

**Shock Therapy and After:  
Prospects for Russian Reform**

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Prospects for Russian Reform\*

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In the third year of its transition to a functioning market economy free from high inflation, Russia began its toughest phase in 1994 under the Chernomyrdin government. The approval by the International Monetary Fund (IMF) in March of the second tranche of \$1.5 billion signaled support for the economic program of the new government. The subsequent adoption by the Duma (lower house of the parliament) of the government's budget and the signing of the civil accord by several parliamentary factions and industry groups marked a step, albeit fragile, in the direction of national consensus.

The onset of this ominous phase of reforms continued to divide policymakers and academics alike in Russia and elsewhere with respect to the appropriate policy framework for the reforms and the prospects for their success.

On one side were the "shock therapists," advocating "an abrupt tightening of monetary conditions, an early pegging of the exchange rate, and large-scale international aid to support the stabilization."<sup>1</sup> On the other side were the "gradualists" who proposed firm but gradual ("non-abrupt") and escalating attacks on the budget deficit and inflation, supported by smaller and more realistic aid flows and without resort to an outright pegging of the exchange rate.<sup>2</sup> The gradualist program of the Chernomyrdin government was in place throughout 1994, having been adopted in effect by former Finance Minister Fyodorov before his departure. It anticipated an inflation rate of between 7 to 8 percent per month by the end of the year and a 1994 budget deficit target of 9

percent of GDP.<sup>3</sup>

The sustained implementation of this gradulist program was threatened as inflation surged to 11.8 percent in October after a steady drop to 4.4 percent in August from 21 percent in January. Indeed, the sharp decline in the value of the ruble by 21 percent on October 11, the resignation of the central bank chairman Viktor Gerashchenko, and the subsequent changes in the central cabinet threatened the prospects of a continuing stabilization of the economy.

But first, it is necessary to take a backward glance by posing three relevant questions: Was shock therapy tried in Russia? Next, if the answer is in the affirmative, why did it fail? Finally, what were its consequences? In conclusion, the prospects for the Chernomyrdin stabilization agenda are discussed in the context of the "Black Tuesday" crash of the ruble and the cabinet reshuffle which followed.

### **Was Shock Therapy Tried in Russia?**

The answer to the question according to Boris Fyodorov, the former Finance Minister of Russia, was a resounding nyet: "Many people in the West, it seems, prefer to close their eyes to the fact that there never was any shock therapy, ever, in Russia." ("Moscow Without Mirrors," The New York Times, op-ed, April 1, 1994). Equally decisive was Sachs's response: "Contrary to recent commentary, "shock therapy" did not fail in Russia. It was never tried." ("Betrayal," The New Republic, January 31, 1994, p. 19).

Three issues must be resolved in providing a definitive

answer: What criterion does one adopt in isolating the shock part of the reform program which was launched in January 1992? Next, what was the Gaidar government's intention ex ante with regard to the shock component of its agenda? Finally, how severe and durable was this shock ex post as the reform package unfolded with the January price liberalization?

### The Shock Criterion

The critical phrase in the Sachs definition of shock therapy, namely "an abrupt tightening of monetary conditions" provides a clue to the search for the shock element in the transition package. In fact, Sachs himself settles for the relative size (as a ratio of the GDP) of the government borrowing from the central bank of Russia (CBR) and the resulting growth of money supply in the economy as an index of the desirability for administering a shock.<sup>4</sup> Thus, the higher the current ratio, the greater the urgency to curtail it sharply; hence, the more "abrupt" the measures to close the budget deficit (which is financed by central bank borrowing), the greater the shock.

### The Shock Criterion and the Gaidar Program

The government of Acting Prime Minister Gaidar adopted this criterion hook, line and sinker when it initiated its transition measures in January 1992.

