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The Economic Reform Process in Russia

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Abstract

Although various factors point to a more arduous and longer transition in Russia than in Eastern Europe, the broad policy approach should be similar.

A necessary condition for effective macroeconomic stabilization is the imposition of hard budget constraints on enterprises. Financial assistance from the Government and the central bank to enterprises must be strictly controlled to ensure compatibility with both inflation objectives and the creation of incentives for reform.

While Russia needs external financial assistance, it must be willing and able to pursue economic policies that ensure that the assistance has the desired effects, especially macroeconomic stability and systemic reform.

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Contents

Summary

The economic problems confronted by Russia at the end of 1991 were in some respects similar to those faced by other countries before major periods of adjustment--the large Latin American economies in the early 1980s, the problems of economic reconstruction in Europe and Japan following the Second World War, and, especially, the countries of Eastern Europe as they move toward a market economy a year or two ahead of Russia. However, various factors point to a longer and more arduous transition period in Russia than in Eastern Europe. The broad policy approach in Russia should nonetheless be similar; it is as important to make rapid progress with macroeconomic stabilization measures and structural reforms in Russia as in Eastern Europe in order to create the conditions in which market mechanisms will eventually grow.

The essential systemic change in the transition to a market economy is trade and price liberalization. Demonopolization, through breaking up large enterprises, removing barriers to entry for new enterprises, and allowing free competition with imports, is an important complement to liberalization. But slow progress in this area does not negate trade and price liberalization.

Russia's experience in 1992 shows that a necessary condition for effective macroeconomic stabilization is the imposition of hard budget constraints on enterprises. Accordingly, financial assistance from the Government and the central bank to enterprises must be strictly controlled to ensure both compatibility with inflation objectives and the creation of incentives for reform. Such assistance should be temporary, with targets for phasing out clearly established, and conditional on satisfactory financial privatization and restructuring plans for enterprises that qualify.

Russia's need for external financial assistance in the short term is comparable to that faced by Europe and Japan at the end of the Second World War. It reflects the need to smooth the consumption stream of the population, restore the infrastructure, and finance enterprise reform and restructuring. Equally important, Russia must be willing and able to pursue economic policies that ensure that the external assistance has the desired effects. These include measures to achieve macroeconomic stability and rapid progress on a wide range of systemic reforms.

providing policy advice. Poland is the chief example, although in many ways, the initial conditions in Russia resembled more those of the less celebrated case of Bulgaria.

Despite many set-backs and frequent revisions in financial and macroeconomic targets Poland, Czechoslovakia, Hungary, and even Bulgaria have progressed toward macroeconomic stabilization, have improved their balance of payments position, and have created conditions attracting new home-grown private entrepreneurs and foreign investments. After cumulative output declines over the same period of around 20 to 30 percent, by the end of 1992 there were clear indications that output growth had turned positive in several of these countries. These developments point to hopeful directions for Russia.

The experience of Eastern European countries supports the view that the transition to a market economy must pass through a period of temporarily lower output. Replacing one system of economic coordination (the plan) by another (the decentralized market economy), inevitably implies a decline in overall production in the short term even if supporting policies and institutions are in place. The more ambitious the reform program, the deeper (but also the shorter) this output dip is likely to be. Thus a fall in output is not necessarily a sign that the reform process is not working; nor is a small fall in output necessarily better than a large one, if the gains in this respect are more than outweighed by the effects of a longer period of low output.

Six key factors point to a more arduous and longer transition period in Russia: first, the dissolution of the Soviet Union, and with it, the breakdown in the trade, payments, and monetary system that made the states of the former Soviet Union highly dependent on each other (even more so than within the Council for Mutual Economic Assistance (CMEA)); second, the greater geographical, historical, and cultural remoteness of Russia from experiences with a market economy; third, the sheer size of the country, which compounded the coordination and distribution problems under central planning, and its diversity (both in ethnicity and in regional distribution of resources), which carries the risk that powerful regional interests could preempt the effective functioning of the central government; fourth, the weak political and social cohesion undermining support for firm reform and stabilization policies, and a breakdown in law and order enforcement capabilities, that is discouraging law-abiding entrepreneurs; fifth, the larger macroeconomic disequilibria in Russia than in most of the Eastern European countries; and sixth, the smaller amount of financial assistance that will probably be made available (related to the large absolute size of financing needs, and the perception that Russia is fundamentally a rich country).

