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Stabilization and Structural Change in Russia, 1992-94

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Abstract

Macroeconomic stabilization and structural reforms in Russia since 1992 have been proceeding in a rather chaotic fashion. The Russian variety of economic gradualism has seen a sharp decline in output, though less than indicated by official statistics, and relatively resilient household consumption. Hyperinflation has been avoided so far by tightened financial policies, but remains a threat. Conventional macroeconomic wisdom on the relation between money, prices and output is relevant for Russia. Moreover, stabilization and structural change interact and are mutually reinforcing.

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Contents | Page

I. Introduction 1

II. Ups and Downs of Macro Stabilization 1
1. Background 2
2. Trends 4
3. Disruptions 9

III. Money, Prices and Output 11
1. Is inflation essentially a monetary phenomenon? 12
2. Is there a trade-off between output and disinflation? 14

IV. Structural Reforms: Leads, Lags and Synergies 15
1. Leads 15
2. Lags 17
3. Synergies 19

V. Conclusions 20

References 21

Table

Russia: Summary Indicators 5

Chart

Russia: Selected Macroeconomic Indicators 6a

Summary

Following decades of central planning and systematic repression of market forces under the Soviet regime, the relatively peaceful dismantling of the old order in Russia has been a major achievement. However, the full complement of economic policies needed to solidify a market system has not yet been implemented. Stabilization in particular has so far proved elusive, as attested by the recent upsurge in inflation. Nonetheless, much progress has been made since late 1991, especially in the structural area.

The paper analyzes output, consumption, inflation, fiscal, and monetary trends. The output collapse was largely inevitable, smaller than indicated by the official statistics, and did not have a commensurate negative impact on household welfare. Following the jump associated with price liberalization, trend inflation in 1992-93 remained very high, oscillating between 10 and 30 percent a month. It slowed to single digit levels in the first half of 1994 but picked up in the fall. Fiscal and monetary policies gradually became tighter, as subsidies to domestic agents and other states of the ruble area shrunk and real interest rates were gradually increased. The sustained erosion of tax revenues forced adjustment on the expenditure side, notably in the form of sequestration. The paper also describes some of the disruptions that tend to mask the underlying trends, including seasonal variations, ebbs and flows of arrears, political turmoil, the mid-1993 monetary reform, and exchange rate crises.

A numbers of observers and policymakers in Russia initially doubted the merits of applying conventional macroeconomic wisdom to the relationships between money, prices, and output. Time series evidence is now sufficient to investigate these links econometrically. It is shown that money growth does indeed cause inflation in Russia. In addition, the data do not support the claim that there is a trade-off between output and disinflation. In any event, the painful lessons from high inflation in Russia and in neighboring countries are being learned, fostering a broader consensus on this set of issues.

Even on the structural side, progress, while genuine, has been very uneven. Slow improvements on the stabilization front have retarded structural change, and vice versa. Price and exchange rate liberalization as well as privatization have moved ahead fast, but enterprise behavior, and the business environment in general, have not improved in tandem. Some firms are adjusting energetically and stand a chance to survive and prosper in the longer run, but others continue to rely too heavily on rent seeking and state subsidies. Institution building is proceeding, but implementation generally lags. The transition process will likely remain chaotic and somewhat unpredictable for some time. But even though muddling through may not sound like an appealing strategy ex ante, it is, ex post, far from the worst outcome.

I. Introduction

The public perception of Russia's economic transition is that the old system has been successfully destroyed but that it has not yet been replaced by a sustainable democracy and an effective market economy. Following decades of central planning and systematic repression of market forces under the Soviet regime, the relatively peaceful dismantling of the old order has been a major achievement. However, Russia has not yet implemented the full complement of economic policies needed to solidify a market system.

This paper develops three ideas. First, the quest for macroeconomic stabilization since 1992 has been characterized by ups and downs rather than continuous improvement. Nevertheless, it is possible to identify some underlying trends in output, inflation, and financial policies. Second, conventional macroeconomic wisdom is more relevant for Russia than acknowledged by those who dismiss it with the argument that "Russia is unique." Third, Russia is undergoing a structural metamorphosis: the former key dichotomies (such as heavy versus light industry, or even state versus private enterprises) are superseded by new ones (in particular, "survivalist" versus "subsidized" enterprises).

The focus is on the significant structural progress that has occurred despite persistent macroeconomic instability (large financial imbalances, continuing high inflation, and exchange rate crises). Not discussed in this paper, notwithstanding their obvious importance, are the international community's assistance to Russia, 1/ external developments in general, 2/ and the lessons that can be drawn from the experiences of all those countries that were once part of the Soviet Union. 3/

II. Ups and Downs of Macro Stabilization

One rule of thumb for non-residents trying to evaluate what is actually happening in Russia is that "In times of trouble, reality is never as bad as it seems, and when circumstances look auspicious, reality is never as good as it seems." 4/ Keeping this warning in mind, major occurrences over the past few years are categorized either as underlying trends which capture the essence of Russia's transformation or as disruptions which, although newsworthy and often quite serious, can be described ex post as transitory.

1/ Brau (1994) and Hernández-Catá (1994) discuss the role of the IMF.

2/ On this topic, see Christensen (1994), IMF (February 1994) and Koen and Meyermans (1994).

3/ Odling-Smee and Wolf (1994) address this issue.

4/ Looking at Russia in the early 1920s, Keynes (1925) noted that "The economic system of Russia has undergone and is undergoing such rapid changes that it is impossible to obtain a precise and accurate account of it. (...) Almost everything one can say about the country is true and false at the same time."

Trends, however, can only be identified in light of the constraints and opportunities faced by policymakers in Russia at the onset of the transition.

1. Background

The conditions under which virtually every formerly planned economy started its transition were in many ways quite discouraging. Common problems facing these countries included the dismantling of the Council for Mutual Economic Assistance (CMEA), the sudden dissolution of the Soviet Union, a West European recession, the absence of a market-oriented infrastructure, obsolete capital stocks, and very limited integration into the world economy. At the same time, one can argue that these countries were ripe for development because their work forces were highly educated and wages would be relatively low.

However, for a number of reasons, it was likely that the transition would be more difficult for Russia than for many of the countries in Central and Eastern Europe:

* The sudden dissolution of the U.S.S.R. disrupted trade and payments arrangements among the newly emerging states and provided Russia with a monetary system that was not completely under its control. 1/

* The Soviet Union's enormous size, the political vacuum left by its sudden breakup and the subsequent demise of the Communist Party left regions with administrative infrastructures which were both independent from and suspicious of Moscow. The vastness of the Soviet Union had necessitated the creation of regional bureaucracies which duplicated national governmental and legislative bodies. Since late 1991, these regional bodies increasingly served as competing seats of authority responding skeptically to Moscow's leadership, not least due to the decades of poor decisions imposed by the center.

* Russia inherited the 1977 Soviet Constitution, which considerably weakened the federal government's control over the economy. In particular, the Constitution did not define the respective roles of the legislative and executive branches of the federal government, opening the way for a power struggle between the two. Moreover, it gave Russia's 16 autonomous republics many of the economic rights of an independent country at a time when the center and the regions had not yet agreed on how to share tax revenues and apportion expenditure responsibilities. 2/

1/ See Odling-Smee and Lorie (1993) and IMF (February 1994).

