



CASE - Center for Social and Economic Research

**Two Years
of Economic Reforms
in Russia.
Main Results**

by

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Materials published in this series have a character of working papers which can be a subject of further publications in the future. The views and opinions expressed here reflect Authors' point of view and not necessary those of CASE.

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1. Introduction¹

Two years ago, at the beginning of November 1991, President Boris Yeltsin appointed the new government of the Russian Federation, working under his own direct leadership. A team of young economists, under deputy Prime Minister Egor Gaidar, began a process of economic transformation toward a market economy. Since that time, events in Russia have been at the center of attention of both politicians and economists. At the same time, there have been many misunderstandings and simplified stereotypes surrounding that process. The one most often repeated is that the introduction of the so-called shock therapy in Russia, similar to the *Balcerowicz plan* in Poland, has failed under Russian conditions. This misunderstanding results from, it would appear, accepting program intentions of some Russian politicians, as well as press commentaries describing, often in a simplified and prejudiced manner, the intentions of the new team as reality. The picture of the economic transformation in Russia is, however, in reality much more complex, in both program intentions, and in their realization. From the perspective of two years it appears obvious that the Russian transformation contained both, certain significant elements of a radical, or even shocking approach, such as the liberalization of domestic prices in the beginning of 1992, and the forced program of corporatization and privatization of state enterprises begun in the summer of 1992, as well as significant set-backs in other areas, such as demonopolization or export liberalization. The factor of the reform process which is the weakest and most sensitive to political turmoil has turned out to be macroeconomic policy. The Russian authorities have been unsuccessful in preventing high inflation, though luckily not as high, for example, as in the Ukraine or Bielorussia.

The goal of this article is the presentation of the general results of the Russian economic reforms in the period from November 1991 to November 1992, with particular emphasis on macroeconomic policy and the failed attempts at fiscal stability. Such a profile of the article results from the personal interests of the author, the specific condition in which Russia found itself after the collapse of the USSR (the existence of a rouble zone with a series of independent central banks), as well as from the importance of macroeconomic balance (often under appreciated) in the success of the process of transformation from a planned to a market economy. Furthermore, macroeconomic policy is precisely the factor of the chosen strategy of transformation, which most differentiates Russia from the countries of the so-called Visegrad group.

¹ This article was written at the end of November 1993. I have had possibility to observe Russian economic developments as the economic consultant to the Government of Russian Federation since November 1991. I am very grateful to Sergei Vasilev, Andrei Illarionov, Anders Aslund, Jeffrey Sachs, Charles Wyplosz, Brigitte Granville, Jacques Delpla, Władysław Jermakowicz and Julian Pańków for helpful exchange of view concerning the economic situation in Russia. I want to acknowledge also the role of the staff of the Macroeconomic and Financial Unit of Ministry of Finance of Russia (MFU), especially of Brigitte Granville and Torun Hedback, in supplying me with necessary statistical data. Michael Cader was the translator of the Polish version into English. However, I am solely responsible for the content of this paper and its deficiencies.

The article will also leave out a deeper analysis of the political situation, even though it has had a significant influence on the course of the reform process.

The article will focus mainly on the second year of the Russian transformation. This is due to the possibility of presenting rather current economic results, as well as formulating more advanced conclusions. Furthermore, the initial program assumptions and the course of events in the first year of transformation (1992) have been the subject of analysis for a number of studies [Aslund and Layard, 1993; Blanchard et al., 1993; Dąbrowski et al., 1993]. It must however be clearly emphasized that it is still too early for formulating definite evaluations of what has occurred in Russia in the years 1991-1993. This will require, as the Polish example illustrates, a somewhat longer time span. An additional complication is the low quality of statistical data dealing with Russia. This is in regards to not only the GDP statistics or inflation, which, in light of the experiences of other post-communist countries, seems obvious, but also such things as monetary and fiscal statistics. Due to this, the conclusions presented in this article should be treated as introductory, and might be corrected as new events unfold and more accurate statistical data can be attained.

The content of the article has been organized as follows: *Point 2* presents a concise view of the characteristics of the starting point of reform at the end of 1991. *Point 3* describes the process of the liberalization of the domestic prices and market. *Point 4* deals with the meanders of the liberalization policy in foreign trade. *Point 5* presents a synthetic picture of the privatization policy. *Point 6* describes macroeconomic policy in 1992, while *point 7* - the stabilization efforts of 1993. In *point 8* there is a short history of the collapse of the rouble zone. *Point 9* contains conclusions and an attempt to forecast future events.

2. Starting point.

The economic situation of the USSR, including that of the Russian Federation in the fall of 1991, at the time of the formation of the Yeltsin - Gaidar government, was unusually difficult, even dramatic. The collapse of the communist regime and the political break up of the Soviet Union resulted in a gradual erosion of central planning, which in the USSR survived the longest and was most resistant to all reforms. The broad attempts of systemic changes, begun in 1987, only accelerated the collapse.

Therefore a situation arose, also typical to other post-communist countries of Central and Eastern Europe, where the system of central planning was dissolved to a point that it could no longer function as a coordinating mechanism at the micro level or a disciplinary one at the macro level. The market mechanism, on the other hand, was too weak to take over that function. Therefore, a systemic vacuum had been created - an economy both unplanned and non-market, without the appropriate microeconomic motivation and without the possibility of attaining macroeconomic balance.

Soviet enterprises found themselves outside of any microeconomic regime. The only directional of their activity became the logic of a deep goods deficit

economy. In addition, a weak government (in the sense that it did not have political support among the population, yet was no longer willing to utilize violence and repression, as in a classic totalitarian regime or, for example, in contemporary China) was willing to gain a transient social calm in return for the emission of inflationary money. This was not only the case in the former USSR between 1989-1991, but also in Poland between 1987-1989, Romania after the fall of the dictatorship of Nicolae Ceausescu, Bulgaria, and Albania. Only the former GDR, Hungary, and Czechoslovakia were successful in avoiding macroeconomic chaos during the transition period.

In the past, the money supply in the Soviet economy (similarly to other countries with a command economy) was excessive relative to the norms of a traditional market economy. For example, the average annual level of increase of M2 in the former USSR between 1981-1985 was 7.5% [*IMF et al., 1990, p.49*]. The excessive monetary expansion, combined with an absolute price control, caused an increase in repressed inflation and forced savings, which, parenthetically speaking, is a normal phenomenon in a command economy. Although it must be noted that the level of repressed inflation in the former USSR was most likely higher than in other socialist countries such as the GDR, Czechoslovakia, and Hungary. The increasing monetary overhang was neutralized to a certain degree, by the commodity inconvertibility of the rouble (the impossibility of the free purchase of goods in return for having financial means), especially in the enterprise sector. What is meant here, is the all-encompassing system of dividing the factors of production, as well as the stiff control over various types of state enterprise expenditures, such as the wage fund or the means intended for investment [*McKinnon, 1991*].

The partial and sometimes rather chaotic liberalization of the *perestroika* period, brought with it an increase in the commodity convertibility of the rouble and an increase in the money velocity. The effects of the liberalization were not neutralized by a more disciplined monetary and fiscal policy. Adversely, the gradual decomposition of the central political authority and its function of repression, an increase in the autonomies of the republics, a loss of fiscal control over state enterprises, the already mentioned willingness to "buy" social support, as well as unfavorable external factors (the fall of oil prices on the world market) led to a fundamental increase in the budget deficit and monetary expansion. This was accompanied by a worsening current account balance of the balance of payments and a fall in industrial production and national income (beginning in 1990).