Thus, the budget deficit for the first quarter of 1992 was to be reduced to zero from an officially-estimated 1991 level of 17 percent (and IMF-estimated 21 percent) of GDP. Defense outlays, state-financed investments, and subsidies to consumers and industry

from the federal budget were slashed. These cuts were Soviet-style: They did not come from political consultations with the parliament or the people. (In the view of shock therapists, no such consensus is necessary for applying the shock, a point which is argued later.) Local governments were told to find their own resources if they wished to subsidize people's purchases of basic foodstuffs and services. (As a result, the regions began withholding tax revenues from the center for financing local subsidization of essential, consumer-goods purchases by their citizens. These details follow later.) The prevailing law of indexation which linked the earnings of state employees and pensioners to the cost of living was scrapped. Prices were almost wholly decontrolled.

Prices jumped by a sharp 300 percent in January as a result of the price decontrol. There was a sudden and sharp decline in the worth of people's cash savings. The loss of indexation of wages to price increases for state employees added to their insecurity. There were also fears about large-scale unemployment from the proposed stoppage of budgetary support to industry. The social safety net, in the form of unemployment insurance, was still far from adequate.

#### **The Shock: How Severe and For How Long?**

The severity and duration of the shock can be assessed from the ex post budget deficit and the resulting rate of growth of money supply.

Thus, according to Sachs, "temporary stabilization" on the

basis of a credit squeeze was accomplished in Russia in the first half of 1992. Indeed, budget figures from January-May 1992 "suggest that Russia was within reach of stabilization in the first half of 1992. Despite the enormous fall in budgetary revenues as percent of GNP, there was a comparable fall in government spending as a percent of GNP. In the first quarter, net Russian Central Bank (RCB) credit to the General Government was actually negative, at - 2.3 percent of GDP.... The overall money supply grew at an average of 8 percent per month during February to May, mostly due to reductions of excess reserves in the banking system rather than net credit from the RCB. By August, inflation rates had declined to 9 percent per month, which proved to be the low point during 1992 and 1993." (Sachs, 1994, pp. 24-25).

In fact, Sachs marshalls this evidence to argue that the IMF did not come up with timely and suitable help (to be augmented by assistance from the G-7) even though the Gaidar government had achieved "temporary stabilization" by drastically cutting back its central-bank-borrowing-financed deficit. In other words, the shock of abrupt credit squeeze (which was applied in anticipation of foreign resource inflow) had produced the expected macroeconomic results in Russia during the first half of 1992.

Why did they not last longer?

#### **Why Did Shock Therapy Fail?**

The reasons for shock therapy's failure were economic as well as political.

#### **The Economic Factors**



The temporary macroeconomic stabilization did not endure because the microeconomic units, the farms and the factories, did not respond according to market economy norms to the price signals.<sup>5</sup> The Gaidar program naively assumed that, in response to the new relative price regime, managers would lay off workers in unprofitable factories; that workers would move to the profitmaking units; that the managers would choose (like their market economy counterparts) to make both ends meet and, failing that, would declare bankruptcies rather than seek, as before, financial support from the government budget. This did not happen. In fact, the large number of monopoly producers raised prices (from their administered levels) and, in the face of reduced demand, accumulated inventories and retained workers on their payrolls rather than undertake restructuring. Macroeconomic stabilization failed later in 1992 because the hoped-for, market-economy type reaction of Soviet-era factory managers to the price signals did not materialize. They were simply not ready for such a response threatening factory closures and worker jobs.

The managerial rejection of the program found ready political acceptance in the Supreme Soviet (the parliament) among the centrists, and in particular, the communists who regarded the radical program as an ideological attack on the planned system. Economically unworkable, it turned out to be politically unacceptable.

#### **The Political Factors**

Shock therapists rule out the need for a political consensus

which characterizes "hesitant democratization." Rather, the recommended strategy consists in outwitting the old guard by identifying a political breakthrough<sup>6</sup> and launching swift and tough reforms rightaway. Evidently, these windows of opportunity opened up in Poland in 1989 after its liberation from the Soviet empire and in Russia in 1991 after the collapse of the Soviet Union.

