilisation. These constraints can either operate *ex ante*, determining which choice of reform plans is politically acceptable or institutionally feasible, or *ex post*, in the form of a backlash against the reforms, once their effects have been felt. There is now a large body of theoretical literature on the 'preconditions' of successful stabilisation, much of which involves an analysis of the respective merits of a 'big bang' or 'gradualist' approach.⁴ The urgency of the macroeconomic problem may create a 'window of opportunity' for shock therapy, but support for it is likely to dwindle if the shock is too severe, galvanising loser

groups into political action. So a gradualist approach may be better insofar as it allows time to build a constituency in favour of continuing reform. The sustainability of a 'big bang' approach depends on such things as the degree of independence of government and central bank from immediate political pressures — in turn partly dependent on the nature of the constitution — the coherence of policy within the government, the credibility of the government's targets, the amount of savings (domestic or foreign) available to finance the budget deficit, and the speed with which reform-supporting institutions and social groups emerge.

Part III of this paper briefly surveys the four stabilisation attempts since 1992. In Part IV we analyse why the first three failed, in the light of the main theories of inflation discussed above. In Part V we consider how far the obstacles to stabilisation have now been overcome.

Our main conclusions may be briefly summarised at this point. The main technical cause of high and persisting Russian inflation has been excessive money creation by the Central Bank. That is, we reject a cost-push explanation of Russian inflation. We recognise, though, the existence throughout the stabilisation effort of severe political and social obstacles to 'turning off the monetary tap', and also the role of policy mistakes in the design of anti-inflationary policy. The initial 'big bang' approach to inflation reduction proved unsustainable, and policy soon became 'gradualist'. Although gradualism was severely sub-optimal from the economic point of view, bringing calamitous distributional effects, which also delayed restructuring of the Russian economy to meet market demand, it has gradually led to the emergence of institutions and structures favourable to low inflation. Many of the preconditions for a low rate of inflation and resumption of economic growth are now in place. But there has been little alternative since 1992 to the agonising process of letting time and experience to do their work.

III Attempts At Macrostabilisation

There have been four attempts to achieve macroeconomic stabilisation in Russia since 1992, each marked by an attack on a particular element in the inflationary process.

- ◆ Gaidar, 1992, tried to lower inflation by cutting the budget deficit through a mixture of tax increases and spending cuts. He largely ignored the problem of inflationary off-budget credits from the Central Bank of Russia (CBR) to enterprises and commercial banks.
- ◆ Fedorov, 1993, focused on cutting off-budget CBR credits to state and privatised enterprises and credits to the former Soviet republics.
- ◆ Chernomyrdin, 1994, concentrated on cutting CBR credits to commercial banks, mainly by manipulating domestic interest rate differentials. This attempt ended in the ruble crash of October 1994.
- ◆ Chernomyrdin-Chubais, 1995. The current stabilisation attempt aims to finance the budget deficit by sales of official bonds and a stand-by loan from the International Monetary Fund.

Gaidar: January 1992 — December 1992

Yegor Gaidar became Minister of the Economy and Deputy Prime Minister in December 1991. His stabilisation programme, which began in January 1992, aimed to eliminate inflation at a stroke by reforming the tax system and cutting state spending. Price liberalisation was a key part of the programme, as it would eliminate the implicit subsidies to state enterprises which at the time amounted to some 15 per cent of GDP.⁵

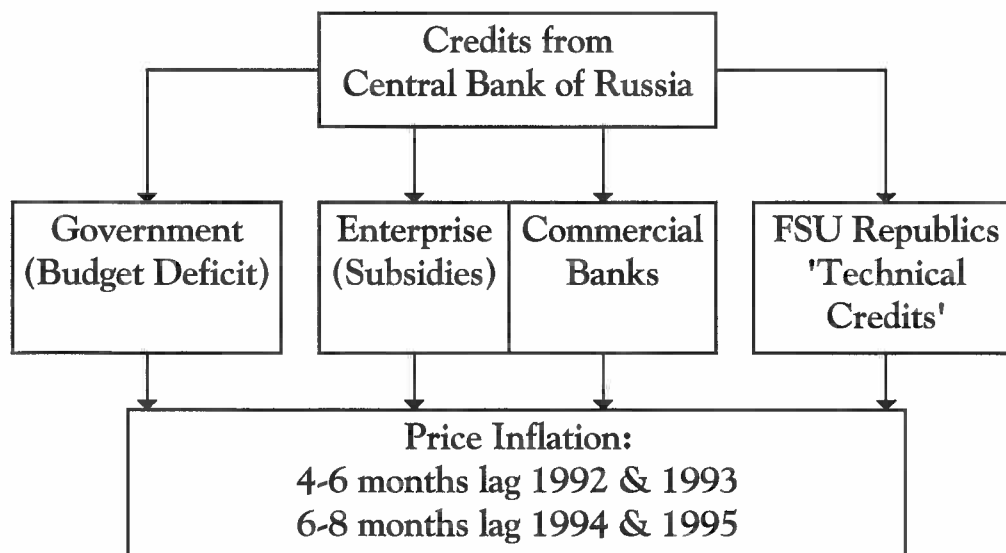
On the revenue side, the chief reform was the introduction of VAT at a rate of 28 per cent in January 1992. Indirect taxation was preferred to direct taxation; though the former is directly inflationary, the latter was seen to be a technical impossibility within the time-frame of the 'window of opportunity'.⁶ On the spending side, Gaidar slashed military procurement by 70 per cent, and also cut consumer subsidies. The reserve requirements of the banking system were increased in an attempt to stem monetary expansion. This increase (from 5 per cent to 20 per cent for demand deposits and from 5 to 15 per cent for time deposits) came relatively late, at the beginning of April 1992.

The initial results were impressive. The government actually spent less than it received in the first quarter of 1992. By May, overall M2 money supply growth — including bank deposits — was down to 9 per cent per month, from 14 per cent in March. Price liberalisation led to a 'once and for all' increase in the consumer price index of 350 per cent. Thereafter, the monthly inflation rate fell steadily from 40 per cent in February to 9 per cent in August. The exchange rate strengthened from 230 rubles to the dollar in January to 115 in June.