2/ Open conflicts did not surface earlier because the Constitution was ignored in practice and the hierarchically-organized Communist Party was the dominant source of authority.

* Russia had been more completely isolated from the West than most countries of Central and Eastern Europe (though perhaps not as much as other states of the former Soviet Union (FSU), Bulgaria, or Albania). Russia's legal and financial infrastructures were therefore decidedly non-market and Russian businesses were far less integrated into the world economy than their Central and Eastern Europe counterparts. 1/

* Russia faced the enormous fiscal burden of undoing a military industrial structure and a network of enterprises which had been created based on strategic rather than economic considerations. Soviet militarization combined with reliance on increasingly ineffective increases of factor inputs had saddled Russia with heavy industry and agriculture which in late 1991 were both disproportionately large and highly inefficient. At the same time, light industry and services were vastly underdeveloped. Russia inherited two additional costly idiosyncrasies: the Northern Territories, which comprise two-thirds of the country's land area but only 7.5 percent of its population, and hundreds of single-enterprise towns which had been created for reasons of national security.

* Beginning with the Gorbachev era, large budget deficits have been a major structural problem. The anti-alcoholism campaign started in 1985 caused substantial losses in indirect tax revenue. Later, the Law on State Enterprises of 1987 allowed firms to retain a higher share of internally generated funds and to allocate retained resources more freely among wages, investment, bonuses, and social-cultural benefits. In effect, the federal government's share of national income had been reduced without a concomitant cut in the federal government's expenditure responsibilities. 2/

* The political/economic liberalization which took place in the Soviet Union from the mid-1980s onward was not accompanied by market-oriented institution building. As a result, the center was stripped of much of its control over enterprises. This combination made it easier for corruption to grow rapidly and for criminal elements to gain control over many enterprises. 3/

* In late 1991, no broad consensus about a transition strategy existed even among reformers, who themselves held only isolated positions within the government and the central bank. This meant that reformers had little control over the administrative apparatus. At the same time, no major interest groups were committed to macroeconomic stabilization.

1/ In particular, the payments system inherited by FSU countries was poorly suited for enacting payments among increasingly market-oriented enterprises.

2/ See IMF *et alii* (1991) and Vavilov and Vyugin (1991).

3/ See Grossman (1993).

Yet Russia at the beginning of 1992 enjoyed advantages most other transition economies lacked: (1) vast mineral resources; (2) a huge internal market; (3) the scope for significant terms-of-trade gains vis-à-vis the other countries of the former Soviet Union as export prices for energy carriers were raised toward world market levels; 1/ (4) sectors in which there was enormous potential for improving efficiency (agriculture and energy); (5) the attention of the West; and (6) the virtual absence of a "restitution" problem. Moreover, it ought to be noted that starting conditions were also dismal in the Baltics and in Albania, yet did not prevent stabilization from taking hold in these countries.

2. Trends

Russia did not really undergo "shock therapy," even though the Russian people have endured the shock of the price liberalization of January 1992 and tumultuous political struggles between the executive and legislative branches of the federal government and between the center and regions. Instead, Russia's transition has been an experiment in economic gradualism and massive political realignment. Budget constraints have been imposed only gradually through the deliberate reduction of government/central bank financial transfers to enterprises, sequestration of budgetary expenditures, and structural reforms. As a result, many enterprises have been left with no viable alternative than to restructure. A new constitution clarifying the respective responsibilities of the branches of the federal government was adopted in December 1993.

The output collapse had already begun by 1990, when the energy sector was plagued with distribution problems, strikes and parts shortages, and trade with Eastern Europe was disrupted. The decline became a major recession in 1991 with the dismantling of the CMEA, political uncertainty, and the announced breakup of the Soviet Union. Further steep drops in officially measured real GDP followed in each of the next three years (Table). In the fall of 1994, the Russian authorities were projecting another 8 percent fall in year-on-year real GDP for 1995, which was consistent with signs that the economy started to bottom out in the third quarter of 1994, when industrial output seemed to stabilize. 2/

Even though output most likely fell by less than the 50-odd percent cumulative drop recorded thus far in official GDP statistics, the magnitude of the decline has exceeded the depth of any depression in Russia during the previous 70 years and may have been of the same order as the contraction of

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1/ See the estimates presented in IMF (February 1994).

2/ The monthly Goskomstat industrial production series should be interpreted with caution because it was redefined from July 1994 to include an estimate of the production of small enterprises.

Russia: Summary indicators
(Year averages unless specified otherwise)

	1991	1992	1993	1994*
Macroeconomic indicators				
Real GDP (% change) 1/	-13	-19	-12	-15
CPI (within-year % change) 2/	144	2,318	842	202
Real wage (1987 = 100) 3/ 4/ 5/	119	86	90	84
Real ruble M2 (within-year % change)	-19	-73	-44	-2
Enlarged government deficit (% of GDP) 6/	16	21	7	10
of which: unbudgeted federal import subsidies	...	12	2	0
Seignorage (% of GDP) 4/ 7/	...	29	15	7
Velocity of ruble broad money (end-year) 8/	1.6	6.4	10.8	10.5
Exchange rate vis-à-vis the US$ 4/ 9/				
Nominal	...	222	933	2,205
Real (July 1992 = 100, rise denotes appreciation) 5/	...	75	156	280
Monthly real interest rate (end-year) 10/	-11	-15	4	-1
Dollarization ratio (end-year, %) 11/	17	41	29	...
Structural indicators				
Privatization (flow of firms privatized, thousands)	1	47	43	22
Share of private sector in recorded retail trade (%)	24	35	53	66
Privatized portion of apartments (end-year, %) 12/	0.5	8	25	32
Number of private farms (end-year, thousands)	49	183	270	285
Availability of foodstuffs (end-year, %) 13/	28	54	72	90
Domestic price of crude oil (end-year, % of world price)	...	20-25	40-45	30-35

Sources: Goskomstat; Central Bank of Russia; Ministry of Finance; Moscow Interbank Currency Exchange; IMF International Financial Statistics; and authors' calculations.

* Preliminary estimates.

1/ Official Goskomstat estimates.

2/ Urban CPI for 1991-92, expanded CPI for 1993-94.

3/ Abstracting from wage arrears.

4/ Average of monthlies.

5/ Using the CPI as a deflator.

6/ Federal and local governments, plus extra-budgetary funds, plus unbudgeted import subsidies; average of quarterly ratios to GDP. For 1991, annual notional budget deficit (concept defined in IMF, 1992) over annual GDP.

7/ Defined as the change in base money divided by GDP. The 1992 estimate is for June-December only.

8/ Annualized December GDP divided by end-December ruble M2.

9/ Rate quoted on Moscow interbank currency exchange.

10/ End-year CBR refinance rate deflated by December CPI inflation.

11/ Foreign exchange deposits with domestic banks over total M2 (since foreign exchange holdings in the form of cash or deposits abroad are excluded, this measure is downward biased).