Thus, Anders Aslund writes: "...the paramount task of the new, noncommunist leadership was to build a democratic state as simply and quickly as possible. Speed was of the essence both in breaking the power of the old communist apparat and in erecting defenses against the counterattacks that it might mount after licking its wounds for a time."<sup>7</sup>

Speed, toughness and appropriate timing mark the Sachs agenda as well. In his view, (Sachs, 1994, p. 19 and pp. 32-33), a handful of Russian reformers in the finance ministry and the central bank could launch the big bang because the president was popular and the populace was acquiescent at the start of 1992, an assumption which the subsequent opposition showed to be a mistake. In particular, the macroeconomic stabilization could not be sustained after mid-1992 because escalating political opposition ruled out monetary control and fiscal discipline.

The program also floundered because of its politically untenable assumption of massive foreign assistance which it failed to procure.

#### **The Role of Foreign Aid**

The speed with which inflation could be controlled by slashing government outlays was conditioned not only by the economic and political realities of Russia but also by the external support which could be mobilized for the purpose.

It was necessary to divert budgetary support away from defunct factories and use it for unemployment compensation, worker retraining, and safety net provisions for the population, and for promoting investment to restructure these factories. But the size of the outside funding for the purpose and the Russian capability to absorb it speedily and efficiently hobbled the process.

The record of external support for Russia since the start of the transition in January 1992 was marked by loud rhetoric, generous promises, and small deliveries.

Only \$8 billion of the promised \$28.4 billion was disbursed in 1993.

The IMF and the World Bank gave \$1.8 billion for short-term macroeconomic stabilization out of the promised \$4.1 billion. The delivery of the massive \$10.1 billion (\$4.1 billion stand-by credits from the IMF for full economic stabilization and another \$6 billion for supporting the ruble) was being negotiated toward the end of 1994.

Only \$6.2 billion of the \$14.2 billion promised by the G7 (group of industrialized market economies) for supporting factory restructuring, infrastructure buildup and overhaul of agriculture and the energy sector was distributed by the end of 1993.

A major concession in 1993 (which would be continued in the

future) was the rescheduling by the G7 of the official principal and interest payments by Russia.

The disparity between aid promises and deliveries to Russia was not surprising. A common thread underlying IMF and World Bank lending is conditionality--"you may continue to borrow only if you perform." In general, aid dollars should not be wasted. Indeed they should be used productively in a free market environment so that the recipient benefits from the aid through steady growth instead of getting overloaded with a debt burden that cannot be serviced or repaid. The ultimate objective of aid activity is to promote private investment.

These conditionalities were hard to fulfil at the Russian end and therefore, moderation in implementing them was necessary. A major problem (noted earlier) was encountered in closing large factories.

In short, massive aid inflows to cushion the burden of unemployment and decline in living standards resulting from deficit reduction in Russia had to be ruled out. Such megabucks underlying the shock therapy agenda were not available; nor could the Russian economy absorb them with the necessary speed.

The mounting political turmoil which followed the launching of shock therapy operated at three levels.

#### **Consequences of the Shock Therapy**

The fastpaced program led to increasing polarization in 1992 between the executive and legislative branches at the center and between Moscow and the eighty-eight territorial units. Both

polarizations continued in 1993. 1993 also witnessed the exit and entry of cabinet ministers with President Yeltsin orchestrating an apparent centrist balance between the reformers and the conservatives in the government.

### The Polarization between the Executive and Legislative Branches

The legislators elected in 1990 to the old Russian parliament were a mixed bag of reforming democrats, ardent communists, and a fringe of diehard nationalists and extreme (Soviet) unionists who were ready to go beyond the war of words for resurrecting old times. The membership was one-third reformist, one-third antireform extremists (including the communists), and the remaining fluid marsh (boloto) which moved in either direction.

The January shock brought out in the open a variety of voices. But increasingly, proreform centrists who were against the speed of the program joined ranks with the old faithfuls who regarded it as an onslaught on the former system of administered prices, bureaucratic management of factories, and their automatic bail-out by budgetary subsidies. Economic measures, in their view, were unleashed to accomplish political goals of destroying the communist planned system. By August 1992, the Supreme Soviet had forced the government to rescue bankrupt factories. By September 1993, it was ready to push the (1993) budget deficit to 25 percent of GDP. The escalation culminated with the dissolution of the parliament, the attack on the White House, and the December elections.