These gains were unsustainable. Cash spending in the first quarter of 1992 was much below the government's commitments. Also the figures for 'internal balance' excluded external debt being incurred to finance part of Russia's imports, giving an 'enlarged deficit' of 25 per cent of GDP. The straightforward 'internal deficit' widened to 7.8 per cent of GDP in the second quarter and 14.6 per cent in the third quarter. This mainly represented subsidies to loss-making enterprises, channelled through the Ministry of Finance. CBR financing of the deficit which had been negative in the first quarter, rose to 6.4 per cent of GDP in the second quarter and 13.5 per cent in the third quarter. At the same time, broad money growth, which had averaged 11 per cent per month from February to May, rose to a 28 per cent monthly average over the next four months. It was driven not just by deficit-financing, but off-budget payments to enterprises in order to 'net out' inter-enterprise debts, and 'technical credits' granted to factories in the former Soviet republics in order to enable them to buy Russian goods.

The complex nature of the inflationary problem facing Gaidar can be illustrated by the following diagram: there was one source of money creation, but four taps:

Diagram 1: Causes of Russian inflation



Gaidar concentrated on eliminating the budget deficit, but had no control over direct off-budget CBR credits to enterprises, or over CBR loans to so-called commercial banks. In the end, he failed to control the budget deficit as well.

Now Acting Prime Minister, Gaidar had a further go in September. In his own words:

We immediately cut the budget deficit drastically, so that the budget was practically balanced from September to December. This created a basis for slowing down the rate of money increase ... In October, there was a cut in the amount of credit provided by the CBR to the commercial banks, and in November we were in a position to cut down drastically on the rate of increase in the money supply ... to 5 per cent ... The dollar fell from 550 rubles in mid-November to 398 on the last day of our government.

Gaidar lost his job in December 1992 and, as he writes, the new government of Viktor Chernomyrdin 'in its first ten days issued an enormous amount of cheap credits and drastically increased the state budget deficit'.⁷ Altogether, in 1992, CBR credits amounted to 40 per cent of GDP. With inflation in 1992 at 1354 per cent, the first stabilisation effort had clearly failed.

Fedorov: 1993

As Finance Minister from March 1993, Boris Fedorov embarked on a more realistic programme of gradual disinflation. Following the 'pro-reform' referendum in April 1993, and with the assistance of the IMF, he persuaded the CBR to accept a Credit Commission to set credit quarterly ceilings, brought CBR credits to enterprises on-budget and drastically cut import subsidies. He then refused to spend more than was raised in taxes plus the predetermined CBR credits. In April 1993, Fedorov cut off CBR credits to the republics of the Former Soviet Union (FSU). His reforms marked a giant stride towards improving the coherence of economic policy-making: his record 'is striking evidence of how much one forceful individual, in a key position can accomplish in such a volatile situation, despite the lack of a genuine political base.'⁸ Largely thanks to Fedorov, credit emissions in 1993 as a whole were only one-third of those in 1992.

Table 2: CBR Credit Ceilings and Outcomes 1993 (billions of rubles)

	Q1	Q2	Q3	Q4
Credit Ceilings	3,500	2,890	4,040	3,614
Actual Outcomes	3,500	3,245	5,407	6,000

Source: Fedorov & Kazmin (1994), p.27 & Tepukhin (1994), p.14

However, as shown in Table 2, the targets were still not met. The control figure was overshoot in each quarter, with the biggest overshoots occurring in the third quarter, due to credits extended to the agricultural sector. In fact, these overshoots would have been far greater had not Gaidar, on his return to government in September 1993, persuaded Yeltsin to sign a decree eliminating CBR subsidies to industry via the commercial banks.⁹ In 1993 as a whole, the flow of domestic credit from the CBR was less than 10 per cent of GDP. Nevertheless, high inflation continued, totalling 890 per cent for the year. Fedorov and Gaidar resigned from the government together in January 1994, following the December 1993 Duma elections. Despite the fact that credits had been significantly reduced, high inflationary expectations continued to drive price rises via an increasing velocity of circulation.¹⁰

Chernomyrdin: 1994

In March 1994, the CBR introduced a new interest rate policy to staunch remaining credit flows to commercial banks.¹¹ For the first time, the CBR set its re-finance — or minimum lending — rate above the market-determined inter-bank rate. (As long as the re-finance rate remained below the inter-bank rate, the CBR would come under pressure from banks to grant credits, which could then be floated on the inter-bank market with large capital gains.) This policy was designed to reduce the demand for CBR credits, lowering the financial (and political) capital to be gained from printing them.

Although CBR credits to enterprises and commercial banks had by now been brought under control, credits continued to be issued in order to plug the budget deficit. In the second half of 1994, monetary financing of the federal budget deficit, running at 10 per cent of GDP, was the largest cause of monetary growth, and thus inflation. Average quarterly growth of M2 increased from 7 per cent between January and March 1994 to 14 per cent between April and June 1994. This increased monetary emission precipitated the collapse of the ruble on 11 October. The monthly inflation rate, having fallen from 20 per cent in October 1993 to 4.6 per cent in August 1994, shot up to 15 per cent in October 1994 and almost 18 per cent in January 1995. This pattern of an austere programme at the start of the year, loss of control in the middle months, and a return to austerity in the winter was becoming a regular feature of Russian stabilisation efforts.

Chernomyrdin-Chubais: 1995

In March 1995 a fiscal and monetary programme was agreed between the government, the CBR and the IMF designed to reduce monthly inflation to 1.3 per cent by the end of the year. The Duma agreed that the budget deficit should not exceed 5.6 per cent of forecast GDP — compared with 10 per cent in 1994. If, due to higher inflation, tax revenues turned out to be higher than forecast, expenditure could be increased only with express agreement of the President. On the monetary side, the programme specified a much lower inflationary financing of the budget deficit than in previous years. It was made illegal for the CBR to provide direct credits for any purpose, even for the government to finance the budget deficit. Some 60 per cent of the deficit was to be financed by external credits and 40 per cent by domestic bond issues. The IMF agreed to a stand-by loan of \$6.4 billion, to be disbursed mostly in 1995, and tied to policy outcomes; and there would be major sales of treasury bills.