12/ Measured by the number of private apartments.

13/ Average proportion of main cities where items were available in state stores.

close to one third observed in the United States between 1929 and 1933. 1/ The length and severity of the output collapse has been induced by the complex interaction of: (1) the actual demise of the Union itself and the consequent disruption of trade links due in part to inadequate payments and settlement systems among the newly independent countries, and in part to deliberate decisions to lessen dependence on traditional suppliers and customers; (2) sharp cutbacks in investment, defense spending and, eventually, financial transfers from the central authorities to enterprises; (3) the increase in relative energy prices which made many enterprises unprofitable; (4) an upsurge in foreign competition stemming from increased openness of the economy and substantial real appreciation of the exchange rate during the second half of 1993; and (5) the failure to achieve macroeconomic stability at an early stage in the transformation. 2/

Since 1989, when overall production in Russia officially peaked, the output statistics depict unrelenting gloom; yet there has not been widespread, sustained social upheaval. One explanation could be that living standards have not suffered anywhere near as much as the loss in measured output would indicate. Indeed, in contrast to the prolonged and sharp drop in measured output, household consumption proved more resilient. Taking into account estimates for street and informal trade, retail sales declined only marginally in 1991 and 1992, and have been rising anew since 1993. Similarly, real wages have broadly held steady since mid-1992 even though gross industrial output continued to decline rapidly (Chart). 3/

The freeing of prices announced in late 1991 and enacted in January 1992 resulted in an almost 300 percent price surge, which far surpassed the jumps associated with large-scale price liberalization in Central and Eastern Europe. 4/ Subsequent monthly inflation rates came down to high single digit levels by mid-1992 but then picked up to exceed 25 percent in the fall; through the summer of 1993 they averaged 20 percent (Chart). In the fall of 1993, the process of disinflation began to take hold when the Ministry of Finance resorted to sequestration to avoid hyperinflation (see

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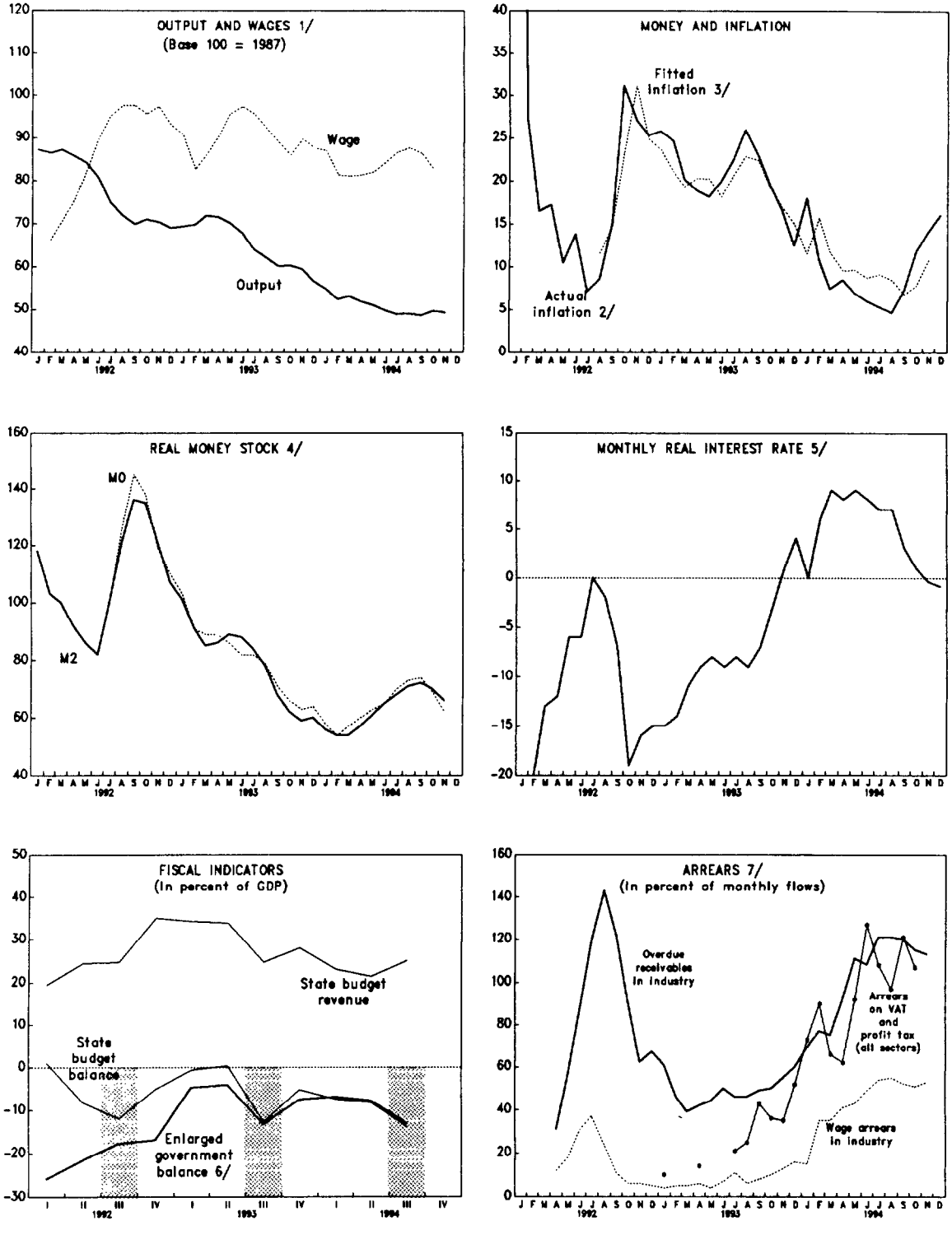
1/ See Gavrilenkov and Koen (1994). Officially measured cumulative drops in real GDP were about 20 percent in Poland and the Czech Republic, 25 percent in the Slovak Republic, 30 percent in Romania and Estonia, 40 percent in Bulgaria and Albania, and 50 percent in Latvia and Lithuania.

2/ See IMF (1992, 1993, December 1994) and World Bank (1992) for details on the evolution of output, employment, real wages, and living standards.

3/ This consumption/production paradox occurred in most transition economies, as the state sector which was integrated into the statistical system withered away while small and medium enterprises with inadequate statistical coverage grew rapidly (see, e.g., Berg (1994) on Poland).

4/ About 80 percent of wholesale and 90 percent of retail prices were freed (in value terms, at 1991 relative prices). However, price controls still were in effect for many basic goods and services and the state distribution sector was constrained by a ceiling on its markup ratio. See Koen and Phillips (1993) for details.

RUSSIA
Selected Macroeconomic Indicators



Sources: Goskomstat; Central Bank of Russia; Ministry of Finance; Center of Economic Analysis; and authors' calculations.

1/ Three-month moving average of deseazonalized real industrial output and of economy-wide average real wage abstracting from wage arrears (using the CPI as a deflator).

2/ Monthly increase in the CPI, in percent (urban CPI in 1992, expanded CPI thereafter).

3/ Based on equation (1) in the text.