But though the transition may be longer and more arduous in Russia than in Eastern Europe, it does not follow that the broad policy approach should be different. It is at least as important to make rapid progress with macroeconomic stabilization measures and structural reforms in Russia as in

Eastern Europe, to create conditions in which market mechanisms will eventually grow.

There are also factors favorable to the reform process in Russia, in particular, the fact that the dissolution of the CMEA--and of the former Soviet Union itself--resulted in an improvement in its terms of trade because of the concentration of its exports in energy and raw materials. This same abundance of energy and raw materials gives Russia a long-term economic potential that should make it particularly attractive for foreign direct investment.

China's reform experience has, of course, differed significantly from that of European transition countries, especially in that the introduction of market mechanisms in China has been largely incremental. It is difficult to attribute the remarkable economic progress achieved in China to this more gradual approach. Many other special circumstances appear to have been important. China's labor-intensive agriculture was well suited to rapid productivity gains once market-oriented institutions were allowed to predominate; China withdrew early from the politically motivated and stifling CMEA trade arrangements; China was able to initiate economic reforms before the emergence of a macroeconomic crisis and to dissociate them from more intractable political reforms; and China benefited greatly from the proximity of highly dynamic economies with plenty of excess capital to invest (in particular Hong Kong and Taiwan Province of China) and from a large Chinese diaspora. None of these circumstances could apply to Russia.

III. Reforming Russia's Economy

1. Price liberalization

What clearly differentiates economic reforms in Russia and other countries that have decided to move from a centrally planned to a market-oriented economy from those like Mexico and Argentina is the sheer dimension of systemic change that such a transition implies. Despite weaknesses and the often large gap between de jure and de facto changes, much has been accomplished since 1991. These reforms have begun to yield fruit; witness, for instance, the successful privatization of retail trade and apartments, and the creation of new owner-operated private businesses and farms.

Rather than review all those systemic changes, it is appropriate to emphasize and assess one that stems directly from the main objective of the transition. This is to replace plan directives by a system of decentralized economic relations that springs from the pursuit of individual utility and profit maximization. The essential systemic change for this to happen is trade and price liberalization. It is no coincidence that the freeing of most prices was the first momentous decision taken by the Russian authorities at the beginning of 1992.

Although the process has not yet been completed, decisive progress has been made. Even so, some people have continued to argue that de-monopolization and the setting up of a market infrastructure should have preceded price and trade liberalization. It is true that price behavior early in 1992 was less than competitive and that the break up of very large enterprises into smaller units ought to be given greater priority under a strengthened anti-monopoly program. Instead of adjusting to the new economic environment, enterprises attempted to maintain both profits and wages by continuing with cost-plus-margin pricing, and by financing their cash flow problem (because little of the production could be sold at such prices) by recourse to arrears, and subsequently bank credit.

But neither competition nor markets can fully be created in a vacuum; they are in part the result of the dynamic process brought about by price and trade liberalization. The changes in relative prices following liberalization stimulate competition as producers respond to the new situation and new entrants identify activities where temporary monopoly profits can be made. While monopolistic behavior can explain higher than competitive prices, it cannot explain high inflation. A monopolist whose only interest was to earn high profits would not be able to increase profits by raising prices continuously if money and credit growth was held down to a level consistent with zero inflation.

In addition to breaking up large enterprises, an anti-monopoly program should emphasize the removal of barriers to entry for new enterprises and free competition with unfettered imports. Direct controls on prices or profit margins, while having a role to play in the regulation of natural monopolies, should be eschewed in the case of Russia's temporary monopolies because of the risk that they will be applied in an inappropriate way, and will damage incentives and retard the development of managerial initiative.

2. Stabilization and hard budget constraints

Inflation and balance of payments difficulties are almost invariably the result of credit policies inconsistent with the productive capacities of the economy. To correct these problems, there is no alternative to tightening credit policies and, usually, fiscal policy which is closely related. Only then will structural reform measures, aimed at restoring sustainable growth succeed. This is clearly the lesson from the experiences of Latin America and even China, as well as from the drastic stabilization effort of Japan under the Dodge Plan, which laid the foundation for decades of price stability and growth.