Although not announced at the outset, a novel feature of this programme was the plan to peg the ruble to the dollar in an attempt to underpin efforts to lower inflation. The logic was as follows. If the exchange rate is fixed, maintaining the peg becomes the sole purpose of monetary policy. Without the fix, the only cost of printing money today is inflation in six months time. The benefits of printing money are immediate while the costs are delayed and furthermore are borne by the entire population in the form of an inflation tax. A fixed exchange rate alters the incentives of the CBR and the Ministry of Finance. Printing money when the exchange rate is fixed results in an immediate and highly visible loss of hard currency reserves.

One consequence of this new conception of stabilisation was the need to monitor the programme in terms of *Net Domestic Assets* (NDA). This concept measures the monetary base minus *net* international reserves of the monetary authorities. Previous programmes had been cast in terms of limits on CBR credits and/or the budget deficit. The IMF decided that the current programme should employ the concept of NDA, the usual analytical framework within which to peg a currency, as additions to reserves offset monetary growth. The important point is that if the government prints rubles and uses them to buy hard currency, NDA does not grow, even though the domestic money supply has been increased.

The programme started at the beginning of 1995 and NDAs have so far grown within their limits as shown in Table 4. By October, NDAs were more than 9 per cent below the agreed ceiling. Moreover, in September the budget deficit was almost 30 per cent below the IMF's target, but this was

partly due to the favourable effect of higher than expected inflation on a nominal revenues. As a result of the monetary squeeze, monthly inflation fell from 17.9 per cent in January to 4.5 per cent in November. Tight money has been accompanied by higher interest rates, leading to a strengthening of the ruble. However, the end of year inflation target has not been met, and has now been postponed till 1996. A more detailed analysis of this latest stabilisation attempt will be given in Part IV.

Table 3: NDA & Budget Targets, 1995

	Net Domestic Assets (Rubles Trillions)		Cumulative Budget Deficit (Rubles Trillions)	
	Actual	Ceiling	Actual	Ceiling
March	40.4	44.5	8.8	9.0
April	45.6	47.0	10.3	15.5
May	39.6	49.7	12.1	20.5
June	46.8	52.3	19.9	25.6
July	54.7	55.2	21.0	34.5
August	58.7	60.2	25.4	45.0
September	63.6	64.0	37.5	52.1
October	61.7	68.1		

Source: Russian Economic Trends.

IV Explanations For Failure

These can be broadly divided into technical mistakes in the formulation and execution of monetary policy, and political/structural impediments to the realisation of the low inflation goal. The categories are not discrete, because what, from one point of view, can be seen as technical mistakes, from another may appear to be the best choices available in an unenviable situation. Specifically, policy choices in a situation of state collapse are bound to be much more constricted than those available when state institutions are functioning normally. As we shall see, policy choices were further constricted by lack of Western financial assistance during the crucial early stages of the stabilisation programme.

Sachs has pointed to technical weaknesses in the conception and execution of Gaidar's reform measures. 'There was no overall stabilisation program put in place with quantified and monitored macroeconomic targets. There was no strategy for dealing with the Soviet ruble...no strategy for exchange rate management.'¹² Further, Gaidar's failure to liberalise energy prices and key food prices resulted in huge subsidies to these sectors which were a major cause of the continuing budget deficit. In essence, Gaidar simply set himself the goal of liquidating a budget deficit of 16 per cent of GDP as quickly as possible by reforming taxation and cutting spending — while at the same time ignoring the off-budget sources of inflation. His fiscal austerity removed the crutch of state spending at the same time as price liberalisation hit a still monopolised economy. The predictable result was the collapse of industrial output, an even greater pressure for subsidies to loss-making state enterprises met by off-budget issues of credit by the Central Bank, and a severe weakening of the political position of the reformers as promised results were not forthcoming.

Unlike Gaidar, Fedorov did institute a medium-term financial strategy. The specified targets of his programme included the reduction of centralised credits in each quarter, drastic cuts in the budget to minimise the deficit to 5 per cent of GDP and the reduction of monthly inflation to single figures by the end of 1993. Fedorov admits that these targets were ill-formulated: the credit targets ignored seasonal variations in the demand for credits; the price targets ignored the impact of price liberalisation measures.¹³

In the absence of adequate inside testimony it is hard to know how far inferior choices made in 1992 and 1993 were due to mistakes in reasoning or forced by circumstances. Gaidar himself seems to have underestimated the effect of price liberalisation on inflation, overestimated the speed of

conversion from state orders to market demand, and overestimated the political will and professionalism available to carry through his austere fiscal programme in face of growing political opposition. In particular, over-optimism about the speed of conversion may have led the reformers to neglect the importance of encouraging the emergence of *new* private firms (e.g. through de-regulation) and also the crucial importance of constructing free standing 'social safety nets'. It would have been far better, and far less costly, to let redundant firms go bankrupt and pay their dismissed workers unemployment benefits than shovel out huge amounts of cash to the enterprise directors. But it must be remembered that the organisational capacity of the Soviet state, once so formidable, had been virtually destroyed by Gorbachev; and no external finance for 'social safety nets' was available.

Gaidar's choices were highly constrained by the situation he inherited from the Soviet Union. The chief of these were the existence of the ruble zone and the passive tax collection system of the planned economy. The first meant that rubles could be issued by central bankers in any of the fifteen republics of the Former Soviet Union, undermining the ability of the Moscow government to control the ruble money supply. According to Gaidar, 'disbanding the ruble zone at that time would have been technically very difficult'.¹⁴ The inherited problem was compounded by bad advice from the IMF, at whose insistence the ruble zone was maintained throughout 1992, largely because it feared that Russia would repudiate the debts of the Former Soviet Union.