4/ Using the CPI as a deflator; July 1992 = 100. M0 includes banks' correspondent accounts with the CBR.

5/ Average monthly CBR refinance rate deflated by contemporaneous CPI inflation.

6/ Enlarged government includes state budget (Federal plus local), extra-budgetary funds, and unbudgeted import subsidies.

7/ Flows used to deflate nominal arrears stocks: wage bill, value of production, and VAT and profit tax receipts.

below): 1/ from February to September 1994, inflation averaged 7 percent per month.

Along with the very gradual decline in inflation, the actual and perceived net cost of inflation has climbed steadily. Actual costs have escalated as inflation has caused a flight from domestic money with real ruble M2 declining and dollarization spreading, which has contributed to the investment slump (due to capital flight) and has had adverse distributional consequences. 2/ Inflation tax receipts as measured by seignorage have shrunk rapidly (Table). Perceptions that inflation is detrimental to growth have gradually become more widespread because the authorities as well as economic agents not only have endured the negative features of inflation but have also come to recognize that macroeconomic stability has brought the beginnings of recovery to Poland, Hungary, the Czech Republic, the Slovak Republic, and the Baltic countries.

Enterprises have generally been slow in adapting to changing market conditions, as illustrated by the magnitude of subsidies, the size of directed credits extended on a nonmarket basis by the Central Bank of Russia (CBR) and the Ministry of Finance, and the accumulation of interenterprise arrears. However, macroeconomic evidence, on the whole, points to a gradual hardening of budget constraints for Russian enterprises. 3/

Subsidies from federal and local budgets declined from 14 percent of GDP in 1992 to 7 percent in 1993 and fell further in 1994, while unbudgeted import subsidies from the federal government fell from 12 percent of GDP in 1992 to 2 percent in 1993, and essentially disappeared in 1994. 4/ Directed credit--a form of quasi-fiscal spending--has fallen sharply, from 48 percent of banking system credit to the rest of the economy in 1992, to 29 and 23 percent in 1993 and 1994 respectively. 5/ The sharp increase in

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1/ Until the end of 1993, when the new constitution was adopted and the formula-based system of fiscal federalism was soon to be introduced, inflation was fueled by the Presidency's and the Parliament's attempts to buy regional political support. Since then, the temptation to engage in such competition has been reduced.

2/ See Easterly and Vieira Da Cunha (1994).

3/ Budget constraints also hardened for households: as subsidies were curtailed, the relative price of services (compared to the overall CPI) rose eightfold in the course of 1992-94.

4/ These subsidies arise when imported goods financed with tied credits are resold to regions and enterprises at prices much below their market value. Such subsidies declined as tied foreign credits dried up, see IMF (December 1994).

5/ See IMF (December 1994) for the 1992 and 1993 estimates. The 1994 estimate is based on monetary data for the first seven months of the year. Banking system credit to the rest of the economy includes CBR and budgetary credit to enterprises and public organizations, and both ruble-denominated and foreign currency-denominated loans.

Amid these circumstances, many reformers did not last long in positions of power as scapegoats were needed whenever macroeconomic policy was beginning to bite. 1/ As a result, Russia has had six ministers of finance and three central bank heads since the beginning of 1992. Several incidents come to mind. First, in July 1992, the Supreme Soviet replaced CBR Chairman Matiukhin with Mr. Gerashchenko, who at that time made it clear that he was more concerned with keeping factories operating than with fighting inflation. A deluge of subsidies and financial transfers from both the CBR and the Ministry of Finance to the regions and to the other central banks of the former Soviet Union (FSU) followed. Simultaneously, the CBR addressed the arrears problem by conducting a netting-out operation and providing credit to net lenders. This increased the likelihood that the arrears problem would reappear, as indeed it did in 1994.

Second, in December 1992, when the country was on the verge of hyperinflation, the Supreme Soviet caused the ouster of Acting Prime Minister Gaidar--considered the architect of Russia's economic reform effort--by refusing to confirm his appointment as prime minister. Market-oriented reform was not, however, left without a highly vocal economic spokesperson when shortly thereafter Mr. Fedorov was appointed Minister of Finance.

Third, while the deficit of the state budget (federal and local budgets) during the first half of 1993 was roughly in balance, the Government increased budgetary expenditures during the third quarter to finance the agricultural sector, Roskhleboprodukt (the state grain procurer), and the Northern Territories, in response to seasonal pressures and to political lobbying from regional leaders prior to the constitutional referendum and the December parliamentary elections. The reformers in the Government reacted by turning to the only anti-inflation policy under their control--sequestration (refusal to spend to the authorized limit). While sequestration in general is neither a sustainable nor a desirable policy option, it was justified to some extent in Russia by the then existing jurisdictional confusion between the legislative and executive branches of government. 2/ However, being forced to deal with Russia's problems in such a haphazard manner represented another setback, and was followed by the departure from the government of Deputy Prime Minister in charge of Economy Gaidar and Minister of Finance Fedorov. Sequestration became even more attractive to the Ministry of Finance in 1994 because of the drop in tax revenues. In addition, the Duma did not approve the budget until June 1994, which provided the Government with some extra leeway during the first half of the year in implementing its policies.

1/ See Hernández-Catá (1994).

2/ Nagy (1994) argues that in this context promises were made at all levels of government which, if fulfilled, would have promptly triggered hyperinflation.

below): 1/ from February to September 1994, inflation averaged 7 percent per month.

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real interest rates that occurred in the course of 1993 (Chart) further contributed to harden budget constraints. However, and partly as a response, the arrears problem has reappeared (Chart): by late 1994, and deflated by the relevant flows, recorded overdue receivables in industry approached the levels which ignited a central bank bailout during the second half of 1992, wage arrears in industry were at record highs, and tax arrears were trending sharply upward.

Tax revenues collected by the federal and local governments hovered around 29 percent of GDP in 1992 and 1993, and are expected to fall to about 25 percent of GDP in 1994. However, these annual figures mask two divergent trends. From the second quarter of 1992 through mid-1993, revenue rose as new taxes were introduced and as enterprises benefitted from financial transfers from the Government and the CBR. 1/ Later, as these transfers were reduced and notwithstanding the reverse Tanzi effect, and as in some cases tax exemptions replaced straight subsidies, tax revenues trended downward and tax arrears upward (Chart). 2/

One response to the decline in revenue has been the cutback in expenditure, with the share of federal and local government expenditures in GDP falling from 44 percent in 1992 to 35 percent in 1993 and 1994. Another response has been the Ministry of Finance's attempts to find seemingly innovative ways to finance the federal budget, clear government arrears, and solve the problem of inter-enterprise arrears. These initiatives, however, have tended to delay dealing with the underlying fiscal imbalance. One example was the proposal floated in early 1994 to permit some commercial banks to buy government securities bearing below-market interest rates, then allow these securities to fulfill reserve requirements at the CBR (for which no interest was paid). The CBR resisted this initiative, recognizing that such a policy would unduly favor the limited number of banks involved and would compromise monetary control. Another example was the issuance by the Ministry of Finance, starting in August 1994, of state promissory notes to clear its own arrears. Some government contractors (especially in the defense sector) were given the choice of accepting these notes or waiting for the government to pay its bills. The state promissory notes are electronic IOUs with a maturity of up to 90 days and a much-below-market interest rate. Holders (whether the original recipients or those to whom the notes have been traded) can use them immediately to pay back taxes or can cash them in upon maturity.