The credibility of such a financial stabilization program is, of course, critical for its early success. But in Russia, the attempt to stabilize the economy in early 1992 through a tightening of financial policies seems not to have been credible enough. How else can one explain the behavior of enterprises, which failed to adjust to the new economic environment and instead opted to run up a significant stock of mutual arrears? The managers of large enterprises expected that the government would eventually intervene to bail them out of a situation resulting from their own lack of adjustment to the new economic environment. The policy response, which involved a considerable loosening of both monetary and fiscal policies, fulfilled these expectations. This separated Russia's experience from that of Poland, Czechoslovakia, and Bulgaria, and brought Russia to the edge of hyper-inflation by the end of 1992.

As illustrated by Russia's failure to stabilize its economy in 1992, a necessary condition for effective financial stabilization is that the government succeeds in imposing <u>hard budget constraints</u> on enterprises. The evidence demonstrates that the much higher than projected credit expansion and fiscal deficit for 1992 as a whole largely resulted from decisions and measures taken to alleviate the impact of new relative prices and demand conditions on the cash flow and financial position of enterprises. Of course, hardening of budget constraints on enterprises is also a necessary condition for economic restructuring to follow other systemic reforms, including price and trade liberalization. Without it, these reforms provide effective incentives for economic restructuring.

3. <u>Enterprise reform</u>

Since hardening budget constraints in practice means that enterprises should adjust their behavior in the face of financial difficulties rather than extend their indebtedness, the core of the reform program must be the reform of enterprises. So far, most Eastern European countries in transition have approached the issue of enterprise reform with varying degrees of "benign neglect", pending privatization. They have generally left to banks, which display increasing signs of more prudential lending behavior, the task of assessing creditworthy customers, while government subsidies have been sharply curtailed. This approach, which implies a hardening of budget constraints, has had some success in forcing enterprises to face their responsibilities to improve management and find new markets. The plight of loss-making large scale enterprises with few prospects for privatization remains, however, largely unanswered; and of late, both in Poland and Hungary, the Government has assumed greater responsibilities as regards financial restructuring of banks and enterprises.

In Russia, because of the huge scale of the transformation that is required, it may not be possible to follow such a "clean" policy of zero subsidies, no Government interference with financial intermediation, and benign neglect of unadjusting and nonprivatizing enterprises. For example, temporary government assistance may be necessary for the downsizing of very large enterprises located in single enterprise towns. Nevertheless, any assistance must be very tightly controlled, to ensure both compatibility with inflation objectives and the creation of incentives for reforms.

Four guiding principles should be followed in the granting of any subsidies to enterprises.

First, their aggregate amount must be consistent with the overall fiscal and macroeconomic program and be explicitly budgeted ex ante. Total subsidies in 1992 were close to 30 percent of GDP, including interest rate and import subsidies.

Second, the subsidies must be transparent and as nondistortionary as possible (which calls for lump sum rather than price subsidies).

Third, they must be strictly temporary, with targets for their phased elimination clearly stated at the outset.

Fourth, the mechanism for their allocation must be based on conditionality, which should be part of and consistent with quantified financial and restructuring plans for the enterprises and include incentives for privatization and breaking up monopolies. Assessment and monitoring of the implementation of these plans should probably be undertaken by a special Government entity collaborating with both the Ministry of Finance and the privatization agency.

The provision and allocation of credit to enterprises through both the Finance Ministry and the Central Bank is now very large--over 20 percent of GDP in 1992. The allocation is not based on economic grounds, and the aim ought to be to move as quickly as possible to market-based and decentralized financial intermediation. Only such a system presents sufficient safeguards to ensure that financial savings are being allocated to the most productive uses; this should also encourage the mobilization of such savings. In Russia, this necessitates eliminating as quickly as possible the policy of directed credit, in particular by the central bank. The present state of the commercial banking system is far from meeting the above standards--despite growing signs of more profit maximizing behavior--in part because the de facto insolvency position of many banks does not provide them with the right incentives, and the practice of lending to large shareholders of the banks remains largely unregulated. But the answer lies largely in financial sector reform rather than more government involvement.

The important problem of what to do with the state enterprises that will remain in the public sector temporarily or indefinitely remains. These enterprises are now in need of restructuring, but cannot obtain financing for this because the existing financial system is currently unable or unwilling to provide credits for such purposes. The solution may involve some assistance from the Government, perhaps to establish a special Restructuring Fund or a Development Bank. Such an entity could be funded by Government or from capital markets, and could serve as a conduit for external assistance.