According to the estimates of the International Monetary Fund, the annual index of the increase of M2 was 8.5% in 1986, 14.7% in 1987, 14.1% in 1988, 14.8% in 1989, and 15.3% in 1990 [*IMF et al., 1990, p.49*]. The main factor determining the increase in monetary stock was the increasing budget deficit. According to the same estimates it was: 2.4% of GDP in 1985, 6.2% in 1986, 8.4% in 1987, 9.2% in 1988, 8.5% in 1989 [*IMF et al., 1990, p.10*]. In 1991 it already reached the astronomical level of 31% of GDP for the Russian Federation [*IMF, 1992, p.12*].

This deficit was financed exclusively by credits from of the central bank (Gosbank) of the USSR, and the republic's central banks (to a lesser degree). Aside from this, there was obviously an immense credit expansion for enterprises. Here the lead role was played out by the republic's banks. As a result, a peculiar

"division of labor" was formed in the stirring of hyperinflation: while the USSR Gosbank was financing the country's budget deficit, the republic banks were amply supplying credit for enterprises as well as financing the budget deficit of the republics. Furthermore, in 1991, and maybe even in 1990, the republic central banks stopped following the guidelines set by the USSR Gosbank regarding the size of credit issues. This, in reality, indicated the beginning of the disintegration of the rouble zone.

A series of additional events, such as the exchange of 50 and 100 rouble notes in February 1991, the administrative increase in the prices of staple food items and services from April 1, 1991, as well as the, lasting since the summer of 1991, discussion on the liberalization of prices, further increased the money velocity and market panic. As a result of the political decomposition of the all-union government, the administrative price control was weakening. Nonetheless, on the staple foods market this control was maintained (together with high, and constantly increasing subsidies). As a result, the high inflation took on a partly repressed and partly open character.

3. Liberalization of prices and the domestic market.

The Gaidar team considered the liberalization of prices to be a priority task. Its goal was the removal of goods shortages, the introduction of adaptive market mechanisms, as well as the remedy of the state budget, where the expenditure side was dominated by subsidies for goods and services.

The *first*, fundamental step in the price liberalization sphere was taken on January 2, 1992 [Koen and Phillips, 1993]. The operation was then unfortunately not complete. The pressures of various political, administrative, and industrial lobbies caused that the administrative price control on a number of consumption goods (bread, milk, cheese, baby food, sugar, salt, margarine, matches, alcohol products, gasoline, oil, etc.) as well as primary and intermediary goods (primarily coal, crude oil and its by-products, electricity, all transport tariffs) was maintained. A control of maximum trade margins was introduced (not more than 25%, and 45% in the Far North territories), as well as an extensive price control of the so-called monopolistic producers. The latter one was based on, above all, the control of the average profit rate in relation to costs. The achieved effect was such, that goods with controlled prices remained mostly unavailable in official retail sale.

The *second* stage of the price deregulation was introduced through the government decision of March 7, 1992, when part of the thus far controlled prices were freed, and part of the administrative price decisions were passed to local and regional levels. This pertained to, for example, the prices of bread, milk and milk by-products, margarine, sugar, salt, matches, as well as transport tariffs on local travel. Local administrations responded differently to the authority passed on to them. Some of the prices were liberalized, while others still remained the subject of

control. There were also significant regional variations.² In places where price control officially remained, it was not always effectively executed.

The *third* stage in the deregulation of prices, can be considered the decree of the president of the Russian Federation "About the state regulation of prices for some types of energy resources", doing away with, as of September 18, 1992, the upper limit of crude oil and gas prices. This was not, however, a complete liberalization, as a progressive tax on producers exceeding 4,000 roubles per ton was maintained. This ceiling was increased several times, as inflation increased, and in spring 1993, entirely eliminated. Since then, export quotas, have become the main instrument in the regulation of domestic prices for crude oil and gas.

Generally, the price liberalization performed in 1992 can be considered significant, taking into account the starting point of reform at the end of 1991, as well as politically daring, for a country where for 60 years nearly all the prices have been controlled by the government. There remained, however, many forms of indirect intervention of state organs, even in the sphere intended for free prices, such as the afore-mentioned anti-monopoly control and the maximum profitability control, or finally the special discount credit to supplement working capital for those enterprises which did not raise prices and salaries in 1992.

At the end of December 1992, the new prime minister, Victor Chernomyrdin, undertook an attempt to return to a tighter price control. The decree dated December 31, 1992, foresaw the introduction of percentage profitability ceilings for the producers of a number of consumption and supply goods considered fundamental [Delpla and Afanassiev, 1993].

This decree was, however, criticized by some of the members of the government, including deputy prime ministers Boris Fiodorov and Anatolii Chubais, who were not present during its passage. As a result, a following decree was passed, dated January 18, 1993, which abolished profitability norms for non-monopolistic enterprises, and planned to shorten the list of those monopolistic enterprises which had a limited independence in the area of establishing prices.

Further steps at deregulation occurred during 1993. As it was mentioned above, the progressive tax regulating prices of crude oil and natural gas was eliminated in spring 1993. In June 1993, the price of coal was freed and part of the subsidies were withdrawn. A similar operation was carried out in October 1993, in regards to prices of bread.

² An extreme case is the example of the ulyanovskaya *oblast'* where the regional authorities maintained throughout 1992 and 1993 far-reaching price control on basic food items, supported by price subsidies from the regional budget. In order for this system to work, it was obviously necessary to maintain a ration system for food, as well as a quasi-directive targets (so-called state orders - *goszakaz*) for the kolhoz and sovhoz, food industry enterprises, as well as the monopolized wholesale and retail trade. In this *oblast'*, the privatization process was actually stopped [see Illatianov and Yasin, 1993].

The gradual liberalization of prices and rules for goods turnover were also accompanied by the gradual limitation of the administrative division of resources and state orders (*goszakaz*). Similarly to price controls, part of the authority in this sphere was decentralized to the regional and local level. Here as well, spontaneous deregulation processes occurred here, related to the political strengthening of the management lobby on the one hand, and the progressive weakening of the state authority on the other.

The progressiveness of the price deregulation, withdrawal of the administrative regulation of goods turnover, and the partial liberalization of foreign trade (see below) caused the shortages on both the consumption and the supply market to remain throughout 1992 and the beginning of 1993. A clear improvement in this area occurred only in the summer 1993, together with a relative stabilization of the exchange rate and an apparent influx of competitive import.

4. Partial liberalization of foreign trade.

The liberalization of foreign relations in the Russian economy, especially in export, turned out to be much more limited than the liberalization of the domestic market. This was due to, it would appear, both the dominating mentality of a shortage economy, as well as the interests of specific lobbies of the administrative apparatus, wanting to continue controlling, in their opinion strategic, transactions in foreign trade.

The first stage of changes occurred on January 1, 1992, based on the presidential decree of the Russian Federation no. 213, dated November 15, 1992, "*About the liberalization of foreign economic activity on the territory of the Russian Federation*". All enterprises then gained access to the foreign exchange market, either through the possibility of a direct purchase of foreign currency from another enterprise, or through participation in a currency auction. Aside from this, the centralized system of the foreign exchange allocation was maintained. The public also gained the possibility of free sale or purchase of foreign currency in a network of private exchange points.

The fundamental problem remains, however, in the broad sphere of export control, made up of:

- 1/ The system of export quotas on products such as fish and fish by-products, coal, crude oil and by-products, natural gas, non-organic chemical products, styrene, phenol, tars, wood, sawn timber, cellulose, paper, pig-iron, ferro-alloys, steel, rolling-mill products, pipes, non-ferrous metals and their by-products, non-ferrous scrap-metals, mineral fertilizer, ammoniac, methanol, recyclable paper, textiles and textile products, steel waste-metal, medicine, etc. Part of the export quotas was divided by administrative means, part through tender [*Rossijskoje Prawitiel'stwo, 1991, appendix 1*].
- 2/ The system of export licenses for, among others: armaments, explosives, radioactive materials, precious metals and stones and their by-products, psychotropic and narcotic chemicals, poisons, milk and milk by-products, margarine, baby food, salt, electricity, matches, meat and its by-products, wild

game, wild plants, ivory, horns, corals, medicine [*Rossijskoje Prawitel'stvo, 1991, appendix 2 and 3*].