1/ As emphasized by Tanzi (1993), the distinction between fiscal and monetary policy can be blurred. For example, the 1992 injection of CBR directed credit to unwind interenterprise arrears led to a fourth quarter increase in VAT receipts. CBR directed credits in 1992 were extended with implicit interest rate subsidies, while in 1994 explicit interest rate subsidies appeared in the budget.

2/ Tax revenues erosion has been commonplace in transition economies, caused inter alia by widespread tax evasion. See IMF (September 1994).

On the monetary side, monthly ruble broad money growth rates have trended downward in a bumpy fashion, averaging 9 percent during the first half of 1992, 23 percent in the second half of 1992, 14 percent in the first quarter of 1993, 19 percent for the next five months, and 10 percent from end-August 1993 through end-1994. Monetary control in 1992 and through mid-1993 was hampered by non-cash credit emission by the central banks of other FSU states and the return of cash rubles sent to those countries. This became less of a problem, however, as the CBR restricted credit to other FSU central banks in mid-1992, as this credit was replaced by smaller amounts of intergovernmental loans in early 1993, and as pre-1993 rubles were demonetized in July 1993 (see below). 1/

Base money (defined as currency outside the CBR plus required reserves plus commercial banks' correspondent accounts at the CBR) declined sharply in real terms starting in the summer of 1992 (Chart), and the scope for seignorage revenue shrunk accordingly. The narrowing of the base for the inflation tax and the embryonic nature of the long term government securities market imply that a fiscal deficit/GDP ratio that may not be perceived as an immediate inflationary threat in industrialized countries could propel the Russian economy into hyperinflation. 2/

3. Disruptions

Since January 1992, the ups and downs in monetary and fiscal policy have determined the swings in monthly inflation in a fairly predictable manner (Section III). They also mirrored political struggles and searches for scapegoats, revealing the weak positions of those who have fought for macroeconomic stabilization. A portion of these ups and downs is attributable to seasonality. In particular, expenditures of the federal and local governments have always been high during the third quarter (Chart). Partly related to fiscal seasonality, money growth typically picks up around the middle of the year.

Interenterprise arrears rose whenever both monetary and fiscal policy were tightened. For instance, during the first half of 1992, when the Government reduced subsidies to enterprises and consumers, and cut public investment and defense spending, and the CBR restricted monetary growth, interenterprise arrears rocketed upwards as enterprises continued to ship goods to non-paying customers, mostly in the belief that the central authorities would ultimately alleviate the problem. In turn, the accumulation of arrears lessened the effectiveness of credit and monetary policy and lowered revenue collected from the VAT and profit taxes.

1/ See Wolf (1994).

2/ In 1992, the general government deficit amounted to 10 percent of GDP in Italy but the ratio of base money to annual GDP stood at 15 percent. In Russia, base money over annualized GDP fell from 12 percent in late 1992 to 7 percent in the fall of 1994, and is likely to drop further, ceteris paribus, as settlement systems improve.

Amid these circumstances, many reformers did not last long in positions of power as scapegoats were needed whenever macroeconomic policy was beginning to bite. 1/ As a result, Russia has had six ministers of finance and three central bank heads since the beginning of 1992. Several incidents come to mind. First, in July 1992, the Supreme Soviet replaced CBR Chairman Matiukhin with Mr. Gerashchenko, who at that time made it clear that he was more concerned with keeping factories operating than with fighting inflation. A deluge of subsidies and financial transfers from both the CBR and the Ministry of Finance to the regions and to the other central banks of the former Soviet Union (FSU) followed. Simultaneously, the CBR addressed the arrears problem by conducting a netting-out operation and providing credit to net lenders. This increased the likelihood that the arrears problem would reappear, as indeed it did in 1994.

Second, in December 1992, when the country was on the verge of hyperinflation, the Supreme Soviet caused the ouster of Acting Prime Minister Gaidar--considered the architect of Russia's economic reform effort--by refusing to confirm his appointment as prime minister. Market-oriented reform was not, however, left without a highly vocal economic spokesperson when shortly thereafter Mr. Fedorov was appointed Minister of Finance.

Third, while the deficit of the state budget (federal and local budgets) during the first half of 1993 was roughly in balance, the Government increased budgetary expenditures during the third quarter to finance the agricultural sector, Roskhleboprodukt (the state grain procurer), and the Northern Territories, in response to seasonal pressures and to political lobbying from regional leaders prior to the constitutional referendum and the December parliamentary elections. The reformers in the Government reacted by turning to the only anti-inflation policy under their control--sequestration (refusal to spend to the authorized limit). While sequestration in general is neither a sustainable nor a desirable policy option, it was justified to some extent in Russia by the then existing jurisdictional confusion between the legislative and executive branches of government. 2/ However, being forced to deal with Russia's problems in such a haphazard manner represented another setback, and was followed by the departure from the government of Deputy Prime Minister in charge of Economy Gaidar and Minister of Finance Fedorov. Sequestration became even more attractive to the Ministry of Finance in 1994 because of the drop in tax revenues. In addition, the Duma did not approve the budget until June 1994, which provided the Government with some extra leeway during the first half of the year in implementing its policies.

1/ See Hernández-Catá (1994).

2/ Nagy (1994) argues that in this context promises were made at all levels of government which, if fulfilled, would have promptly triggered hyperinflation.

As mentioned above, the CBR finally managed to shield Russia from inflows of cash rubles which earlier had been issued to other FSU countries. However, the monetary reform that was carried out actually accelerated the migration of rubles into Russia and put downward pressure on the exchange rate. On Saturday July 24, 1993, the CBR unexpectedly announced that all pre-1993 banknotes would be shortly demonetized. Enterprises were given two days to transfer old notes to bank accounts, while residents received a bit more time to make the conversion. There is no final record on how many old rubles flooded into Russia from other FSU states during August 1993, but the upward blip in inflation of 3-4 percentage points in that month suggests it was a sizeable amount. By the end of the year, and with the exception of Tajikistan, all the countries that in July 1993 were still allowing rubles to be used as legal tender had stopped doing so and those that did not have their own national currency had introduced one.

The aforementioned political and economic disruptions twice triggered a short-lived but acute exchange rate crisis. In September 1993, following the dissolution of the Supreme Soviet by President Yeltsin, and despite heavy CBR dollar sales, the ruble depreciated by 20 percent within a couple of days (in US$ per ruble terms). On "Black Tuesday" October 11, 1994, the exchange rate plunged by 22 percent. In both cases, it subsequently recovered most of the lost ground, partly thanks to an increase in the CBR refinance rate. In both cases as well, short run inflation expectations worsened considerably. 1/

III. Money, Prices and Output

When he was last Minister of Finance, Mr. Fedorov reportedly offered Prime Minister Chernomyrdin a compilation of the work of G. Ya. Sokolnikov (author of the 1922-24 monetary reform), highlighting the latter's claim that "emission is the opium of the national economy." 2/ This section revisits the issue of the impact of money creation on prices and output, and reaches a similar conclusion.