The composition of the post-election parliament signaled the adoption of a gradualist transition (implying firm rather than

abrupt inflation control) during 1994. The adoption and fulfilment of the monthly inflation target of 1 to 1.5 percent in the 1995 budget also called for a careful balancing of the claims in the budgetary pie of the parliamentary factions which must approve the budget.

### The Polarization between the Center and the Periphery

Over time, this friction was brought out in the open by the hasty fiscal measures of early 1992 which were calculated to roll back the federal budget deficit in a grand swoop. A number of expenditure items were summarily taken out of the central budget and passed on to lower levels without a proper agreement on the principles of financial rearrangements between the center and the regions.

The regions in the Soviet days were responsible for education, health care, culture, housing, local roadbuilding and the like. They also got the necessary finances from the center. In 1992, more federal programs such as capital investments in rural areas, subsidies for livestock products, development of local passenger transport were shifted to the regions without matching finances. The ad hocism continued into 1993: The 1993 budget initially proposed that the regions could keep between 5 to 50 per cent of the value-added taxes with the minimum to be kept by the highest tax contributors. The center would then redistribute the tax revenue as it saw fit.

The resulting pattern of taking and transferring cash turned out to be neither equitable nor logical. Thus, in the truly poor

regions of Tuva, Buryatiya, Dagestan, Mari El and Kabardino-Balkariya, the 1992 per capita budget expenditure (including contributions from the center) was about half the average level for Russia as a whole. Again, Ulyanovsk Province was contributing 50 per cent of value-added tax to the center in contrast to the 80 per cent "tribute" of nearby Yaroslavl.

There were other forces such as ethnic identity which were pulling the regions away from Moscow but the perceived fiscal armtwisting by the center of the resource-rich members was increasingly pushing the "primeval Russian lands" into demands for economic autonomy. The center reacted by capitulating to the more vociferous claimants and weakened the tenuous fiscal arrangements further. By the fall of 1993, almost thirty of the eighty-eight members had unilaterally cut back their tax contributions to Moscow. The charge was led by Bashkortostan, the Chechen Republic, Tatarstan and Yakutiya which gave nothing to the federal budget in 1992.

The lesson for the Chernomyrdin government from the rash fiscal ad hocism of the radical reformers was to avoid its repetition. The assignment of expenditures and matching revenues called for firm but fair negotiations with the regions on the basis of mutually acceptable principles of the devolution.

#### The Polarization within the Central Cabinet

Throughout 1993, President Yeltsin had to contend with two opposing pressures: He had to have a radical finance minister to control inflation so that the IMF would release its promised aid;

he had to have a conservative component in the cabinet (arguing for production boost via industrial subsidies) to pacify the parliament which had a similar view. By September 1993, he faced defeat on both counts. Parliament voted to triple the budget deficit (from the original 8 trillion rubles) and the IMF refused to release the second tranche of the promised \$3 billion funding. At the same time, the divisions within the cabinet were openly ventilated by radical ministers on the national TV and the western media bringing the level of public discourse to its lowest level. It created a legitimate worry among western policymakers and international business that there was no government in Russia.

By contrast, the post-election cabinet consisting of like-minded colleagues was cohesive. Whereas the "technocrats" of radical reform failed at managing the politics of implementing its agenda, the new government of "managers" held out the promise of a credible policy scenario of measured inflation control. By contrast, its reconstituted "snake and hedgehog" mix toward the end of 1994 (following the sharp decline in the ruble's value on October 11) created uncertainties in regard to further progress on inflation control.

#### **The Economic Balance Sheet**

The radical agenda of January 1992 ushered in a revolution of ideas at the two levels of market-determined prices and of private ownership of means of production. The planned economy principles of administered prices and of state ownership of productive assets were jettisoned forever.



Progress on both fronts in practice however was far from complete.

Thus, despite price decontrol, prices of food items and consumer goods continued to show a dispersal (which could not be accounted for transport costs) in the vast territory of Russia. Again, prices of raw materials and machinery goods failed to approach world levels: Energy prices moved up from 7 to 9 percent of world levels in 1991 to 30 to 40 percent by mid-1994; on the other hand, domestic prices of raw cotton and wool, zinc and copper, and timber declined relative to world prices. These prices were not fully liberalized nor was the trade regime completely freed. Segmented markets and transport bottlenecks also persisted.