- 3/ Obligatory surrender of part of the foreign currency.
- 4/ Export tariffs with a branch differentiation of rates.

The effects of the above system included maintaining a multiple exchange rate for the rouble. Next to the rate at the exchange, there functioned a free-market tourist rate (about 110-130 roubles for 1 USD); the so-called quasi-commercial rate (110 roubles per 1 USD), used in centralized import and obligatory surrender of 10% of foreign currency from export to CBR; the special commercial rate (half of the previous), used in the obligatory surrender of the next 40% foreign currency from export; finally the so-called official rate (initially 0.60 roubles for 1 USD, later raised to 10 roubles for 1 USD), used in, among other things, the settling of some credits and servicing diplomatic posts. I am not exhausting the entire list of special rates and convertibility tables, such as the one in "Aeroflot" (25 roubles for 1 USD).

The currency market was still very fragmented, and many of the old currency restrictions of the USSR Gosbank still obliged in the first half of 1992. Therefore, for example, the foreign exchange cash market was entirely separated from trade operations.

The described export restrictions as well as the fragmentation of the currency market and easy accessibility to cheap credit caused that the supply of foreign currency was low. Part of the potential export was held up by administrative and financial restrictions. An additional anti-export stimulus was the lowered and administratively controlled prices for crude oil and coal, causing their exaggerated use domestically, while they represent products easiest to export. Exporters did not hurry with the sale of foreign currency, hoping for a lowering of the rate of the rouble. The obligatory surrender of foreign currency did not encourage debt collection from abroad. All this caused an artificial overvaluing of foreign currency and an undervaluing of the rouble on the exchange market.

Additionally, it should be noted that the created system of administrative barriers and fiscal burdens in export turned out to be minerly effective, among other things due to the lack of tariff boundaries between Russia and the other countries of the CIS (the transport of goods, non-ferrous metals for example, into other republics, and from there re-exporting it beyond the CIS borders) as well as numerous others exceptions and exemptions (from export quotas, export tax, the obligatory surrender of foreign currency, etc.), resulting from pressures of various lobbies.

Import policy during the same period was much more liberalized. Up until the end of August 1992, import tariffs were practically not collected, and up until the end of 1992, nor was the value added tax (VAT) from imports. A certain amount of import quotas and licenses were maintained (significantly greater than in the case of export). The role of the main import barrier was played by the artificially high foreign currency exchange rate. The Russian economy, in practice, still remained a closed economy, and the balance of payments showed great tension.

The second stage of the liberalization of foreign trade occurred on July 1, 1992. A single, market exchange rate for the rouble in relation to foreign currency was implemented. From September 1, 1992, it was also utilized in credit operations. In practice, however, part of the so-called basic import (food, medicine) was still realized with a heavily lowered exchange rate for the dollar (20-50 roubles for 1 USD), theoretically recompensated from the budget, yet the current budget did not take into account these subsidies to credited import. In the first half of 1992, the privileged import represented 40% of total import, while in the second half of 1992, it fell to 10%.

On July 1, 1992, also introduced was a single norm for the obligatory surrender of foreign currency (50%), but at the market rate. Export taxes were differentiated, mainly on energy resources, and the list of export quotas and licenses was substantially narrowed.

A system of centralized export of crude oil and natural gas was created, based on the purchase of these products by the government at domestic prices, much lower than world prices, and exporting it abroad at world prices. It is thus a peculiar form of treasury monopoly. The difference between the world and domestic price does not however constitute budget income and is not included in budgetary statistics. This is due to the fact that the acquired foreign currency is generally destined directly for the servicing of foreign debt as well as centralized import (for example, grain or medicine). This in reality constitutes maintaining a system of differentiated currency exchange rates.

On August 1, 1992, a single 15% tariff rate was introduced, and from the beginning of 1993, a VAT in import. At the beginning of 1993, import tariffs were differentiated. In the case of food, medicine, and most consumption articles, a zero rate was used, and in the case of machines and appliances a rate of 15% (!). It is a result of the pressures of the lobby of the domestic machine industry, most likely one of the least effective, yet the one with the most political influence.

The described regime of trade policy remained fundamentally unchanged throughout 1993, aside from the, undertaken in the summer of that year, attempt at limiting the number of exporters of strategic raw materials. Under the authority of the law of the Council of Ministers of the Russian Federation dated November 11, 1993, the next, though not very radical, limitation of the list of goods covered by export quotas and licenses was performed (valid from January 1, 1994). Export quotas will encompass: crude oil together with gas concentrate, part of the oil-based products, hydrocarbon resources, natural gas, electricity, part of non-ferrous metals, cellulose, wheat, sunflower and soy seeds, ethyl alcohol, fish, and caviar. The list of licensed goods will encompass the same items as above, and additionally nitrolime and phosphates, as well as uncut diamonds.

There is also discussion and political bargaining about a larger differentiation of import tariffs, including an introduction of clear prohibitive tariff barriers for the import of automobiles and a number of machine industry products.

5. Radical acceleration of the privatization process.

The privatization of the Russian economy appears so far to be the most dynamic and consistent element of the transformation policy, though not free from heated political disputes and professional controversy. The limitations of the framework of this article do not allow for a more extensive description of this process, the more so as there are a number of other studies dealing with the various aspects of the Russian privatization. [Blanchard et al., 1993; Dąbrowski et al., 1993; Jermakowicz and Pańków, forthcoming]. I will therefore limit myself to presenting the most important trends of the privatization policy. They include:

1. Small privatization, based on the sale for cash (through public auction) of state assets, mainly stores, repair shops, small enterprises. This process, initiated with the help of IFC (International Finance Corporation) experts in Nizhni Novgorod in the beginning of 1992, spread throughout the territory of Russia. Until the end of August 1993, via this path 81 thousand enterprises have been privatized, with a joint budgetary income of 710 billion roubles [Obzor, 1993, table 12]. Already in April 1993, the share of private enterprises in trade amounted to 52.3%, in public catering - 47.0%, and in consumer services - 52.3% [Chubais and Vishnevskaya, 1993].
2. Mass corporatization of most of the mid-size and large state enterprises. The main effort of this process occurred in fall 1992 and beginning 1993. On July 1, 1993, among the 17,470 enterprises selected for corporatization, 10,663 (61.0% of the total) had approval for privatization (meaning they had passed the second to last step of corporatization), 6,878 (39.4% of the total) had already been registered as a stock corporation (final stage of corporatization) [Jermakowicz and Pańków, forthcoming, p.78].
3. Emission of privatization vouchers for all the citizens of the Russian Federation on October 1, 1992. The nominal value of one voucher is 10,000 roubles. It was the equivalent of about 80 dollars at the time of decision to emit the vouchers, at the beginning of July 1992, and about 30 dollars at the actual beginning of emission, October 1992. The voucher is a bearer instrument, and is easily transferable.³
4. A large privatization of enterprises, formerly encompassed by corporatization, according to three models, varying by the extent of privileges to insiders (management and personnel). In each of these methods the sale of vouchers plays an essential role. The large privatization process was initiated in December 1992 and gained significant pace in 1993. In the period from December 1992 to May 1993, at the voucher auctions, 1,725 enterprises were sold [Boycko and Shleifer, 1993]. The second method, giving the largest

³ In November 1993, the market value of 1 voucher was around 35,000 roubles, in other words 30 USD.

preferences to the personnel, is definitely the dominating one. It has been utilized in about two-thirds of privatizing enterprises [*Jermakowicz and Pańków, forthcoming, p.87*].