Gaidar also inherited a budgetary crisis, both on the revenue and expenditure side. The shrinkage of the state's revenue base was already a major source of fiscal imbalance in the Soviet Union, the result of falling oil prices, the disastrous Gorbachev-Ligachev anti-alcohol campaign, the resistance of increasingly independent regions to transferring local revenues to the central government, and the unprofitability of state enterprises. The collapse of enterprise profitability implied growing subsidies to state enterprises, increasing the deficit from the expenditure side. In addition, Gorbachev had sanctioned large increases in military expenditure to counter the Reagan arms offensive and large increases in social expenditure to buy time in his last two years in power. Expenditures were also forced upwards by bidding between the Soviet Union and the Republics, with competing governments increasing procurement prices and lowering taxes to buy the support of agricultural and industrial elites.

Table 4: Monetary Incomes, 1985-90. (annual average percentage growth)

	1985	1986	1987	1988	1989	1990
Total Incomes	3.6	3.6	3.9	9.2	13.0	16.9
Social Benefits	5.2	6.4	5.5	11.9	13.5	25.5

Source: Aslund (1991) ¹⁵

In the planned economy there was no capital market and therefore no possibility of financing the budget deficit by borrowing domestic savings. In the absence of foreign financing the only way to reduce credit emissions and thus inflation was to cut the budget deficit, even though this risked a major transitional slump.¹⁶ For this reason, Sachs and others have emphasised the importance of *external* support for stabilisation programmes. 'No matter how valiant, brilliant, and lucky are Russia's reformers they won't make it without large-scale external assistance' he wrote in 1994.¹⁷ Outside help was essential in order to finance at least part of the budget deficit, thus relieving the pressure to bail out failing enterprises by printing money. Money provided by the IMF or other agencies to finance pensions and adjustment-assistance to displaced workers could have replaced CBR credits to enterprise directors. This would have both lowered inflation and spread the burden of adjustment more equitably. Sachs roundly condemns foreign governments and the international agencies for withholding assistance from Gaidar. Not only did the IMF provide his government with 'very little detailed' technical economic assistance, but 'there was not a single Western loan in support of the Russian budget in the first six months, and in practice almost no such loans during the first 18 months of reform'.¹⁸ The IMF responded that the 'central problem has been the inability of the Russian authorities to make or implement credible commitments to control money and credit and the fiscal deficit'.¹⁹ But credible commitments to end monetary financing could not be made without foreign assistance, which could have been conditional on their fulfilment. The IMF did provide a niggardly \$1.5bn. loan to support Fedorov's programme in 1993, but withheld the second tranche when its quarterly targets were predictably missed. If adequate IMF assistance is a precondition for sustainable stabilisation programmes, this requirement is now in place.

A different technical criticism of Gaidar has been offered by Marshall Goldman. What Gaidar should have done, Goldman argues, is to implement a currency reform (swapping ten old rubles for one new one) before liberalising prices. This would have eased inflationary pressure resulting from price liberalisation, allowed the authorities to de-control energy prices, removed the gains from smuggling oil out of Russia, led to a

more rapid move to ruble convertibility, and helped with other aspects of the overall programme.²⁰ Technically, there is much to be said for this, but Goldman does not discuss the feasibility of implementing a successful currency reform in the conditions which the reformers faced: the lack of preparation for any such reform, the recent failure of two previous efforts, the lack of information about the extent of the monetary overhang, the complications of the ruble zone, and above all else, the acute food shortage which meant that getting food back into the shops was the most urgent priority.

The early reformers certainly faced severe political obstacles to the successful implementation of their reforms, and they have emphasised these in their own accounts. The key inherited obstacle was the nature of the Soviet constitution, in which all the state institutions (including the presidency) were subordinate to the Supreme Soviet. This gave the parliament and Central Bank an independent base from which to sabotage government policy. As Gaidar said: 'the Supreme Soviet could change the expenditures in the budget almost every day.'²¹ Thus a compromise between the anti-inflationists and the 'soft inflation' lobby became inevitable, symbolised by the appointment of Viktor Gerashchenko as chairman of the CBR in July 1992. From this perspective, the key failure of the reformers was to press for a presidential constitution early in 1992, when their credit was still high. Having said this, it does seem to us that President Yeltsin could have made more use of his power of decree to expedite de-regulation of the economy and create a legal basis for commercial activity.

According to Gaidar, 'it became more and more obvious that it would be impossible to maintain [our] economic policies ... because of purely political reasons'. His programme of cutting military spending and agricultural subsidies and imposing new taxes on industry 'undermined all the political bases needed to support the policies we were trying to promote'. An alliance of enterprise managers formed in the Supreme Soviet which campaigned against the continuation of restrictive budgetary policy. 'All that was needed [they said] was more money.'²²

It was to counteract the concentrated pressure of the state industries that Gaidar embarked on his dramatic voucher privatisation policy in the summer of 1992. This did not proceed rapidly enough to save him or his anti-inflation policies, and he was forced to make damaging concessions to the enterprise directors, but it led gradually to the emergence of a private sector with an increasing interest in low inflation and a legally-based capitalism.

Fedorov's explanation for the failure of his stabilisation attempt also emphasises political factors: '[Our] program [was] strongly opposed by the agro-industrial lobby within the government, the Supreme Soviet and by the conservative leadership of the CBR. The abnormal and useless confrontation between ... the Ministry of Finance and the CBR ... blocked all attempts to clear up the mess.'²³ Fedorov's failure was symbolised by his inability to remove the chairman of the CBR, Gerashchenko, who was protected by the prime minister, Chernomyrdin. This was only achieved after the ruble crisis of October 1994. On the other hand, the ending of subsidised credits from the CBR speeded up the emergence a new breed of private banks committed to purchasing equity, competing for deposits, and extending loans both to the private sector and the government on commercial terms. These banks became key supporters of a low inflation environment.