1/ On two other occasions both in connection with the exit of reformers from the government (January 1993 and January 1994), the ruble suffered similarly large and abrupt slides, but no significant appreciation followed.

2/ The stenographer's notes of Sokolnikov's March 1922 statements to the 11th Congress of the Russian Communist Party include the following:

> "If a man goes to a doctor and insists that the latter give him opium, or a pain-killing injection of morphine, etc., then naturally, if the patient is near death and wants a few hours of relief from his death agonies, the doctor must give the morphine injection; any humane doctor would do that. But are we in such a position and, consequently, can we (...) institutionalize a financial policy consisting of further poisoning the organism of our economy? (...) On the wall near the Iverskaya Chapel it is written 'Religion is the opium of the people'; I would like to propose that near the Supreme Soviet of the National Economy we hang a sign saying 'Emission is the opium of the national economy'" (Sokolnikov, 1991, p. 11).

1. Is inflation essentially a monetary phenomenon?

In the early months following the January 1992 price liberalization, many in Russia--including numerous economic policymakers--argued that inflation was not essentially a monetary phenomenon, but rather was to be largely blamed on monopolistic behavior or other market imperfections. However, over time, the notion that money creation is the ultimate cause of inflation has tended to become more widely accepted. 1/

Supporting evidence initially appeared in the form of simple correlations between money growth and inflation three or four months later. 2/ In general, money affects prices with long and variable lags, and the length of the latter tends to fall as inflation rises. Moreover, a number of short-run shocks (such as administrative price adjustments, exchange rate swings, or discrete income policy decisions) may render the lag structure unstable. Therefore, it is perhaps not surprising that the aforementioned tight bivariate relationship broke down in the course of 1993.

The available number of observations by now permits a reexamination of the link between money and prices using a somewhat more sophisticated lag structure. 3/ The specification shown below is a five Almon lag equation based on a third order polynomial, estimated with a first-order autoregressive Cochrane-Orcutt correction. The sum of the coefficients is constrained to one. 4/ Using ruble broad money (ruble M2) as the independent variable M and consumer prices as the dependent variable P, the following result obtained, where hats denote the percentage change operator and t-statistics are indicated in parentheses (see also Chart):

1/ But it is not unanimously shared. See for instance Petrakov (1994), who maintains that inflation in Russia is fundamentally caused by the "structural deformities" of the economy.

2/ See for example IMF (1993) or Fischer (1994).

3/ Monthly data from January 1992 through November 1994 are available for the consumer price index and the money stock. Raw money stock figures apply to the last day of each month and are converted by linear interpolation into monthly averages so as to ensure that the time frame is the same for money and prices.

4/ Such a functional form is of course very restrictive, but it is only meant to establish the causal relationship between money and prices, not to provide a full explanation of monthly inflation movements. An alternative approach left for future research would involve cointegration analysis (for which longer time series would be desirable).

$$\hat{P} = \underset{(1.77)}{0.22\hat{M}} + \underset{(2.08)}{0.14\hat{M}_{-1}} + \underset{(2.63)}{0.18\hat{M}_{-2}} + \underset{(3.91)}{0.23\hat{M}_{-3}} + \underset{(3.21)}{0.21\hat{M}_{-4}} + \underset{(0.23)}{0.02\hat{M}_{-5}} + \underset{(0.92)}{2.15} \qquad (1)$$

$\bar{R}^2 = 0.79$, standard error of the regression = 3.55,
Durbin-Watson = 1.81, $F(4,23) = 26.1$, $\varepsilon = \underset{(4.67)}{0.70}\varepsilon_{-1}$.

Experimentation with specifications including 4 lags or more than 5 lags, with the imposition of a constraint on the far end of the coefficients of the Almon polynomial, and with the exclusion of a constant term did not produce substantially different results. In all cases, the bulk of the impact of money growth on inflation was felt two, three, and four months later. Contemporaneous money was weakly significant (as in the equation shown above) or insignificant, while the coefficient associated with the first lag was typically relatively small and not systematically significant. Furthermore, January inflation was underpredicted in all specifications, presumably owing to the effect of the administrative price increases that are typically implemented at the beginning of the year. Finally, all equations tended to overpredict inflation in much of 1994.

Similar regressions were run replacing ruble broad money by: i) broader monetary aggregates (ruble M2 plus arrears, M2, M2 plus arrears); 1/ ii) narrower ones (cash in circulation, base money); and iii) a measure of credit (net domestic assets of the banking system). In all cases, the coefficient associated with the fifth lag was not significantly different from zero at the 5 percent level of significance. The coefficient pertaining to contemporaneous money or credit was insignificant in all but one case. 2/ Again, inflation in 1994 was typically overpredicted.

The implicit early presumption that prices lagged money by about one quarter is thus broadly validated. The fact that across specifications actual inflation in much of 1994 was unambiguously lower than forecast could be ascribed to a perception during the first half of the year, fostered by very high real interest rates, that disinflation was actually taking hold. Another reason could be that the recovery in actual (as opposed to officially measured) output started around early 1994. In both cases, real money demand would be expected to pick up, as it did (see the turnaround in real ruble M2 in the Chart). However, it should also be noted that by the

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1/ M2 also includes foreign exchange deposits with domestic banks; arrears are total interenterprise arrears as estimated by the authors based on available (partial) information.

2/ Only in the case of M2 did it turn out to be significantly different from zero, for reasons that remain to be investigated (one possibility being that during most of the sample period domestic inflation was instantaneously reflected in exchange rate depreciation and thus into an increase of the value of the foreign exchange component of M2).

fall of 1994, and as real interest rates were rapidly coming down, inflation was catching up with past money growth (Chart).

2. Is there a trade-off between output and disinflation?

The domestic debate on stabilization in Russia initially placed a heavy focus on what some perceived as a trade-off between output and disinflation. In 1992 and 1993, however, neighboring countries (particularly Ukraine) experiencing much higher inflation and witnessed output declines of the same order of magnitude as Russia, while other countries of the FSU (particularly the Baltic states) successfully brought down inflation and saw an early turnaround in output. As a result, the claim that there is a trade-off increasingly lost credibility. Broader cross-country evidence confirms that in the long run, indulging in more inflation if anything is detrimental to output growth. 1/

The issue resurfaced in early 1994, however, as measured output collapsed further and disinflation materialized. Some then argued that there might at least be a short run trade-off, insofar as a genuine financial squeeze would immediately cause loss-making enterprises to stop producing but would only spur growth of the profitable ones over time. It was also pointed out that in the context of an underdeveloped financial market, a credit crunch could hurt firms that are viable but unable to borrow. On the other hand, the deeper the transformation-induced fall in output, the stronger the pressure for inflationary subsidies to ailing firms. 2/ On that account, one could expect a negative correlation between output and inflation.