5. The formation of open mutual funds, receiving privatization vouchers from citizens and investing in their name in privatizing enterprises. The process of forming the funds was initiated in the first months of 1993, and gained pace in late spring and summer 1993. In June 1993, over 450 such funds were operating [*Jermakowicz and Pańków, forthcoming, p.125*].
6. The spontaneous emergence of new private firms, mainly in trade and services (including street trade).⁴ Part of the newly forming private firms do business in the so-called second economy, meaning that their activity is partially or entirely unregistered.
7. The formation of firms with a share of foreign capital (*soumestnye predpriyatiya*). This process is not yet advanced. It is concentrated mainly in trade, services, and small scale manufacturing as well as in certain regions (Moscow, St. Petersburg, Far East).
8. The initiation of agricultural privatization, authorized by of a special decree of President Yeltsin from the end of October 1993. Earlier, transformations in agriculture were effectively blocked politically by a strong *kolhoz-sovhoz* lobby in the Supreme Council, which did not permit for the resolution of constitutional amendments and bills allowing land turnover.

A complex and consistent policy of the State Committee on Managing State Property allowed Russia to achieve, in a relatively short period of time, significant quantitative results in the privatization sphere, placing it in a position of a definite leader among post-soviet countries, and perhaps even in comparison to certain Central and Eastern European countries.

Denationalization appears to be irrevocable in Russia. It also indirectly contributes to the weakening of the traditional branch structures of management as well as relics of the command economy system. The topic of controversy are, however, the qualitative characteristics of Russian privatization. The most often mentioned reservations are:

1. Corporatization and the so-called large privatization were not preceded by a deconcentration of the existing state enterprises, especially in industry and foreign trade, and often an elimination of various regulations giving them monopolistic rights. This constitutes a danger of transforming many of the so far state monopolists into private ones, and can also make the process of structural changes at the enterprise level more difficult.
2. Privatization is being performed in conditions of high inflation, a not fully liberalized economy, and a significantly imperfect competition, especially

⁴ There is, however, a lack of credible statistical data allowing to illustrate this process.

foreign. This constitutes a danger of the participants of the privatization process making erroneous investment decisions, as well as many bankruptcies of privatized enterprises in the future. Formally privatized enterprises are still functioning in "soft" budgetary constraint conditions. This also creates a possibility of the appearance of strong pressure groups, opposing consistent stabilization, the hardening of budgetary constraints for enterprises, and the liberalization of the Russian economy.

3. The realization of both the small and the large privatization so far has given an immense advantage to insiders, that is the enterprise personnel and management, which is, for the most part, not changed since the previous system (as opposed to, for example, the far reaching personnel changes among directors of state enterprises in Poland in 1990-1991). This questions the ability of privatized enterprises to perform deeper adjustive measures, such as the excessive employment.
4. Similar doubt also pertains to the threat of excessive dispersion of property as a result of strong preferentialism for personnel as well as the voucher method. As a result, a distinct foreign strategic investor, interested in increasing profits, might not appear in privatized enterprises. Counteracting this danger, according to the authors of the Russian privatization, should be the spontaneously emerging mutual funds.

6. The Failed Stabilization of 1992.

One of the goals of the Gaidar team was, aside from the liberalization of prices, macroeconomic stabilization. This goal was not, however, achieved, partially as a result of opposition to it by successive governors of the Central Bank of Russia (CBR). **Table 1** illustrates the dynamics of the increase of the main monetary aggregates in 1992-1993. It irrefutably shows that the money supply was relatively restrictive (this above all pertains to the formation of the monetary base) only in January 1992, when there was a repeated fall of the real stock of money, and at the same time neutralization of a significant part of the monetary overhang. Over the next four months, base money (**H**) and **M1** grew at a pace of several percent a month (more or less at the pace of inflation), and the wider monetary aggregates (**M2** and **M3**) - somewhat slower. This latter phenomenon was connected to the constantly increasing participation of cash and demand deposits in the general stock of money.

6.1 Sources of monetary expansion

The main factor in monetary expansion, in the period since May 1992, has been the increase of CBR credit for commercial banks. A significant part of that increase was for special lines of refinancing credit for chosen branches: the agro-industrial sector, the defense industry sector, the energy sector, finally for the regions of the far North and far East. The budget deficit, due to its limited dimensions, was not, in the first five months an essential source of the creation of monetary expansion (see **Tables 2** and **3**).

Table 1: INCREASE OF MONETARY AGGREGATES, 1992-1993 (previous month = 100)

Month	Monetary aggregate				
	M0	MB	M1	M2	M3
January 1992	110.8	101.3	115.7	112.7	112.5
February 1992	113.9	115.0	113.9	112.1	111.9
March 1992	118.3	130.6	117.6	114.1	113.9
April 1992	128.2	120.4	112.5	110.4	110.3
May 1992	115.1	119.4	110.6	109.2	109.1
June 1992	124.5	167.7	131.2	128.0	127.8
July 1992	141.2	114.0	127.6	125.5	125.3
August 1992	125.1	198.1	132.9	130.9	130.8
September 1992	118.1	93.1	133.0	131.5	131.4
October 1992	120.6	117.3	127.9	127.0	127.0
November 1992	120.4	123.3	105.4	105.2	105.2
December 1992	124.4	118.1	120.7	120.4	120.3
January 1993	113.4	105.4	119.2	118.3	118.3
February 1993	119.3	113.0	110.0	110.0	110.0
March 1993	112.0	121.0	115.9	117.0	117.0
April 1993	128.5	114.0	122.9	122.9	122.9
May 1993	120.9	115.0	118.6	119.0	119.0
June 1993	127.0	114.0	101.4	101.5	101.5
July 1993	122.2	134.0	138.0	137.0	137.0
August 1993	119.0	110.0	114.0	114.0	114.0
September 1993	115.0	107.0	103.0	103.0	103.0*

Explanations: M0 - cash money; MB - monetary base of CBR; M1 = M0 + demand deposits; M2 = M1 + time deposits; M3 = M2 + certificates of government debt

Source: CBR data and data of Macroeconomic and Finance Unit of Ministry of Finance (MFU).

Table 2: SEIGNORAGE (quarterly, % of GDP)

Quarter	Credit for commercial banks	Credit for government	Credit for CIS countries	Total CBR credit (seignorage)
Q1 1992	11	---	---	---
Q2 1992	12	11*	12	35
Q3 1992	19	25	23	67
Q4 1992	20	11	5	36
Q1 1993	6	12	3	21
Q2 1993	6	5	3	14

* Data concern only credit for federal budget (no data concerning extra-budgetary funds)

Source: MFU data

Table 3: DEFICIT OF CONSOLIDATED AND FEDERAL BUDGET OF RUSSIA, 1992

Month 1992	Deficit of consol. budget		Deficit of federal budget	
	bn rbl	% of GDP	bn rbl.	% of GDP
I - III	(21.5)	(1.6)*	4.7	0.3
I - VI	215.9	5.4	301.3	7.5
I - IX	544.1	6.6	716.4	8.7
I - XII	641.9	4.3	957.9	6.4

* budget surplus

Source: Dąbrowski et al. (1993), tabl. 11.3 i 11.4.

Just the same, the growth of the active saldo of correspondence accounts of the CBR with other republic banks (that is the import of credit money, created in other countries of the rouble zone) has not yet gained immense proportions (see **Table 2**). In this last matter, there is no absolute certainty due to the low credibility of the interrepublic settlement statistics - the system of correspondence accounts of the CBR began functioning only since March 1, 1992, while the accounts of the former USSR Gosbank were not closed until the fall of 1992.