A question often raised is whether Government ought to target specific priority sectors for a development effort, toward which assistance--including foreign financing--would be channeled on a preferential basis. Under price, trade, foreign exchange, and financial liberalization, such sectors should emerge naturally, without Government encouragement, as the most promising for investments. Ought it to be assumed that Government is better equipped to "pick winners," at either the enterprise or the sectoral level? Given its still recent emphasis on central planning, the Russian civil service could not be expected to undertake the same kind of market-based assessments as are made by Governments in other industrial countries such as France, Germany, or Japan. The allocation of Government assistance remains very exposed to political pressures and corruption. Recent experience in Poland suggests that there are successful enterprises in every sector; a policy of discriminating among sectors would not necessarily maximize the success of the economy as a whole.

The sectors frequently mentioned for targeting are oil and agriculture. The former, of course, is the single most important source of foreign exchange, and the latter has great potential as a source of future growth. They may be fairly safe bets; but these sectors have faced difficulties in attracting investments in 1992, not so much because of financial market failure which could in principle justify intervention, but because of continued distortions. Liberalization (in particular price liberalization) has not been allowed to proceed as fast in these sectors; and institutional factors--particularly in property rights--have not been sufficiently clarified, which has given potential investors cause to be wary. Removal of these barriers should be the first priority. Of course, when there are clear positive externalities, the Government <u>ought</u> to take the initiative and mobilize the necessary financing, which is more likely to happen for modernization of the administrative and physical infrastructure than for tradable goods sectors.

IV. External Financial Assistance

Now to the question of external financial assistance for Russia from industrial countries and international institutions. Here again, the historical experience of other countries is relevant. This paper earlier compared Russia's economic problems with those of Latin American countries and of the Post-WWII reconstruction in Europe and Japan. In both cases, those in the international community which were able to help did so, in the form of debt relief and by new financing flows. The latter were on a very large scale under the Marshall Plan for Europe.

On the face of it, Russia's financial assistance needs in the short term appear comparable to those faced by Europe and Japan at the end of WWII, and this for three reasons.

First, there is a great need to smooth the consumption stream of the population. An excessive short term decline in standards of living, in line with the unavoidable short term fall in output (which cumulatively could well be anywhere between 30 and 50 percent before recovery), would be unnecessarily painful from a human point of view, would increase the risk of social unrest, and would provide arguments for a gradual approach which from a broader perspective would likely be sub-optimal, even if it were achievable. Foreign financing which, directly or indirectly, enables the Government to provide an adequate social safety net seems to be an excellent investment, especially if linked to measures encouraging labor mobility.

Second, much of the administrative, service (particularly health), and productive infrastructure (including transportation and communication) needs repair, modernization, and new investment. Without these, productivity gains from the restructuring of enterprises, the development of the private sector, and the attraction of foreign capital will be delayed. It is certain, however, that such outlays, which are the responsibility of the Government, would be severely constrained by the availability of domestic savings for the budget under even the most optimistic scenario. Of course foreign-financed investment projects would need to be fully assessed for their social rates of return and be carefully ranked within a fully articulated public investment program.

Third, it is difficult to imagine the major transformation needed in the enterprise sector taking place without a substantial influx of foreign investment and expertise. In the long run this will have to take the form largely of foreign direct investment, in ways which take account of sensitivities about foreign control and exploitation. In the short run there is a need for official financial flows to government agencies with responsibility for providing finance for enterprises which are reforming and restructuring, such as the Restructuring Fund or Development Bank. Western managerial expertise could be associated with such financial assistance.

This is not the place to debate the appropriate scale of financial assistance. The Marshall Plan analogy points to a large sum, (financial assistance from the western to the eastern part of Germany has exceeded US$100 billion a year). But there must be willingness and ability on the Russian side to pursue economic policies that ensure that the external financial assistance has the desired effects. This requires, first, policies aimed at achieving macroeconomic stability, so that people have the confidence to invest in Russia rather than take capital out of the country as fast as it comes in. This also requires rapid progress on a wide range of systemic reforms, ranging from the creation of the legal and institutional framework for a market economy, the further removal of direct controls such as export quotas, to elimination of state trading in the form of so-called centralized exports and imports. Finally, it requires administrative arrangements enabling the proper monitoring and receipt of assistance. The slow progress in some of these aspects accounts for the delay in disbursements of assistance from the international financial institutions, including the International Monetary Fund, World Bank and European Bank for Reconstruction and Development.