The Rutskoi-Khasbulatov coup attempt in October 1993 brought the political impasse to an end. The referendum in December 1993 — which took place simultaneously with the election of the first post-Communist legislature — approved a constitution which placed all executive functions in the hands of the President, reinforcing the power to rule by decree originally granted to him by the Supreme Soviet, and also allowing him to veto parliamentary legislation. Specifically, the new constitution made the chairman of the CBR a presidential appointee. The relatively greater success of disinflation policies in 1994 suggests that this constitutional change was important in facilitating the stabilisation effort.

It is important to note that Grigori Yavlinsky, head of the Yabloko faction in the Duma, has persistently denied that the constitution was the main structural obstacle to macrostabilisation. Yavlinsky emphasises the prevalence of monopoly as the decisive obstacle. In a situation where prices are set monopolistically, applying a monetary squeeze simply leads to the collapse of output. This generates political pressure for credit expansion. Yavlinsky points to the cyclical character of output fluctuations, with over-tight monetary policy leading to sharp falls in output, temporarily reversed by credit emissions, followed by renewed bouts of monetary stringency. He argues that money supply growth cannot be reduced to low levels until the Russian economy is de-monopolised. The reduction of inflation should thus be tied to the speed of de-monopolisation. He believes that the minimum 'sustainable' rate of inflation — ie., one which does not cause output to turn down and political opposition to build up — is 8-10 per cent a month, well in excess of 200 per cent a year. If monetary policy is any tighter, his argument goes, the political will to conquer inflation goes into reverse. His anti-inflation programme 'includes breaking down monopolies,

encouraging small businesses ... completely revamping Russia's bureaucratic machine ... [and] making Russia's fuel monopolies pay taxes'.²⁴ Yavlinsky's views are important because he is likely to be a presidential candidate in June 1996.

Insofar as he sees monopolisation as an independent cause of inflation, Yavlinsky's position just seems plain wrong. Monopolistic pricing can be a source of inflationary pressure if it produces a wage-price spiral, as happened at the end of the Gorbachev era. But this has been far from the position in post-Communist Russia where real wages have collapsed — in October 1995 they were 15 per cent below their level in January 1995. Nor is it clear that the political opposition to monetary stringency was caused by the monopolistic structure of the economy. Contrary to conventional wisdom, monopolies and oligopolies account for a relatively small share of total output.²⁵ It was the fact that the Gorbachev constitution gave the 'monopolies' political control over the Central Bank which was the crucial impediment to the Gaidar-Fedorov programmes. In addition, as Mau has argued, 'it is not deliberate break-up or reorganisation of enterprises but consumer choice which attacks ... monopolism and concentration. As soon as Russians were allowed to fly different airlines, Aeroflot lost the possibility of monopoly pricing'.²⁶ Yavlinsky's further argument — endorsed by Goldman — that the reformers should have done more to stimulate the growth of *new* businesses through massive de-regulation and the rapid introduction of commercial codes is more to the point.

Apart from this, Yavlinsky's anti-inflation strategy is self-defeating. Excessive money creation *prevents* structural reform by redistributing resources towards the inefficient sectors of the economy, while fostering nomenklaturist rent-extraction. Subsidised interest rates, discretionary distribution of credits and quotas encourage state corruption, not industrial restructuring. High inflation, combined with an undeveloped legal system, creates contractual uncertainty which is a major disincentive to investment. In Russia, as in all high inflation economies, inflation politicises the economy, with each group trying to push the inflation tax onto someone else. Preferential interest rates and politicised credit distribution prevent the emergence of a private financial sector. Yavlinsky reflects a very Soviet belief in the ability of the state to dictate structural change. In practice, it is only market forces which can accomplish this task, and high inflation prevents them from working properly. So while legislative steps to increase competition are welcome, they are no substitute for tight monetary policy. Yavlinsky's state-led de-monopolisation programme is likely to become just another justification for the partial re-introduction of credits to state and former state enterprises.

A rather different, though influential, non-monetary theory of inflation is advanced by Sergei Glashev, until December 1995 chairman of the Duma's Economic Policy Committee, who subscribes to what might be called 'Keynesian-Communism'. Glashev argues that the high Russian inflation has been caused by a shortage of goods, resulting from the deflationary shock to production imposed by Gaidar's cancellation of state military orders. The supply of goods can be increased only by restoring state demand and protecting domestic industry. Privatisation should be halted, and in some cases reversed. In addition, 'monopolies' should be subjected to rigid price controls.

The analytic flaw in Glashev's position is that he ignores the link between money creation and inflation. He seems to suppose that he can cure inflation by *increasing* the money supply, provided only that the additional money is spent producing military-related goods. But any increase in output which such a policy will bring about will be swamped by price effects. Glashev is logically driven to advocate the reimposition of price controls to suppress the inflationary impact of printing more money. But this is a major step back to the command economy, which is not only impossible to execute, but which Glashev himself claims not to want. Glashev talks about the 'degradation of the structure of the economy' in the post-Communist period. But policies aimed at restoring the old structure of production are incompatible with the transition to a market economy. More generally, a 'Keynesian' approach to stabilisation makes little sense when millions of people are in the wrong jobs.

The high inflation policy of both Yavlinsky and Glashev ignores the empirical evidence that high inflation is inconsistent with stable growth. The point has been well put by the economist Andrei Illarionov:

Analysis of over 120 countries from 1960 to 1994 showed there had been no country in the world with stable rates of economic growth and annual inflation rates of 90 per cent. Moreover, there had been no country with stable rates of economic growth above zero and rates of inflation higher than 40 per cent annually. Furthermore, the lower the rates of inflation the higher the rates of economic growth.²⁷

These conclusions are supported by the EBRD statistics on inflation rates and growth rates for post-Communist countries.²⁸

Our informal testing of the main theories of inflation supports the view that high persisting inflation over the first three years of the Russian reforms was due not to a mistaken diagnosis of the problem, but to political and institutional obstacles in the way of carrying out an effective anti-inflation

policy. The domestic preconditions for a successful attack on inflation were secured with the creation of the presidential system at the end of 1993, the emergence of a commercial banking sector, and the growth of a financial and commercial sector committed to low inflation. One important external precondition was secured with the IMF's support for the budgetary programme. If the IMF were to provide a ruble stabilisation fund to reinforce the 'nominal anchor' of the ruble band, the main pieces of the stabilisation jigsaw would be in place.