Since June 1992, the already rather expansive monetary policy of the CBR succumbed to a further dramatic relaxation, which is clearly illustrated in **Tables 1** and **2**. It was a cumulative effect of the simultaneous influence of three immense factors of the creation of the monetary base of the CBR.

- 1/ An essential worsening of the budgetary situation from May 1992, which caused the rapid accumulation of net credit of the CBR to the government sector, beginning in June 1992 (see **Tables 2** and **3**).
- 2/ The accumulation of active saldo on interrepublic correspondence accounts of the CBR, above all with the Ukraine and Kazakhstan [*Dąbrowski, 1993; Granville and Lushin, 1993*] - see point 8.
- 3/ The accelerated increase in the internal credit expansion in Russia.

The pace of the increase of the monetary base (**H**) and **M1** exceeded 25% per month in the third and fourth quarter of 1992. In November 1992, there was a distinct slow down in the pace of the increase of **M1** and **M2**, which later returned to about 20% per month. **M2** and **M3** grew slower due to the lack of a nominal increase in savings deposits as well as in long-term bonds. A confirmation of this tendency is the systematically increasing share of **M1** in **M3** - from 80.0% on January 1, 1992 to 97.4% a year later. This indicates a disappearance of the inclination to save *sensu stricto*, which does not appear surprising in conditions of high inflation and low interest rates. The predominant part of the money balance is kept for current transaction purposes, in the form of cash, or in the form of demand deposits.

Table 2 also illustrates the immense seignorage of the CBR, calculated as a sum of CBR credits, given to the budget, commercial banks, and countries in the rouble zone. The share of seignorage in GDP was from about 11% in the first quarter of 1992 to 67% in the third quarter of 1992 (and 89.4% in August 1992) - [*Russian Economic Trends, 1993, table 8*]. This illustrates the immense level of the inflationary tax, placed by the CBR on money stocks in the Russian economy. This policy did not rescue GDP and industrial production, and at best it delayed their fall in the second half of 1992 and beginning of 1993 (see **Table 4**).

Table 4: RUSSIA: GROSS DOMESTIC PRODUCT, NET MATERIAL PRODUCT AND INDUSTRIAL OUTPUT (the same period of previous year = 100, constant prices)

Period	GDP	NMP	Industr. output
1991 - all year	85	89	85
Q1 1992	*	86	87
Q2 1992	*	78	86
Q3 1993	*	76	76
Q4 1993	*	80	77
1992 - all year	81	80	81
Q1 1993		81	81

Source: *Russian Economic Trends* [1993b], tabl. 28.

6.2 Cheap credits for the economy and negative interest rates.

The credit expansion was performed under the banner of rescuing the Russian industry, supporting its restructuring, and clearing payment arrears. Aside from the traditional instrument of special lines of credit with preferential interest rates, two new phenomena should be noted:

1. At the end of July 1992, based on of a telegram of the acting governor of the CBR Victor Gerashchenko, a special system of clearing payment arrears between enterprises was utilized, compiled in commercial banks in the so-called *kartoteka* no. 2. This operation was in fact performed on separate accounts in commercial banks, yet in the end the final settlement of the arrears was connected with additional injection of about 500 billion roubles of additional credit for the economy starting from October 1992.
2. Also in July 1992, a special line of strongly subsidized credit in the amount of 300 billion roubles was utilized for the supplementation of circulating capital of enterprises, divided by the Ministry of Finance of the Russian Federation and department Ministries. This credit was renewed twice - in September and December 1992 - for a total of about 600 billion roubles.

Both of these forms of providing credit constituted *de facto* additional funding of the government sector and were tied to an additional budget deficit, not displayed in the official statistics due to the lack of adaptation of the budgetary methodology and classification to international standards.

During the entire period of reform, the interest rate of the CBR was strongly negative in the real terms. It was in fact raised from 8% to 20% in January of 1992,

and then gradually to 80% in May 1992, and 100% from April 1, 1993, yet it was still highly insufficient in conditions of the significantly faster increase of prices. Furthermore, the 80% rate was rarely utilized in 1992 - with the prevailing credit having a preferential interest rate of 10% to 20% annually. In reality, the interest rate on the interbank market was in 1992 generally higher than 80%. The low interest rate discouraged saving, artificially increased demand for credit, had a negative influence on the rouble's noting on the currency exchange, and finally, was conducive to the increase of payment arrears.

6.3. Budget deficit

Table 3 presents a synthetic illustration of the events in fiscal policy in Russia in 1992. It is easy to distinguish three time periods, varied by their ability to balance the state budget:

1. The period from January to April 1992, which was characterized by a relatively balanced state budget and its comparatively low share in GDP. At the beginning of this period, an ambitious and complex reform of the tax system was initiated, introducing a value added tax (*nalog od dobaulennoi stoimosti - NDS*), a single income tax, as well as a personal income tax.
2. The period from May to August 1992, which was characterized by an immense expansion of budgetary expenditures and a fall in revenues (mainly caused by the difficulties in indexing the tax advance - the so-called *Tanzi effect*).
3. The period from September to November 1992, characterized by a substantial improvement in balancing the budget in cumulative calculation (in September a budgetary surplus was even noted), mainly due to an increase in revenues. It was possible thanks to overcoming problems with the indexing of advances on the value added tax and income tax on legal persons, and thanks to an inflationary supplying of enterprises with cheap credit, and credit related to the clearing of payment arrears. December brought a renewed deficit increase as a result of the need to settle past budgetary obligations.

Even though the relation of the budget deficit to GDP did not appear to be dramatic, relative to other countries, it must be realized that the whole of the deficit was instantly monetized. Furthermore, the official methodology of budget statistics hides part of the deficit. This pertains to, among others, the servicing of foreign debt, centralized import at a privileged rate and on credit, budgetary credit for the supplementation of working capital of enterprises, as well as numerous unappropriated funds. Also part of the central bank credits, such as the specified lines of subsidized credit to individual branches and regions, or the so-called technical credits for CIS countries, are actually hidden subsidies, and thus are quasi-fiscal operations.

6.4. Inflation and the currency rate

The conducted monetary and fiscal policy has been reflected in inflationary trends. **Table 5** presents indicators of the increase of consumption prices (calculated

Table 5: MONTHLY INFLATION IN RUSSIA, 1992-1993 (previous month = 100)

Month	Consumer price index	Wholesale price index
January 1992	345.0	482.2
February 1992	138.3	174.7
March 1992	129.8	128.1
April 1992	121.6	117.0
May 1992	112.0	123.0
June 1992	118.6	136.0
July 1992	111.0	117.0
August 1992	109.0	113.0
September 1992	112.0	114.0
October 1992	123.0	127.0
November 1992	126.0	127.0
December 1992	125.0	120.0
January 1993	126.0	132.0
February 1993	125.0	130.0
March 1993	120.0	123.0
April 1993	123.0	124.0
May 1993	119.0	119.0
June 1993	120.0	117.0
July 1993	122.0	129.0
August 1993	126.0	127.0
September 1993	121.0	121.0
October 1993	122.0	*
November 1993	115.0	

Source: *Russian Economic Trends*, Vol.2, No.1, Government of the Russian Federation, Whurr Publishers, tabl. A18 i A19; *Russian Economic Trends. Monthly Update*, 23.03.1993, tabl.1. and 29.10.1993, tabl.1.

according to a basket of consumer goods) and wholesale prices. In January 1992, after the liberalization of most of the prices from administrative control, a single powerful increase of them occurred, eliminating most of the accumulated monetary overhang. In February, this index fell significantly. Then from February to August 1992, a systematic fall in the officially registered inflation rate took place. In its evaluation, it is necessary to take into account seasonal price fluctuations, especially for vegetables and fruits, which most likely had a certain influence on the relatively low average increase in prices in the summer months (similar to Poland). From September 1992, inflationary tendencies clearly accelerated. The weekly consumer price index was, from the end of September until the beginning of 1993, at the level of 4-5%, and the monthly one - about 25%.