The record of privatization too was mixed.

The State Committee for the Management of State Property reported that 103,796 units from the federal to the republican, regional and municipal levels had been privatized under its mandate by July 1, 1994. Russian citizens had placed 144.5 million vouchers (out of 148 million) in enterprises and investment funds of their choice.

The achievements were momentous in the sphere of "petty" privatization: Over 67,000 enterprises in retail and wholesale trade, public catering and restaurants, and consumer services were sold, or leased with prospects for future purchase.

By contrast, large and medium factories were only corporatized, i.e. formally converted into joint stock companies. About 30,000 such units had started this process of conversion

beginning with approval of plans and ending with actual registration (of 21,000 units). A quarter of the 2,000 defense factories were excluded altogether from the privatization mandate. While a few small and medium-sized companies had increased production efficiency, shed labor and diversified product mix, the big enterprises had responded tardily to market forces, accumulated payment arrears, and continued operating. The daunting task of restructuring the viable and liquidating the bankrupt enterprises lay ahead.

The Federal Bankruptcy Agency of the State Property Committee had started functioning by September 1993 and bankruptcy agencies were in place in 82 regions of Russia by September 1994. Contracts were being signed with private auditors for screening enterprise balance sheets. By early August, 100 factories were put on the insolvency list and the number was increasing daily by several dozen. The bankruptcy resolution of the government of May 20, 1994 laid down the procedures: It granted a moratorium on enterprise debts for 18 months during which the enterprise was required to pay off arrears by selling property and finding new investors. State subsidization was ruled out. Given the unprecedented scale of insolvency--in some regions 40 to 70 percent of the factories were bankrupt--, restructuring was bound to proceed slowly.

Farm privatization too faced an uphill task. Private farms, 277,000 in all, averaging 43 hectares each, represented barely 5 to 6 percent of the arable land by July 1, 1994.

Finally, the income distribution consequences of the

transition raised concern. These issues related to the increasing unemployment, properly measured, of the workforce, the widening income gap between the rich and the poor, and the escalating nonpayment of wages and salaries to the workers on the factory payroll.

By July 1994, 4.6 million people were jobless and were looking for work; another 4.5 million were forced to work part time or take vacations with or without pay. The total of 9.1 million unemployed and semi-employed implied that one out of every eight able-bodied persons was without a steady job.

Next, the income gap between the haves and the have-nots was widening although the July 1994 disposable incomes, adjusted for inflation, rose by 11 percent over July 1993. 26 percent of the earned income went to the top 10 percent of the population and 2.4 percent went to the bottom 10 percent in the first seven months of 1994. This ratio of 11 to 1 had jumped from 8 to 1 in 1992. 24.5 million Russians or every sixth citizen had income below the minimum living standard in July defined at 96,500 rubles per month for an adult.

The nonpayment of wages had risen from 2.3 trillion on April 1 to 3.8 trillion on August 1. More than 20 million people in 34,000 enterprises were denied payments due to them.

The income distribution could worsen if the government were to fail in guaranteeing financial support to the most vulnerable citizens and in providing unemployment compensation and job retraining to the unemployed workers. Some jobless could be

absorbed in the expanding tertiary sector but the Soviet practice of allocating factory housing to employees restricted labor mobility.

The resources available to the government for the purpose toward the end of 1994 were meagre. Its financial health and indeed the pace of macroeconomic stabilization continued to engage Russian policymakers and the IMF teams which began negotiations in October on the \$4.1 billion standby credits to Russia.

#### **The Financial Fragility of the Government**

The 1994 budget which was approved by the Duma (after three readings on May 11, June 8, and June 24) provided for expenditures of 286 trillion rubles (194 trillion rubles at the federal level), revenues of 230 trillion rubles (the federal share was 124 trillion rubles), and extrabudgetary contributions (from the state pension and insurance funds) of 8 trillion rubles. The deficit of 48 trillion rubles (estimated at 6.5 percent of the projected GDP of 746 trillion rubles) was to be financed largely by government borrowing (of 40 trillion rubles) from the central bank.

