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Russian Dilemmas

By Axel Leijonhufvud and Christof Rühl*

The performance of the ''transition economies'' varies from very encouraging to agonizing. For the major successor states to the Soviet Union, the transition is proving to be a long, hard road. Recovery is just around the corner, we are told, but so far that corner stays at least another block away.

Much ink was spilled on ''shock therapy'' versus ''gradualism,'' but taking a position on this one-dimensional issue is not helpful. Today, the debate has shifted to the issue of whether the degree to which countries succeed in controlling inflation suffices to explain the differences in their growth performance (e.g., Stanley Fischer et al., 1996). We share the belief that monetary stability is a necessary condition for satisfactory growth (Daniel Heymann and Leijonhufvud, 1995). However, in this paper, we want to discuss some aspects of the legacy of the socialist past that make Russia's (or Ukraine's) macropolicy problems rather different from those of the Latin American countries whose stabilizations are often cited as models for the U.S.S.R. successor states. In particular, we want to consider (i) the structure of the inherited capital stock and (ii) the lack of financial instruments, institutions, and markets.

The privatization drive was motivated in no small part by the urge to cut the government-controlled sector down to a size that would make a return of the totalitarian state and its central planning impossible. But shrinking the government has been even more difficult to do right than making a private sector grow.

The macroeconomic aspect of the task seems almost paradoxical. The starting point is a government controlling perhaps 80–90 percent of society's productive resources. It has no particular problem with macroeconomic stability. The aim is to cut the public sector down to some 30–35 percent of GNP, but to do so while maintaining functional control of that much. The trouble, of course, is that the government must also be transformed in the process from one exercising the power to command to one relying on the power of the purse.

In Russia, this transformation has yet to be completed. Modern tax systems are not built in a day. The totalitarian state has been followed by a state lacking the authority to collect its taxes. In 1996, Russian governments may collect about 65 percent of taxes due (including those paid with ''commodity credits'' and promissory notes!). The central government's revenue collection was running at less than 10 percent of GNP in the first half of 1996—hardly enough to run a nightwatchman state at today's prices.

The reform strategy urged on Russia at the beginning of the decade was to start by liberalizing prices, proceed to transforming enterprises into corporations, and go on to privatization (David Lipton and Jeffrey Sachs, 1990). Price liberalization was to make relative prices reveal ''true'' relative scarcities; to work properly, it required that there be no more than moderate inflation. ''Corporatization'' was to create independent, profit-oriented enterprises; to work properly, it required the imposition of hard budget constraints. Market competition would now weed out the unprofitable enterprises and, in the same process, provide the basis for the capital valuation of the survivors, which could then be privatized.

The implementation of this strategy went off track. Price liberalization, starting in January 1992, allowed high inflation to develop. Hard budget constraints were not imposed on ''corporatized'' state enterprises. And privatization of large segments of the economy came to pre-

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cede the developments that had originally been seen as its preconditions.

The logical blueprint was not followed because of the dilemma faced by Russian policymakers at the outset of reforms. It is a dilemma that is only now starting to fade away. Five years ago, one horn of the dilemma was perfectly well understood in the East but little appreciated in the West. This was the problem of preserving as much as possible of the capital stock inherited from the Gosplan past. The other horn was well understood in the West and hardly at all in the East, namely, the dangers of high inflation.

Russia's depression has been more severe than the worst recessions experienced in the West. The totalitarian state left the legacy of a giant overgrown military–industrial complex. So the necessary structural transformation was very large. But the size of the undertaking does not by itself explain why the contraction of inherited industry has been so drastic and the expansion of new sectors so anemic. Another aspect of the Gosplan legacy provides a partial explanation (Leijonhufvud, 1993).

Through their successive five-year plans, the Soviets built up a manufacturing sector composed of a number of vertically integrated industries, each one under its own Moscow ministry, and each one with a core of very large plants. This was an exceedingly vulnerable system, made more inflexible by the sparse transportation network.

To understand the problems inherent in such an industrial structure, think of the plants under one of the old Moscow ministries as analogous to workstations on an assembly line. Like a workstation receiving its intermediate good input from the preceding station and delivering its output to the succeeding one, such an enterprise is basically without alternative suppliers for many of its inputs and largely without alternative customers for its outputs. The line is only as strong as its weakest link. If one station on the line breaks down or fails to deliver, the failure cascades up and down the whole line and brings it to a halt. If control and decision-making were to be decentralized, the result is an unstable chain of bilateral monopolies.