V Prospects For Stabilisation 1995-96

The 1995 budget was a turning point in Russian attempts at macroeconomic stabilisation. The planned federal deficit was 5.6 per cent of GDP, down from 10.4 per cent in 1994. Moreover, whereas between 1992 and 1994 three-quarters of the larger deficit was financed by inflationary CBR credits, with external financing at less than 1 per cent of GDP, the budget law passed by the Duma in February 1995 envisaged that the deficit would be entirely financed by domestic and foreign borrowing, as well as privatisation revenues. Both President Yeltsin and Prime Minister Chernomyrdin were strongly committed to the programme. For the first time, the budget represented a meaningful working document, which could be referred to as law throughout the fiscal year. This was designed to overcome the old problem of phone-call financing, whereby power ministries would simply call on CBR cronies in order to get money.

The political situation was also much more favourable. The gravity of power had shifted from the old guard of 'red' directors, power ministries and the security forces, to the financiers, commercial banks and the energy industry. Because Russia's most powerful vested interests were now broadly pro-market, macroeconomic stabilisation seemed more feasible. At the beginning of 1995, Sergei Alexsashenko, former Deputy Minister of Finance remarked: 'The foundation for fighting inflation this year is much stronger than it was a year ago'.²⁹

This stabilisation attempt started in a very promising manner. During the first quarter of 1995, monetary policy was extremely tight by Russian standards: M2 grew by a mere 3 per cent per month, a vast improvement on the 7 per cent per month registered during the same period in 1994. During this period, monthly inflation fell from 18 per cent to 8.5 per cent. And the return of positive real interest rates meant the ruble began to firm for the first time since the October crash. Given these improvements in the fundamentals, the Russian government and the IMF agreed upon a \$6.4 bn stand-by loan to be distributed in monthly tranches. The early spring optimism of Russia's reformers was bolstered by the emergence of the pro-market bloc in the Duma, 'Our Home is Russia', which marked the entry into party politics of Prime Minister Chernomyrdin and, more importantly, placed him firmly in the pro-market camp.

During the second quarter of 1995, it looked as if Russia's fourth stabilisation attempt — Chernomyrdin's second — would also fail. Broad money grew by an average of 14 per cent per month, in sharp contrast to

the monetary restraint shown by the government during the first quarter. The government maintained that because the extra rubles had been used to buy dollars on a bullish domestic currency market, in turn, strengthening hard currency reserves lost during the October currency crash, these extra rubles were 'benign' in terms of inflation. In fact, only a thin membrane of expectations was preventing the errant second quarter rubles from becoming inflationary. As long as the population thought the ruble would continue to get stronger, they would hold their savings in rubles rather than dollars. But once it was clear that the rise in the ruble had ceased, inflation-proof dollars became preferable to rubles which no longer offered capital gains. This meant the passive rubles were traded for hard currency, bringing them into circulation and allowing them to feed into inflation.

In July 1995, partly to avert the high inflationary expectations resulting from excessive monetary expansion between April and June, the government announced its policy of maintaining the ruble at a dollar rate of between R4,300 and R4,900. Since July, monetary policy has been almost as tight as during the first quarter of 1995, with base money growing by a mere 5, 3 and 2 per cent respectively in August, September and October respectively. Along with the currency band, the 1996 budget gives considerable room for optimism about the possible success of this latest Russian stabilisation attempt.

The Budget for 1996

The current tight policy stance is buttressed by the fully-passed budget for 1996. The budget envisages a deficit of 3.9 per cent of GDP. While 60 per cent of the 1995 budget deficit was to be financed by foreign borrowing and 40 per cent by domestic borrowing, in practice these proportions have been reversed: during the first nine months of 1995, the Russian government financed almost 64 per cent of its deficit by sales of government bonds. The 1996 budget reflects the pattern achieved in 1995: the target of financing 2.4 per cent of GDP by bond sales is not unreasonable in view of the 1.7 per cent achieved in 1995.

Table 5: Financing the federal budget deficit, 1994-1996

	Budget Outcome 1994		Budget Law 1995		Budget Outcome (Jan-Sept 95)		Budget Law 1996	
	Structure	% of GDP	Structure	% of GDP	Structure	% of GDP	Structure	% of GDP
CBR Credits	66.9	7.0	0.0	0.0	0.0	0.0	0.0	0.0
Sales of bonds (net)	19.3	2.0	41.8	3.3	63.5	1.7	60.4	2.4
Foreign Credits	7.9	0.8	58.2	4.6	36.5	1.0	39.6	1.5
Others	5.9	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Total	100.0	10.4	100.0	7.9	100.0	2.7	100.0	3.9

Source: Russian Economic Trends

The government's commitment to avoiding inflationary CBR credits hinges on its continuing ability to sell government debt. Since the government first issued three month GKO's — or non-coupon bonds, sold at a discount and redeemed at par — in May 1993, the size of the market has grown exponentially, from R885m (\$950,000) to R16,000bn (\$16 billion) as of January 1996. The government still has to offer extremely high yields in order to sell government debt, partly due to continuing inflationary expectations. A three month GKO investment in July 1995 would have brought an annualised ruble yield close to 125 per cent, and even more in hard currency terms if real ruble appreciation against the dollar is taken into account. The problem was that, with monthly yields reaching a peak of 8.8 per cent in September, the government found itself spending more money servicing outstanding GKO's in the third quarter of 1995 than the market itself could raise, so that the GKO market was a drain on, rather than a contributor to, the domestic budget. Although yields remain high, the GKO market is again generating a net gain to the budget.