The budget projections were unrealistic even as they were being debated; they were in tatters as the year advanced.

#### **1994 Budget Revenues**

Take revenues first.

The center's ability to raise tax revenues was projected unrealistically. The continuing decline in industrial output shrank the tax base. (It was expected to fall sharply by 25 percent

in 1994 compared to 16 percent in 1992 and 1993, and 11 percent in 1991.) Again, consumer subsidies were abolished at the center but they persisted in the regions. As a result, the net revenues transferred to the federal government became more unpredictable as the subsidy claimants in some localities increased. Finally, in the Soviet days, taxes were automatically passed on by enterprises and localities to the central treasury. With mounting decentralization and regional autonomy, the voluntary transfer required transparent and stable tax rules, commitment to fiscal contracts, and fear of revenue authorities. None of this was fully in place in Russia. Tax evasion increased.

As a result, 1994 federal revenues were unlikely to exceed 70 trillion rubles (in contrast to the targeted 124 trillion rubles) requiring an expenditure trimming of 54 trillion rubles if all other pieces of the original exercise including the projected deficit of 48 trillion rubles were to remain unchanged.

#### **1994 Budget Expenditures**

With regard to expenditures, the 1994 budget appropriations gave substantial allocations to agriculture and energy. The urgency to guarantee adequate food supplies to the population by supporting agriculture and to stabilize the oil industry as an export earner was in evidence here. Explicit defense allocations amounted to 19 percent of the total. The budget provided resources (usually transferred in early autumn) to the administrations of the Northern Territories enabling them to store food, energy and materials for the needs of 11 million residents in the winter months. On the

other hand, there was no provision for support to industry except for coalmining. Resources were to be handed to the claimants as cheap credits rather than outright grants.

The ability of the government to cap appropriations at agreed levels was tested to the hilt in the summer.

By midyear, loans in the amount of 1.4 trillion rubles were granted from the budget to various factories among them the Rostov Farm Machinery Plant, the Kama Automobile Plant, the Altai Diesel Plant and several others. On a trip to the Tuva region in mid-June, President Yeltsin promised generous support to the local leadership to build a sheepskin coat factory and develop its water transport system. He forbade all government and presidential officials from demanding that the republic earn its own money and live without federal subsidies (Izvestiya, June 18, p. 2). More presidential decrees providing support to industries which were not covered by budgetary appropriations followed. Thus, the decree of early August sanctioned an appropriation of 3.5 trillion rubles for defense industry conversion: 2.9 trillion rubles were to be issued at an interest rate of 37 percent which was one-fourth of the Russian central bank's discount rate.

As a result of the manifold largesse, central bank monthly credits to the government reached 7 trillion rubles in July in contrast to the average 3 trillion earlier raising serious doubts about the government's ability to control inflation at the August rate of 4.4 percent.

A direct outcome of the widening gap between disbursements and

revenues was the indiscriminate use of budgetary sequestration: Expenditures were cut back or postponed and wage payments on government account were delayed. A serious consequence of slackening inflation control and rising inflationary expectations was the October 11 crash in the ruble's value which was magnified by the central bank's mismanagement.

### Budgetary Sequestration

The only course of action open to the government to get out of the financial logjam was budgetary sequestration: Collection of existing taxes could not be improved overnight nor could new taxes be levied without parliamentary approval; at the same time, the targeted deficit (enacted by the lawmakers) had to be met whereas the expenditure ceilings could be left unfulfilled.

By July, the agro-industrial complex had received less than 10 percent of the appropriated funds from the budget. No money had been allocated for investment in the economy. Millions of state employees failed to receive wages on time. By the end of June, the federal government had settled 1993 wage arrears of 4 trillion rubles but new obligations arising in particular from the 90 percent salary increases to state employees beginning January 1, 1994 had accumulated. The state and its workers lived from hand to mouth. And the army lived in poverty according to Defense Minister Pavel Grachev who declared in the Duma on November 18 that military funding ran at about half the appropriations.