Changes in inflationary trends and expectations were reflected on the currency markets. **Table 6** illustrates the free-market currency rate from the end of 1991 until the end of 1992, both on the non-cash operations market, meaning the Moscow Interbank Currency Exchange (MICEX), and on the cash market (banks, private exchange points, and street transactions).

The dramatic increase in the price of the dollar on the free market at the end of 1991 was caused by a tremendous monetary disequilibrium of that period, as well as further inflationary expectations related to the planned liberalization of prices. The strong upward tendencies lasted until the end of January 1992. Then for five months the nominal rate of the dollar not only did not increase, but even systematically fell. This represented a reflection of a somewhat less expansive budgetary and monetary policy of that period, and was also, to a certain degree, a reaction to the speculative overvaluing of the exchange rate of the dollar during the period from November 1991 to January 1992.

From July 1992, the rate of the dollar has again begun to increase, initially at a limited pace, and then - from the end of August - significantly faster. The spiraling devaluation of the rouble became an additional factor of stirring of new high inflation (through the prices of imported and exported goods). Further history of the exchange rate fluctuations is a relative stabilization of the rate in November and December 1992, rapid depreciation in January, February, and March 1993 and another stabilization (see **Table 7**). These oscillations on the one hand illustrate (with some delay) the fluctuations in the money supply, and also interventionary policy of the CBR on the MMBW, and on the other are reflections of the, natural in this situation, speculative behavior of the participants of the currency market.

Only an exceptionally fortunate series of coincidences prevented Russia from reaching hyperinflation of 50-100% per month. In an economy with a more advanced financial market as well as more market-oriented behavior on the part of enterprises and banks (for example, in Latin America or even in Central Europe) stubborn "injections" of an immense amount of new credits into the economy, would have to bring about a drastic acceleration in the money velocity. All owners of money balances would attempt to avoid the inflationary tax by escaping, for example, from the endangered domestic currency to foreign currencies, gathering a inventories of goods, etc. In Russia such a phenomenon did not occur. On the contrary, in certain months with the largest increases of the monetary base of the CBR, the money velocity fell instead of rising (see **Table 8**).

Table 6: RUSSIA: EXCHANGE RATE, November 1991 - End of 1992 (rubles for 1 USD)

Date	Non-cash market	Cash market
Mid of 11.1991	80	75
End of 11.1991	105	83
Mid of 12.1991	144	106
24.12.1991	169	123
14.01.1992	180	137
28.01.1992	230	128
18.02.1992	170	112
03.03.1992	140	95
17.03.1992	160	115
31.03.1992	160	130
14.04.1992	155	125
28.04.1992	144	124
14.05.1992	128	124
02.06.1992	113	123
16.06.1992	119	125
30.06.1992	135	140
16.07.1992	136	143
30.07.1992	161	165
04.08.1992	161	165
18.08.1992	163	181
25.08.1992	168	187
03.09.1992	211	206
22.09.1992	241	221
29.09.1992	254	270
08.10.1992	334	295
27.10.1992	393	343
10.11.1992	402	409
24.11.1992	450	453
08.12.1992	419	440
22.12.1992	415	469

Source: *Russian Economic Trends* (1993a), tabl. A21;

Table 7: RUSSIA: EXCHANGE RATE, 1993 (rubles for 1 USD)

Data	Non-cash market (MICEX)
12.01.1993	423
26.01.1993	568
09.02.1993	561
23.02.1993	576
11.03.1993	653
25.03.1993	684
08.04.1993	740
22.04.1993	795
06.05.1993	829
20.05.1993	940
04.06.1993	1072
15.06.1993	1116
18.06.1993	1085
02.07.1993	1059
16.07.1993	1020
30.07.1993	987
13.08.1993	985
27.08.1993	985
10.09.1993	997
23.09.1993	1299
08.10.1993	1191
22.10.1993	1191
05.11.1993	1176
12.11.1993	1180
19.11.1993	1203
25.11.1993	1214

Source: *Russian Economic Trends* (1993b), tabl. A21; *Obzor* (1993), tabl.6; MFU data.

Table 8: MONEY VELOCITY IN RUSSIA, 1992-1993

Month	monthly GDP:M2
December 1991	0.108
1992	
January	0.347
February	0.410
March	0.417
April	0.436
May	0.458
June	0.464
July	0.433
August	0.365
September	0.315
October	0.312
November	0.366
December	0.360
1993	
January	0.496
February	0.576
March	0.616
April	0.567
May	0.535
June	0.573
July	0.577
August	0.593

Source: Russian Economic Trends (1993b), tabl. A16; MFU data.

The explanations of this phenomenon should be sought in, among others, the technical inefficiency of the banking system, its incompetence for a rapid absorption of new "injections" of refinancing credit from the CBR (especially the branch or territory aimed special lines of subsidized credit), the lack of development in the interbank credit market, in the lack of interest and competence of enterprises in protecting their money balances, etc.

7. Stabilization efforts in 1993.

7.1 Prevention of the danger of hyperinflation at the beginning of 1993.

The description of the second year of economic reforms in Russia should begin at the moment of Gaidar's leaving the position of acting prime minister in mid-December 1992. As seen in the analysis performed in the previous point, the

macroeconomic situation at this point was exceptionally difficult. The increasing confrontations between the President and the government (with its own tensions) on the one hand, and the Supreme Council on the other hand blocking the possibility of any relatively coherent policy in this matter. In spite of the achieved political concessions, Gaidar had to leave. He was replaced as Prime Minister by Victor Chernomyrdin. It appeared that Russia is straying from the attempts at market reforms and is choosing the Ukrainian way of conserving the relics of the command system. It, however, was not like that.

The new deputy Prime Minister and Minister of Finance, Boris Fiodorov attempted to achieve that, which Gaidar was not able to - control the high inflation. The effect of his efforts is not unanimous - though the danger of hyperinflation was in fact avoided in the beginning of 1993 and the monthly rate of price growth was lowered, it nonetheless remained at the level of about 20% (see **Table 5**).

Fiodorov in his efforts at stabilization met three significant political obstacles - the CBR, the Supreme Council, as well as the industrial lobby inside the government. The management of the CBR was subordinate to the parliament, and the mentality of most of its members remained in the era of the USSR Gosbank, from which it was borne. Fiodorov was however successful in appointing an interdepartmental credit commission, which partially controls the monetary policy of the CBR. This control is not fully effective in practice, which was illustrated by the CBR decision to exchange old bank notes at the end of July 1993, without prior consultation with the Minister of Finance.

The size of the credit emission were, however, significantly limited in the spring of this year, which is illustrated in **Tables 1** and **2**. This especially pertains to credit for commercial banks and for other CIS countries. This did not, however, provide proportional results in lowering the rate of inflation. Furthermore, at the end of the summer 1993, a distinct acceleration could be noticed. In August the inflation was 26%, and in September - 21%. The money velocity was therefore systematically increasing (see **Table 8**). The phenomenon of a calm reaction by economic entities to high inflation, mentioned earlier, belonged to the past. The real value of free resources of commercial banks fell on the correspondence accounts of the CBR. The credit multiplier increased. Economic entities learned to avoid the inflationary tax. This is, in part, an effect of privatization and an increased interest in the optimal allocation of monetary resources.