Table 6: GKO's — Issues & Proceeds (Rubles, billions)

	1994	Q1 1995	Q2 1995	Q3 1995	Oct 1995	Nov 1995
Securities Issued	20,530	21,800	35,600	39,000	18,600	21,500
Total Proceeds	12,866	11,300	22,600	24,600	12,900	14,400
Net proceeds to budget	5,742	1,600	6,100	-470	300	1,200
Proceeds as % of GDP	3.3%	0.6%	1.7%	-0.09%	0.2%	0.7%

Currency stability

GKO yields are likely to fall considerably during 1996 — partly because the government is planning to open the GKO market to foreigners, partly because it may also be in a position to issue debt in the Eurobond market. (A precursor to the opening of the GKO market may be the issue of derivatives linked to official Russian debt on Western stock exchanges.) However, the main reason why GKO yields will fall is the ruble currency band, which the government has recently announced it will extend to 1 July 1996. A stable currency lowers GKO yields because government paper no longer has to compete with the currency market in order to attract speculative rubles; an exchange rate peg also considerably lowers the currency risk of investing in a ruble-denominated instrument. The main impact, though, of the currency band on GKO yields is on inflationary expectations. As long as the ruble band is in place, a renewed bout of CBR

credits would result in an immediate and painful loss of international reserves. Thus the ruble corridor provides a 'nominal anchor' for economic stabilisation.

Can the currency peg be sustained? With continuing price inflation, a pegged nominal exchange rate implies an appreciation of the real exchange rate. This need not matter much, and has the beneficial effect of pushing down import prices. Many experts argue that the ruble is undervalued. Given Russia's current account surplus — the extent to which the value of exports exceeds the value of imports — as well as its potential competitiveness, the ruble *should* appreciate in the medium term. But this does not preclude political pressure by the powerful energy export lobby to lower the nominal rate, or periodic speculation by the currency markets against the ruble, with all the detrimental effects on savers' deposits, inflationary expectations and the government's standing. There remains considerable scope for politics to interfere with the 'economic fundamentals'.³⁰

Given that the ruble band is at the centre of Russia's current stabilisation attempt, there is much to be said for the West providing Russia with a ruble stabilisation fund to bolster the government's anti-inflationary credibility. A zloty stabilisation fund was crucial in reinforcing Poland's currency peg in 1990, and would do the same in contemporary Russia. In the Polish case, the money was not even used — its presence was enough to protect the domestic currency. As yields fall on the GKO market during 1996, speculators' attention will shift back to the ruble, increasing the need for a stabilisation fund. It is also worth noting that a ruble stabilisation fund would also provide additional indirect budgetary support, given the favourable effects of the extra reserves on GKO's yields paid out by the government. However, any decision to provide the Russian government with extra external financial support today must rest on a judgement on how far it will remain committed to stabilisation policy in the run-up to the Presidential elections in June and beyond.

The 1995 parliamentary elections

What do the elections held in December 1995 mean for stabilisation policy? The optimistic answer is that the tight stance of the government's economic policy is unlikely to change. Any attempt by parliament to change the agreed budget law can be vetoed by President Yeltsin. To overturn the veto, the Duma needs a two-thirds majority. The Communists and the nationalists between them control around 45 per cent of the Duma, some way below the 67 per cent danger level. Moreover, the 45 per

cent anti-stabilisation total assumes that the Communists and Nationalists will work as a unit. Given the rivalry between the presidential hopefuls from these camps, such co-operation will probably not materialise. In addition, a veto reversal also requires two-thirds of the Federation Council. Recent legislation — appointing regional governors and heads of legislatures as members — makes the Federation Council, for the foreseeable future, even less likely to mount an effective attack on the status quo than the new Duma.

The threat to stabilisation comes not from the Duma but from the President, who may decide that the only way of getting himself re-elected is to buy voters' support by a populist spending programme, heedless of short-term inflationary consequences. Yeltsin has certainly been making pro-inflationary statements and, more tangibly, has dropped the remaining reformers, notably Anatoly Chubais from the government. This would seem to face the IMF, currently considering a new \$9bn three-year budget stabilisation loan, with an unenviable choice. Should it back the 'populist' Yeltsin, come what may, for fear of worse (a Communist victory) or should it delay the loan till after the Presidential elections on 16 June? The danger is that the initiative to loosen the budget stance will come from Yeltsin himself, with few incentives for the Duma to resist.

In fact, the choice may be less dire than it seems. While priming of the electorate is inevitable, some strategic spending flexibility has already been built into the budget, as the result of the Ministry of Finance's success in November 1995 in securing the Duma's agreement to a deliberately low inflation assumption of 1.9 per cent a month. If inflation is greater than assumed, *nominal* revenues received by the government increase, while the nominal expenditures written into the budget — the government's legal obligations — stay the same. An artificially low inflation assumption therefore gives the Ministry of Finance, rather than the Duma, jurisdiction over a significant amount of 'extra' revenues during the course of the fiscal year. This low inflation assumption will inevitably be over-shot during the first half of 1996. While higher than expected inflation is not welcome in general, it will provide substantial extra-budgetary revenues in the run-up to the presidential elections, allowing the government to pay-off wage arrears and boost pensions without increasing the budget deficit beyond the stipulated 3.9 per cent of GDP. This flexibility may be enough for the President's purposes.

Whatever the politics of the next five months will bring by way of alarming rhetoric, it is almost inconceivable that any Russian government will seriously go against the low-inflation preferences of Russia's most powerful

interest groups — the energy sector, the major private banks and the export-oriented manufacturers — as well as those of the majority of the population. If, as we have argued, the structural obstacles to low inflation have been largely overcome, the identity of the next President is unlikely to be the crucial factor it was in the first years of post-Communist transformation.