In order to try and test these hypotheses, a large number of regressions of output on various measures of money, credit, prices and interest rates and lags thereof were run. In the absence of a reasonably plausible monthly real GDP series, output was measured by deseasonalized gross industrial output. Output was introduced both in level terms and as a deviation from trend, with the trend defined in several ways.

In stark contrast to the regressions of prices on money, no consistent and robust results emerged. While some specifications showed a significant negative association between output and lagged increases in money or credit, as well as between output and interest rate levels, the value and significance of the coefficients were very sensitive to the choice of the sample period and other equation idiosyncrasies. One factor casting serious doubts on any results obtained in such regressions is that economy-wide value-added is grossly mismeasured by officially recorded gross industrial output, which constitutes a shrinking portion of the overall production of goods and services. Another important caveat is that the decline in the

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1/ See, for instance, Fischer (1993) or Chart 22 in IMF (October 1994).
2/ This point is made by Delpla and Wyplosz (1994).

output of some items may not have a commensurate negative impact on welfare.

While econometrics does not deliver a clear-cut verdict, it does not invalidate the presumption that given the largely inevitable output decline associated with the structural transformation involved with the move to a market economy, lax financial policies overwhelmingly translate into higher inflation and imports rather than into higher production.

IV. Structural Reforms: Leads, Lags and Synergies

Duality has taken on a new identity: the heavy versus light industry dichotomy of the Soviet period has been replaced by what could be called the "survivalist" versus "subsidized" delineation. Survivalists have emerged in response to price liberalization, the slashing of subsidies and other financial transfers, the advent of positive real interest rates, and privatization. 1/ The subsidized have remained in that condition because either they have not been allowed to change--many military firms were not part of the privatization process, restrictions still exist on the sale of land--or lobbying has been perceived as being more beneficial than restructuring. While a significant portion of survivalists uses its energies to make profit via product development, marketing, lowering costs, and improving quality, another portion uses force to maintain monopoly power. The latter's importance is one sign that the legal and institutional underpinnings of a stable market economy are not as yet in place.

1. Leads

Price liberalization and administrative price adjustments, exchange rate unification, and privatization constituted the first stage in Russia's sequencing of reform measures. On January 2, 1992, controls on many prices were removed and the remaining administrative prices were increased several-fold. Additional liberalization occurred in March 1992. Now most domestic prices--except for natural gas, electricity, water, telephone service, and inter-city transportation--are free of direct federal intervention. However, local authorities control municipal transport prices and public housing rents, and have the right to regulate other consumer prices. 2/ In addition, in 1992 and 1993, many enterprises considered to be monopolies faced a maximum profitability markup of 25 percent (this rule elapsed in early 1994). Also, local authorities have imposed regional export quotas for agricultural products in an attempt to increase the availability of those goods on local markets. Yet it is difficult to estimate to what extent local authorities have enforced such measures.

1/ While survivalists may also receive subsidies, they are still characterized by the extent to which they have altered their behavior to find new markets, clients, products, and input combinations.

2/ See IMF (1993, December 1994) and Koen and Phillips (1993).

The exchange system was liberalized in the course of 1992. Commercial bank participation in foreign exchange auctions was widened early in the year, the exchange system was virtually unified in July, and current account convertibility was formally introduced for residents in November, when the new foreign exchange law was passed. With the unification of the exchange system, the effective taxation of exports was greatly reduced. In 1993, further growth of the interbank market and greater non-resident access to that market increased the openness of the Russian economy. 1/

Privatization in Russia effectively began in 1987 with the Soviet Law on State Enterprises, which transferred control of enterprises from the ministries and local governments to enterprise managers. This law opened the way for Russian enterprises to engage in nomenklatura privatization, a process by which enterprise managers have transferred valuable property, structures, and equipment to themselves or their business partners by leasing portions of the original enterprise at give-away prices. 2/

Dissatisfied with nomenklatura privatization and mistrustful of the ability of federal ministries and local authorities to manage state assets well, reformers in 1992 initiated privatization via: auctions of or tender offers for small retail establishments and most medium-sized enterprises (mainly owned by municipalities); 3/ employee buy-outs and voucher auctions (the so-called mass privatization) of some medium-sized enterprises and most large enterprises; 4/ the monitored sale of shares in the largest firms to strategic foreign investors; the sale of apartments to the current tenants at very favorable terms; and the establishment of private farms. In addition, in late 1994 a large number of enterprises in the defense sector which previously had been excluded from privatization became eligible.

Approximately 130,000 enterprises have been privatized or leased with a purchase option through late-1994, which represents over half of the 250,000 state and municipal enterprises that were operating at the beginning of 1992. Most privatized enterprises have been small-sized trade and service enterprises, with three fourths of such enterprises already privatized. About 70 percent of those enterprises were purchased by members of workers'

1/ See IMF (1993, December 1994) and Koen and Meyermans (1994).

2/ See the October 6, 1992 speech of Acting Prime Minister Gaidar to the Supreme Soviet (published in FBIS-SOV-92-195, October 7, 1992, p. 25). As of September 1991, leased enterprises (often associated with nomenklatura privatization) employed 6 1/2 percent of the Soviet labor force.

3/ Small enterprises are defined as having fewer than 200 employees and a January 1, 1992 book value of fixed assets smaller than rub 1 million; medium-sized enterprises as having between 200 and 1,000 employees or fewer than 200 employees but a book value of fixed assets between rub 1 million and rub 50 million; and large enterprises as having more than 1,000 employees or a book value exceeding rub 50 million.

4/ For details, see Boycko, Shleifer and Vishny (1995).

collectives, who enjoyed significant concessional terms. In addition, about one million completely new small private businesses have been registered.

Privatization through voucher auctions started in December 1992. By mid-1994, 13,500 enterprises, employing more than 16 million workers, had been privatized in this manner, and an estimated 40 million Russians were stockholders in joint-stock companies or in investment funds.

Privatization of housing and farms has also made progress. By late 1994, almost one third of all apartments had been privatized (Table), most of which were given to tenants at no cost. Existing land legislation permits the private ownership of land for farming, and about 285,000 private farms had been created as of late 1994 covering 11.8 million hectares (or 5 percent of agricultural land).

The gradual tightening of budget constraints was effected through various channels. Privatization, competition from imports, and the cutback of financial transfers played an important role. Also effective were the disruption of traditional supplier/distribution relationships and the arrears crises, as well as the sequestration of government expenditures in late 1993 and 1994. Many enterprises had to look for new solutions in order to survive--they simply did not have the resources to wait for the government to bail them out.

Just as significant has been institution building, which has gone a long way in helping Russia surmount her inherited disadvantages. Russian authorities have gradually been gaining control over public finances. One way this came about was with the demise of the most of the ruble area and the emergence of new currencies in most neighboring countries. Furthermore, and although it involved a tortuous political process, the independence of regions has been curtailed with the adoption of the new constitution. In addition, in April 1994, a new formula-based system of effecting financial tax and subsidy transfers between the center and regions was introduced. This may lessen some of the bargaining between the center and regions, which earlier led to higher federal deficits.