An additional factor accelerating the money velocity was the ill-fated exchange of bank notes. There occurred an increase in the inflow of cash in roubles from the other CIS countries. Furthermore, as a result of the exchange, it turned out that there is at least 3 trillion roubles more in circulation, than is noted in the balance-sheets of the CBR [*Veselov, 1993*]. This fact seriously questions the credibility of the entire monetary statistics of the CBR. It could then be that not only the increase in the pace of monetary circulation, but also a larger than noted by the official statistics, emission of money is responsible for the renewed increase in the rate of inflation.

7.2. The agreement with the International Monetary Fund and its realization

In June 1993, the government of the Russian Federation negotiated an agreement with the International Monetary Fund (also signed by the governor of the CBR, Gerashchenko), within the framework of the newly formed (specially for the countries of the former USSR) *Systemic Transformation Facility* - (STF), in the amount of 3 billion USD. The credit was to be granted in two phases. The first of them, in the amount of 1.5 billion USD, was received by Russia in August 1993, immediately after the acceptance of the agreement by the managing board of the IMF. The second installment was to be initiated after a review of the program in September 1993. The agreement with the IMF assumed relatively calm goals of macroeconomic policy as well as limited obligations in the sphere of systemic change:

- 1/ Lowering of monthly inflation to single digit level at the end of 1993, and further advances in this area in 1994.
- 2/ Slowing of credit expansion by the CBR. For the first half of 1993, the maximum allowed increase in overall credits of the CBR was set at the level of 19.0% of GDP (2,890 billion roubles in the II quarter), for three quarters - 15.9% of GDP (6,930 billion roubles in the II and III quarter), and for the entire year - 13.8% of GDP (10,544 billion roubles between March 30 and December 31, 1993). Credit for the government sector should not exceed 7.3% of GDP for the duration of the program. Direct CBR credits for economic entities were to gain the approval of the already mentioned Commission on Credit Policy. The interest rate for CBR refinancing credit could not be lower than 7% below the interest rate on the interbank market. The Russian authorities obliged not to issue new credit for the clearing of payment arrears between enterprises (the so-called *wzaimozacziot*, which significantly contributed to the monetary expansion of the second half of 1992).
- 3/ Not exceeding, by the cash deficit of the enlarged government sector, the level of 3,278 billion roubles in the first half of 1993 (8.6% of GDP), 7,104 billion roubles in the first three quarters of 1993 (9.0% of GDP), and 10,141 billion roubles over all of 1993 (8.3% of GDP). Part of this deficit was to be financed by the emission of government bonds in the sum of 650 billion roubles.
- 4/ Limited cuts in budgetary expenditures. These were mainly to deal with a 40% reduction in import subsidies (mainly wheat), a reduction of the internal subsidies for wheat by an additional 0,5 trillion roubles, limiting the financing of preferential credits (by 336 billion rouble), subsidies to the mining industry (1 trillion rouble reduction).
- 5/ Increase in budgetary revenues through raising the excise tax for crude oil and natural gas (and by with this method obtaining an additional 600 billion roubles), more effective administration of funds from the sale of products imported on credit, mainly wheat (so-called counterpart funds), gradual elimination of tax preferences and discouraging the introduction of new ones.

- 6/ Managing a floating exchange rate and non-interference by the CBR on the currency market with the intention of maintaining the rate at a given level. In the agreement it was, however, clearly emphasized that a fixed rate policy is planned for the future. The Russian side is also obliged to broaden the access to the currency market for non-residents and introduce a daily noting of the rate. The net international reserves of the CBR should be no smaller than 4.4 billion USD at the end of June, no smaller than 3.4 billion USD at the end of September, and not less than 2.4 billion USD at the end of December 1993. The fall of net reserves was supposed to be supplemented tranche of the STF credit in such a way that the gross international reserves of the CBR were to increase from 5.8 billion USD at the end of June to 6.8 billion USD until the end of 1993.
- 7/ Export quotas were to be increased by 20% for non-energy products, and by 100% for energy products. Most of the quantitative limitations in export were to be removed until the end of 1993, and in regards to oil, oil by-products, and natural gas - until the end of 1994. Also foreseen was not increasing the amount of centralized export (above all oil) and its limitation in 1994 to one-third of the 1993 level.
- 8/ Continuation of privatization and a series of other institutional reforms, such as the approval of a new civil and commercial code, bankruptcy law, removal of restrictions in agricultural economy, etc.
- 9/ Regulate the functioning of the rouble zone through reaching the appropriate agreements with the other post-soviet countries expressing interest in further use of the Russian rouble as means of payment. Acceptance of principle that new credits for CIS countries will be granted only through the mediation of the state budget.

The realization of the agreement (in spite of its relatively mild conditions) did not proceed smoothly. From the available data it appears that for the first three quarters of 1993, the only criteria which has been met has been the level of international reserves.

A difficult situation also prevailed in the sphere widely accepted as fiscal policy. Though the official statistics of the budgetary realization (see **Table 9** and **4**) show a lower level of budget deficit in relation to GDP than in 1992, the data of **Table 2** indirectly confirms the earlier formulated thesis that we are also dealing with an additional, hidden deficit. The CBR financing of the government sector was in the first half of 1993 substantially higher than the official deficit.

On the side of budgetary revenues, the key role appears to be played by three factors: the Supreme Council decisions from 1992 and the beginning of 1993, lowering the rates of the value added tax, and introducing reduced profit tax rates for investment (tax exemptions), the gradual decline of enterprise profitability and low fiscal discipline, as an effect of the political crisis (for example, part of the regions withheld payment of taxes to the federal budget during the first nine months of 1993). From among the fiscal provisions of the STF agreement, up until November 1993, only the liberalization of the coal prices and the lowering of

subsidies to that sector has been realized, and with delay relative to the provided time-frame, a decision about reduction of subsidies for wheat and bread.

Table 9: RUSSIA: CONSOLIDATED BUDGET, 1993 (% of GDP)

Months of 1993 r.	Revenues	Expenditures	Deficit
I-III	30.5	35.2	4.7
I-VI	31.6	33.2	1.6
I-IX	31.8	36.3	4.5

Source: MFU data

In the summer of 1993, the Supreme Council passed a budgetary bill, providing a budgetary deficit exceeding 20% of GDP. This law, twice vetoed by President Yeltsin, was not in the end passed, due to the dislvement of parliament. Thus Russia remained in 1993 without a formally approved budget.

Also obligations of a systemic nature were only partially being realized. A particular discord pertains to export regulations. The export quotas were not increased, and the extent of centralized export was not limited. In addition, the Ministry of Foreign Economic Cooperation limited the list of exporters of the so-called strategic raw materials (especially oil), which only increased the monopolistic structures in foreign trade.

From June 1993, despite earlier stated agreements, the government and the CBR attempted to stabilize the exchange rate at approximately 1,000 roubles per 1 US dollar. As a result, the internal price structure and the relation of purchasing power parity were partially comparable to those of a market economy. The role of competitive import increased, especially on the consumer goods market. Russian stores and street stands were reminiscent of Polish ones from 1990. However, as the stabilization of the exchange rate was not accompanied by a disciplined monetary and fiscal policy (see above), a strong real appreciation of the rouble and a decline of reserves occurred, beginning in August 1993. In this situation, the government and the CBR were forced to withdraw from intervening and allow a devaluation of the Russian currency to the level of approximately 1,200 roubles for 1 USD at the end of September 1993. The political tensions related to the dislvement of parliament turned out to be very significant. Beginning in early October 1993, a renewed attempt at stabilizing the currency at a level of about 1,200 roubles per 1 USD was undertaken. In light of the persistent high inflation and an increasing money velocity, the perspectives for this policy are not clear. There exists a danger that through this, an instrument which could be crucial in the deciding fight against inflation, might be discredited.