VI Conclusions

The main conclusions to be drawn from Russia's four attempted macroeconomic stabilisations between 1992 and 1995 are as follows. First, the early reformers were right to believe that in a situation where inflation exceeds 40 per cent per year, its cause is monetary, with the cure lying in the reduction in the rate of growth of the money supply. The failure of their attempts to secure a rapid disinflation lay not in the wrong diagnosis of the causes of inflation, nor even mainly in technical mistakes in the formulation and execution of policy, but in inherited political and structural obstacles which could not be rapidly overcome. It follows that political will is a necessary but not sufficient condition for implementation of stabilisation policies. The preconditions for rapid inflation reduction were not present in January 1992, and were only assembled over the four years of gradual disinflation. But this does not mean that the strategy of 'shock therapy' was wrong, since the initial postponement of any single item of the reform programme would have given the old guard their chance to restore the old order. As it was, they were converted into (very effective) claimants for cash handouts in the new dispensation — an inferior outcome, but better than the alternative.

Secondly, in a high inflation environment, 'industrial policy' of the kind advocated by Yavlinsky and Glasyev is more likely to lead to the resumption of state credits to sunset enterprises than catalytic subsidies to sunrise economic activity.

Thirdly, more important than the size of the budget deficit is the manner in which the deficit is financed. However, the Russian government is still finding it difficult to sell its own debt at reasonable rates of interest. The London Club deal, if strengthened by a similar Paris Club deal, will help to lower yields by providing alternative sources of finance, in particular issues of Eurobonds.

Fourthly, a fixed exchange rate can act as an important nominal anchor, provided it is introduced once the institutional obstacles to implementing a tight monetary policy have been overcome.

Finally, external help is important, in both political and financial terms. External financial assistance in order to maintain the current peg of the ruble would lower speculative pressure on the domestic currency and encourage inflows of foreign capital.

In terms of policy, this suggests that the West should not only go ahead with the new budget stabilisation loan, but should seriously consider providing resources to maintain currency stability.

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NOTES

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- ¹ VTsIOM opinion poll, September 1995.
 - ² Gaidar, q. Yeltsin, p.156.
 - ³ See Kindleberger, 'A Structural view of German Inflation' q. Feldman *et al* (1984).
 - ⁴ For a useful survey, see Asilis and Milesi-Ferretti, 1995.
 - ⁵ Gaidar, p.6.
 - ⁶ The decision to favour VAT was in keeping with conventional wisdom in the West regarding economic policy during transition. See, for instance, McKinnon (1991).
 - ⁷ Gaidar (1993), pp.48-50.
 - ⁸ Aslund A (1995) p.197.
 - ⁹ Between 1992 and 1994, federal subsidies in Russia fell dramatically, from 32 per cent of GDP to less than 6 per cent. See Halligan L, Teplukhin P & Willer D, 'Subsidisation in the Russian Economy,' *Russian European Centre for Economic Policy Working Paper*, July 1995.
 - ¹⁰ In the second half of 1992, monthly M2 velocity — nominal GDP over broad money - averaged 0.51. This rose to 0.59 in the first half of 1993 and 0.92 in second half of 1993.
 - ¹¹ The distinction between enterprises and commercial banks was often fictional. In order to avoid new regulations, many enterprises set up 'pocket' banks under their own control. Such banks acted as channels for direct credits to enterprises, even when such transfers were illegal.
 - ¹² Sachs (1994b) p.33
 - ¹³ Fedorov and Kazmin (1994) p.28
 - ¹⁴ Interview with author, q. Halligan (1995)
 - ¹⁵ Aslund A, *Gorbachev's struggle for Economic Reform*, London: Pinter, p.188
 - ¹⁶ The size of the budget deficit is important only to the extent that it is financed by inflationary credit. A budget deficit of 10 per cent of GDP may be consistent with stabilisation if financed by bonds sold at reasonable rates of interest. On the other hand, stabilisation will not be achieved if a deficit of 5 per cent of GDP is financed by the CBR. A lower deficit is desirable only insofar it makes inflationary

financing less likely: during transition, it is a tool rather than a goal of economic policy. In fact, in the early stages of transition, excessive limitations on budget deficits could hinder marketisation by preventing spending on social and economic infrastructure. This sentiment is not without support even within the IMF. See, for instance, Tanzi (1993).

¹⁷ Sachs (1994a) p.504.

¹⁸ Sachs (1994b) p.33.

¹⁹ Anjaria (1994) p. 522.

²⁰ Goldman, pp.240-2.

²¹ Gaidar Y (1995) 'Post-Communist Reform — Five years on', *Voprosy Ekonomiki*, No.12.

²² Gaidar Y (1993) pp.37-8.

²³ Fedorov and Kazmin (1994) p.26.

²⁴ Bershidsky L. (1995). Yavlinsky's general line is endorsed in Goldman, *op.cit.*, pp.239-40.

²⁵ Brown, Ickes, and Ryterman (1993).

²⁶ Mau (1995) p.73.

²⁷ Illarionov (1995) pp.93-4.

²⁸ EBRD Transition Report (1995) pp.185-6.

²⁹ Address to the Moscow American Chamber of Commerce, March 1995.

³⁰ Most commentators dismiss fear over the ruble band by pointing to the fact that the CBR has had to sell rubles and buy dollars since the introduction of the band to 'rein in' the value of the ruble. However, this ignores the fact that 'semi-official' exchange rate intervention has been taking place, with the government using commercial banks as 'fronts' through which to make large purchases of domestic currency. The fact that during the last six months of 1995, ruble instruments required a return five times greater than their dollar counterparts is perhaps the most telling indication of doubts about the currency band, which the government acknowledged by shifting dollar-rate boundaries to R4,550 and R5,150 in November.

There are also concerns over the levels of reserves. The latest available figures (August 1995) show gross international reserves at \$13.4bn. However, net international reserves (excluding short-term liabilities) were only \$6.9bn. Not counting illiquid assets — such as gold — net foreign exchange reserves, with

which the government could immediately defend the exchange rate — amount to just over \$4bn. This exceeds only slightly hard currency reserves in the summer of 1994, prior to the Black Tuesday currency crash.