### The "Black Tuesday" Ruble Crash

An ostensible purpose in letting the ruble slide beginning

September 22 when the Russian central bank stopped supporting it on the Moscow InterBank Foreign Exchange was to augment federal revenues. The "benign" neglect of the currency however turned out to be a nightmare on October 11.

A depreciating ruble would bring in higher ruble earnings from exports of items under the Centralized Export Scheme (which became effective in January 1993) under which the government bought a variety of strategic items such as oil, gas, nonferrous metals, fertilizers and timber from domestic producers and sold them abroad at world prices. The difference between the domestic and world prices became budgetary revenues. (Licensed exporters of these items who were required to hand in all foreign exchange to the Finance Ministry received 5 to 7 percent of the export earnings for their services.) Such net earnings from the Centralized Export Schemes of 2.5 trillion rubles were 58 percent of the total export taxes of 4.3 trillion rubles in 1993.

This apparent scheme to boost revenues in the central treasury misfired as traders on the Moscow Interbank Currency Exchange manipulated the currency by unloading rubles in a thin market in which the daily transactions averaged 100 to 150 million dollars. The ruble bounced back to its previous value with delayed central bank intervention of \$100 million. The acting central bank chairman Tatyana Paramonova would need to remain watchful and quickfooted in the foreign exchange market in order to avoid a recurrence of such destabilizing episodes.

The deteriorating inflationary expectations certainly played



a role in the speculative flight from the ruble. The ruble's slump brought home the critical need for inflation control as the reconstituted government and the IMF awaited the passage of the 1995 government budget by the Duma. The budget proposed a monthly inflation rate of 1 to 1.5 percent by mid-1995 and a budget deficit of 8 percent of the projected GDP. Its plan was to bring government borrowing from the central bank to zero and to keep federal outlays on agriculture and defense at 1994 levels. The deficit was to be covered by borrowing from the public and financed partially from an expected credit of \$13 billion from the IMF.

Thus, as 1994 was closing, financial stabilization involving domestic resolve and foreign participation was once again at the top of the Russian reform agenda. A credible program of inflation control would strengthen the ruble, induce domestic savings, attract foreign investment and stabilize production.

### **Prospects**

On the eve of the Duma's debates on the budget, President Yeltsin had reorganized the cabinet of Prime Minister Chernomyrdin with his unfailing touch for pitting reformers against hardliners. Vladimir Panskov, a bureaucratic budget advisor on Yeltsin's staff, was brought in as Finance minister along with the mildly reform-oriented Yevgenii Yasin as the Economics Minister. Anatoly Chubais with impeccable reformist credentials was elevated as First Deputy Prime Minister and put in overall charge of the economy. Despite the cabinet reshuffle, Chernomyrdin managed to present the tough budget to the parliament signaling a unified cabinet position on

inflation control.

The parliamentarians on the other hand, watchful of their reelection chances in 1995, could be expected to argue in favor of lowering the monthly inflation target and test the government's determination to hold the line. As before, there would be demands to raise budgetary support for defense and agriculture. The government's inability (evidenced in 1994) to collect adequate revenues, the need for escalating budgetary resources to provide support to the unemployed, the uncertain prospects (arising from the fragile infrastructure) of channeling public savings into federal bonds would be brought out in the Duma discussions. The government's expectation of budgetary support from IMF would be questioned as unrealistically high.

But toward the end of 1994, the new wrinkles in these old debates on stabilizing the economy appeared from two directions.

Not only was the need to strengthen the ruble more widely acknowledged but the procedures for accomplishing the goal had entered the phase of vigorous bargaining and the inevitable give-and-take between the government and the parliament. This interaction by its very nature ruled out a breakthrough on financial stabilization (marked by say a "big bang" single-digit annual inflation) but held out the promise of a monthly inflation regime by the end of 1995 of less than 3 percent.