In the situation of a less than complete realization of the agreement, rising level of inflation, and a deepening political crisis, the IMF has practically suspended, at the end of September 1993, further realization of the program of aid to Russia. This put a stop to the second tranche of the STF credit, and perspectives of negotiating a

new stand-by agreement. The experiences of 1992 were being repeated, when the agreement reached with the IMF on the so-called credit of the first tranche (also very mild) was broken by Russia right after its signing.

With this in mind, a general reflection seems to appear - what is the sense of the IMF negotiating "soft" agreements, which neither guarantee the achievement of the sought economic results (as inflation, instead of falling, rises), nor are they conducive to political consolidation (as populist forces are instantly escalating their demands), and aside from that, are broken instantly after signing. They are not, furthermore, conducive to supporting the image of the IMF as an institution, which above all directs itself with rigid professional prerequisites, and not current political tactics.

7.3. An attempt to accelerate reform after the October events.

The return of Egor Gaidar to the position of first deputy Prime Minister in mid-September 1993, and the dissolution of the Supreme Council and the Congress of People's Deputies on September 21, 1993 as well as the suppression of the bloody communist-fascist revolt in Moscow on October 3-4, 1993, opened up new political possibilities for the process of economic reforms. Their results include the decree on land (see point 5) as well as the limited liberalization of export (see point 4). Certain efforts were also undertaken in an attempt to discipline fiscal and monetary policy.

The budgetary provision for the IV quarter of 1993, approved by the government in mid-November, anticipates a federal budget deficit of 17 trillion roubles for the entire year, including 5.5 billion in the IV quarter. Part of this sum is to be financed through foreign credits and the issue of treasury bonds (which enjoyed significant interest of potential investors in the II and III quarter of 1993). According to the decision of Government Commission on Credit Policy dated October 11, 1993, an increase in the CBR credit in the IV quarter of about 6 trillion roubles was foreseen, which included 4 trillion roubles directly for the budget. The remaining 2 billion are to be used for the centralized CBR lines of credit for specific branches and regions, and they are to be offered at the normal interest rates (210% since October 1993⁵). It is anticipated that the conditions surrounding the granting and repayment of this credit will be tightened.

The increase of the CBR credits by 6 billion roubles represents an increase in the monetary base of about 40% over a quarter. Assuming a 3 month time-lag in the inflationary reaction and an unvaried money velocity, an average monthly inflation of 13-15% should be anticipated in the I quarter of 1994. It is the result constantly distant from the awaited radical break-through in anti-inflationary policy.

⁵ In the case of CBR credits, there is a monthly capitalization of interest. This means that the real annual yield is 539%. It is still, however, below the level of inflation, which is maintained at a level of 21-22% monthly (869-987% annually).

The extremely slow progress of the anti-inflationary policy is limited by circumstances of a political nature. From the above mentioned barriers, the socially non-representative and politically irresponsible parliament has been eliminated. Remaining, however, is the unchanged management of the CBR, as well as divisions inside the government, despite the return of Gaidar. The ongoing election campaign to the new parliament is also not conducive to the difficult economic decisions.

8. The disintegration of the rouble zone

The existence and gradual disintegration of the rouble zone has become a politically institutional factor significantly hindering the stabilization policy in 1992-1993. Not entering into a detailed analysis of the history of the disintegration (a thorough description of this process can be found in the work of *Hernandez-Cata [1993]*, *Dąbrowski [1993]*, as well as *Granville and Lushin [1993]*), three of its phases can be distinguished:

- 1/ The functioning, in the first half of 1993, of a monetary union *de facto* with 15 independent central banks, behaving with the idea of a free ride, in other words attempting to mutually outbid one another in the emission of credit money. Particular activity in this area has been displayed by the National Bank of the Ukraine, which as the first on the territory of the former USSR, initiated, in June 1992, the so-called *wzaimozaciot*, or the multilateral clearing of debt between enterprises with the help of an additional credit supply. Russia remained a monopolist in the emission of cash roubles, though part of the former USSR republics began introducing a parallel cash currency. This pertains to, among others, the Ukraine, Lithuania, and Azerbajdzan.

An extremely expansive monetary policy in certain post-soviet countries (even more expansive than in Russia) as well as a traditional structural imbalance in the interrepublic trade turnover, beneficial for Russia (in the past financed by immense capital transfers from the USSR budget to some of the republics [see Selm and Dölle, 1992]) caused a huge "import" of credit money by Russia in 1992 and the first half of 1993.

- 2/ The introduction by the CBR, at the beginning of July 1992, of the rules of bilateral clearing of accounts between Russia and the post-soviet countries still using the rouble. The payments from these countries to Russia were realized only up to the sum of the given day on the correspondence account of the given central bank in the CBR. This step in practice meant the end of the rouble as a single currency in non-cash settlements and the creation of national non-cash roubles. This fundamental change in the monetary system was "softened" until spring of 1993, through an abundant supply of so-called technical credits for CIS countries from the CBR and the Russian government. This meant a continuation of the import of inflation by Russia from other post-soviet countries, especially Kazakhstan, Uzbekistan, and Bielorussia. In the cash turnover, the rouble remained a common currency, although it intensified the process of introducing monetary substitutes (coupons), in relation to the Russian rationing of the rouble bank note supply.

- 3/ Full exit by individual post-soviet countries from the rouble zone, through the introduction of own national currencies. This process was initiated at the end of June 1992 by Estonia, followed in the summer and fall of 1992, by Latvia, Lithuania, and the Ukraine, and in May 1993, the Kyrgyz republic.
- 4/ The final disintegration of the rouble zone, initiated by the CBR exchange of rouble bank notes on the Russian territory at the end of June 1993 (see point 7). After a few months of political bargaining about the idea of forming the so-called new type of rouble zone [see Granville and Lushin, 1993], all the remaining post-soviet countries introduced their own national currencies. This occurred in the period from September to November 1993.

The rouble zone has become history.

9. Summary

In spite of a radical rhetoric and certain achievements, especially in the sphere of domestic liberalization and privatization, the real course of economic transformation in Russia is more reminiscent of gradual changes, rather than shock therapy. There are more concessions and political compromises, incoherences, sometimes apparent changes and attempts to return to the old system etc., in other words all that characterized traditional reforms of the socialist economy, beginning in the sixties, than total and radical changes of the economic system characteristic of Poland and the former GDR in 1990, or Czecho-Slovakia in 1991.

The shortcomings of the gradual approach are especially apparent in the sphere of foreign economic exchange, demonopolization, and above all in macroeconomic policy. Despite numerous attempts, Russia has not succeeded in controlling inflation with the help of a gradual limitation of money supply and a relatively "mild" struggle with the budget deficit. In this manner, the fall in production and real wages was not prevented. Furthermore, it was the population which bore the brunt of the inflationary tax for sustaining ineffective enterprises.

Everything seems to illustrate that the policy of gradual restraining of inflation and insignificant steps in the sphere of systemic changes ultimately exhausts its possibilities. Economic history has yet to see a case where this method has been effective in taming high inflation. Therefore, there is no reason for such a miracle to work in Russia. Furthermore, the continuation of current policy poses the danger of losing all control over the macroeconomic situation and slipping into hyperinflation, which happened a few months ago in the Ukraine. It is therefore time to undertake more radical steps which would finally stabilize the Russian economy.

The policy of concessions and compromises has not bore the anticipated political fruits. The authorities had to bear all the political costs related to the introduction of financial limitations (which despite all compromises had to exist), the fall in production, the lowering of real wages, uncontrollable stratification of incomes, not achieving distinct stabilizing effects, as well as a quick balancing of the market. Compromises also did not prevent a dramatic political confrontation, which in the fall of 1993 shook the basis of a young Russian democracy. It should be an important lesson for the critics of systemic change in Central and Eastern Europe.

November 1993

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