Russia also is no longer an isolated country. Especially since 1991, endless waves of technical assistance teams have provided advice on the creation of a market-oriented legal system; on revamping the tax structure; on introducing indirect monetary policy instruments; on the set-up of bodies and rules to regulate banks, investment funds, commodity exchanges, and other financial organizations and to promote foreign direct investment; and on ways to improve the payments and settlement system. A fair amount of this advice has been followed, which is bringing Russia's legal and financial infrastructure closer to international norms.

2. Lags

Russia has a long history, partly due to her sheer size, of being a country where the difference between theory and practice has been enormous.

Along this vein, modern Russia has lagged most glaringly in the implementation of the plethora of laws, decrees and regulations which have been enacted. Property rights legislation, bankruptcy laws, and land reform decrees exist, but have not been applied sufficiently widely and consistently to yield any consensus concerning their practical content. Weak implementation has been paralleled by jurisdictional conflicts that have resulted in outright confusion as to which laws have precedence, especially with regard to taxation and property rights. Finally, Russian federal and local authorities have not as yet become convinced of the inviolability of contracts. For instance, agreements concerning foreign direct investment have been broken repeatedly. Such a legal nightmare has discouraged investment of all types and hindered the restructuring of enterprises.

The authorities have not as yet developed comprehensive programs for the relocation and retraining of people in the Northern Territories and single-enterprise towns, which are required to address the root causes of the perennial subsidization of these areas. Nor has a coherent strategy guided military conversion. In fact, until recently, many defense-related enterprises were in a no-win never-never land: they were not allowed to attract outside investors, and at the same time, they were manufacturing products for some governmental agency for which they were only being paid, if at all, with great delays.

Even the privatization process, which deserves high praise for wresting control of property away from ministerial bureaucrats, has primarily succeeded in transferring ownership and power to managers and employees (with the balance clearly tilted towards managers). While this may diminish incentives for asset stripping, vesting too much control with insiders can slow down enterprise reform. 1/ Indeed, the incumbent managers were often selected for their ability to lobby for credits or inputs, or because of their position in the Communist Party hierarchy. These skills are obviously less relevant once restructuring, cost-cutting and marketing become the key challenges. Partly because outsiders have insufficient influence in corporate decision-making, the transfer of property titles so far has stimulated only meager inflows of new capital. Moreover, the efficiency gains expected from privatization are limited by the large measure of control local governments retain over the use of real estate.

Finally, opportunities for corruption expanded due to the slow or incomplete liberalization of economic activity. 2/ For instance, price liberalization without fully removing quantitative controls on domestic and foreign trade, combined with privileged access to certain resources and markets, may encourage criminal networks to enlarge their control over the

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1/ As stressed by Shleifer and Vasiliev (1994).

2/ Corruption is not new, however. As emphasized by Gerschenkron (1962), it was widespread in late 19th century Russia. It was also pervasive, albeit less conspicuous, under the Soviet regime.

economy. In the Soviet period, when a totalitarian government was in place, the criminal portion of the shadow economy was kept in check. Since the demise of the union and in the ensuing regulatory and jurisdictional chaos, a private sector that is part entrepreneurial and part criminal has emerged.

3. Synergies

Some economists have argued that optimal sequencing of policies should feature structural and institutional change as prior conditions for macrostabilization, involving for example the demonopolization and privatization of domestic trade before the liberalization of prices. However, as Berg (1994), discussing Poland, aptly put it, macroeconomic reform to some extent causes structural adjustment. Moreover, abstract arguments about optimal sequencing often ignore some of the real world constraints facing policymakers: price liberalization or exchange rate unification can be decreed overnight, while implementing privatization and bankruptcies is by necessity a drawn-out process. If the reformers want to use their political window of opportunity wisely, they should press ahead with those measures that can be promptly executed. Finally, a considerable measure of stabilization has been achieved in several transition economies (e.g., the Baltics and Albania) notwithstanding lagging structural reforms.

Structural reforms and stabilization are most often complements. Delaying the latter is likely to postpone the former insofar as it means that hard budget constraints are slower to become the rule. Any attempt at gradualism on the macroeconomic front will encourage enterprises to continue to lobby for subsidies in various guises rather than to change their way of doing business and their product mix. Stabilization further diminishes relative price uncertainty and the deadweight losses entailed when agents devote time and energy to protect themselves against the inflation tax. If perceived as sustainable and combined with structural reforms, stabilization improves the investment climate (not least for foreign investors) and thus growth prospects. In particular, it will put in motion reverse capital flight, thus broadening the pool of domestic savings. In sum, insufficient stabilization impedes structural progress.

Admittedly, there may sometimes be a tension between structural reform and stabilization objectives. For example, reform of the archaic Russian financial system is eroding the inflation tax base. So far, the sluggishness of the settlement system has sustained transactions demand. The limited availability of alternative financial assets outside large cities also has bolstered money demand. However, the modern technologies that are being put in place, and inflation as it forces agents to learn cash management techniques, cause a ceteris paribus rise in velocity. But even this type of interaction could be interpreted as a case of synergy, to the extent that here structural progress reduces the scope for one of the most inequitable forms of taxation and forces policymakers to move more rapidly to a more desirable tax mix.

Russia has achieved significant progress in spite of the relatively slow movement toward macroeconomic stabilization. Structural reforms have been mutually reinforcing, and budget constraints have gradually hardened for a substantial portion of the economy. The liberalization of foreign trade and the general opening up of the economy have acted both as an anti-monopoly device and as a stimulus for more rapid adjustment among survivalist firms, all the more as the real exchange rate appreciation accompanying the move toward positive real interest rates rendered import competition increasingly fierce.

V. Conclusions

As the recent upsurge in inflation attests, it is too early to describe Russia's transition as a success story. Nonetheless, much has been achieved since late 1991, especially in the structural area, and while financial stabilization has so far proved elusive, hyperinflation has been avoided.

The collapse in officially recorded output was largely inevitable and has by no means had a commensurate negative impact on welfare. 1/ At the same time, if macroeconomic stability could have been attained earlier, domestic and foreign investment in Russia would likely have been much higher, and the economic transformation would have been more deeply grounded than it is now.

Financial stabilization is becoming increasingly difficult insofar as repeated failure has hurt the authorities' credibility, which was never impressive in the first place. In the meantime, agents are learning how to cope with high open inflation, thus making disinflation harder. On the other hand, the painful lessons from high inflation in Russia and in neighboring countries are also being learned, implying that there may now be more of a consensus on the merits of conventional economic wisdom in this area.

Even on the structural side, progress, while genuine, has been very uneven. Privatization has moved ahead very fast, but enterprise behavior, and the business environment in general, have not improved in tandem. Some firms are adjusting energetically and stand a chance to survive and prosper in the longer run, but others continue to rely too heavily on rent-seeking and state subsidies.

As behavioral change still has a long way to go in some sectors and regions, and in light of political uncertainties, the transition process will likely remain chaotic and somewhat unpredictable for some time. But if muddling through may not sound ex ante like an appealing strategy, it is, ex post, far from the worst outcome.

1/ In this regard, the situation is much bleaker in some of the other countries of the FSU.

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