Finally, the economy showed signs of qualitative changes. Industrial production began to pick up in the late summer of 1994; sizeable rubles were increasingly drawn into investment rather than

financial speculation. Domestic savings in Russia had increased from 5 trillion rubles in January 1994 to 15 trillion rubles in July. The sale of government stock and the issue of new shares for cash in the corporatized factories began to provide resources, domestic and foreign, for their restructuring. Parliamentary legislation in early 1995 marking a stable tax system and guaranteeing ownership by foreigners was expected to start the long-awaited flow of foreign investment in Russian industry.

Will the political give-and-take and the economic turnaround prove sufficiently resilient in 1995 to stabilize the ruble and hold at bay the negative aspects of the process, namely the gathering unemployment and the widening income distribution? Perhaps the emergence of a stable market economy has proved to be more macabre in Russia than the early beginnings of free markets elsewhere in the western world. Despite the ominous setting, 1995 could prove to be the year of Russia's start of that historic journey.

1. This description is from the chief exponent of shock therapy, Jeffrey Sachs ("Russia's Struggle with Stabilization: Conceptual Issues and Evidence," Annual World Bank Conference on Development Economics, April 28-29, 1994, p. 1). Also see his book on Poland's experience and its promise for Russia (Poland's Jump to the Market Economy, Cambridge, Mass: MIT Press, 1992).

2. See Padma Desai, "Confused Thinking about Russian 'Gradualism'," The Financial Times, Letters to the Editor, April 19, 1994.

Note that price liberalization and privatization are a necessary feature of this version of gradualism. Its hallmark is firm but manageable control of inflation supported by feasible flows of foreign assistance. (See Padma Desai, "Ease Up on Russia," The New York Times, op-ed, December 10, 1993). It must, therefore, be distinguished from the market-socialism-type gradualism in which enterprises were freed from obligatory state quotas (and, therefore, matching input supplies) but prices remained administered, consumer subsidies on essential purchases were retained, wages outpaced prices because monetary discipline was missing, the state continued supporting enterprises and running budget deficits for the purpose, and state ownership of assets persisted.

3. These figures are from Viktor Chernomyrdin, "No Exits on the Road to Market," The Financial Times, May 16, 1994.

Note that Anders Aslund incorrectly characterized the Chernomyrdin agenda as shock therapy. See his "Gradualism Has Proved Ineffective in Russia," The Financial Times, Letters to the

Editor, April 12, 1994, and the author's response "Confused Thinking about Russian 'Gradualism'," op. cit.

4. Note that, in the absence of subscription by the public and financial institutions to government bonds, the mounting Soviet and Russian budget deficits were covered by government borrowing from the central bank.

This official definition includes actual rather than appropriated outlays and excludes the massive subsidies (to domestic users) on imports on government account in 1992 which were financed by (foreign) supplier credits. The IMF by contrast uses the definition of "enlarged deficit" which allows for these subsidies (in budgetary outlays) and includes contributions to revenues from extrabudgetary sources such as government pension and insurance funds. Thus, its estimate of the Russian budget deficit for the first quarter of 1992 was 25.3 percent of GDP.

5. For a discussion of the problems facing Russian factories, see the author's "Give Russia a Tough Accountant," The New York Times, Letters to the Editor, July 7, 1993, and "Ease Up on Russia," The New York Times, op-ed, December 10, 1993.

6. Thus Leszek Balcerowicz identifies two stages of "extraordinary" and "normal" politics which follow a "great political breakthrough in a country's history." During the "extraordinary politics" phase which is "close to a great change in a country's history," the readiness to accept radical economic measures is high. "It is based on the assumption that liberation from foreign domination and domestic political liberalization produce a special state of mass

psychology and corresponding political opportunities: the new political structures are fluid and the older political elite is discredited. Both leaders and ordinary citizens feel a stronger-than-normal tendency to think and act in terms of the common good....Extraordinary politics, however, quickly gives way to the more mundane politics of contending parties and interest groups... ."

Details are in Leszek Balcerowicz, "Understanding Postcommunist Transitions," Journal of Democracy, Vol. 5, No. 4, October 1994, pp. 75-89.

7. Anders Aslund, "The Case for Radical Reform," Journal of Democracy, Vol. 5, No. 4, October 1994, p. 64.

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