All integrated complex systems have to depend for their functional survival either on the high reliability of their components or on ample redundancy of components. The Gosplan system lacked the "redundant" alternative suppliers and customers of a competitive market order. It was far more dependent, therefore, on the reliability of the component links in its vertical chains of large plants. A combination of institutions ensured this reliability, with the Moscow ministries acting as the "firms" running the vertically integrated industries of the Gosplan system, and the Communist Party ensuring the authority of management.

The Gosplan system was not only larger than Russia, it lapped over the borders of the Soviet Union into the "satellite" Eastern European nations. Trade was based not on mutually recognized gain, but on Moscow's political hegemony. With its loss, the system has progressively unraveled. The collapse of Council of Mutual Economic Assistance (COMECON) trade during the Gorbachev regime stands as a "model" of subsequent, more far-reaching developments. The twin aspects of the political disintegration of the Soviet system were already present: on the one hand, the loss of legitimacy and authority at the center; on the other, the ethnic and territorial fragmentation around the periphery. The collapse had nothing to do with "shock therapy," but everything to do with political disintegration and the loss of power at the center.

The next stage commenced even before the dissolution of the Soviet Union as the republics began to use the threat of withholding deliveries in bargaining among each other. The Gosplan legacy made such threats highly effective: cessation of deliveries from one republic could seriously disrupt production in others. The result was a "commonwealth" within which the relationship between republics came to be negotiated very largely through threat games of this sort.

It is obviously true that the inherited, utterly arbitrary system of prices offered hardly a clue to what enterprises were socially efficient or inefficient. In the West, it became conventional wisdom that the socialist economies could only be rationalized by liberalizing prices, privatizing all enterprises, and letting the market weed out the inefficient ones. Moreover, this could best be done with a "big bang," before pressure groups could form. But

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the "sink-or-swim" test of what enterprises deserve to survive is terribly risky in this particular setting. Not only may some plants fail that would survive if prices were competitive, but failures of one enterprise may force a cascade of failures up and down the vertical chain of plants. This was a reality that the industrial managers of Russia understood.

The potential instability of bilateral monopolies seems to have become manifest mostly where new political boundaries among the successor states cut across these vertical industry chains. Where this did not occur, Russian managers were more likely to form a coalition up and down the line in order jointly to extract subsidies from the government to keep their industry in operation. In so doing, they could count on the threat of collapse being taken seriously by government officials and politicians, most of whom had themselves come up through the system by the managerial route.

Under central planning, transactions at arbitrary prices would cause some enterprises to run cash-flow surpluses and others to run cash deficits. But surplus firms were simply taxed to subsidize deficit ones. Soviet enterprises never had to worry about maintaining sound working-capital positions. Monetary outcomes did not determine the expansion or contraction of enterprises. Money was not the control system.

The Russian government has been urged, therefore, to deny such subsidies and force loss-making enterprises to contract or close down—in other words, to put a monetary control system in place of the command system that has disintegrated. With the pressures and promises of IMF and other international organizations added to this advice, budgetary policy has hardened sufficiently in the past year to bring inflation down to rather tolerable levels. But the warnings of the industry managers that many enterprises without adequate working capital on hand would have to curtail production have not proved unfounded.

Freeing prices was not sufficient. Three years ago, the dilemma was the following: Cash deficits of some firms were no longer counterbalanced by surpluses of others, because of capital flight from Russia. Deficit firms were kept going, if at all, by subsidies financed by the inflation tax. Enterprises running a cash-flow surplus either succeeded in placing it abroad or else had to see the real value of their cash positions eaten up by inflation at home. Indirectly, capital flight was thus to a considerable extent responsible for the continuing inflation. At the same time, a capital reflux could not be expected unless inflation was brought under control.

Today, the situation has changed. Inflation has been brought down, but the subsidy payments that caused it have not declined in pace with inflation-tax revenues. It is now possible to earn a very high real interest rate, but that rate is earned on the treasury bills that finance the Russian federal deficit. The high real rate, coupled with IMF support, seems to have reversed the capital outflow. The problems now are (i) that the capital inflow finances government subsidies and not industrial investment, (ii) that the enterprises subsidized tend to be the least efficient ones, and (iii) that the resulting rise in the real exchange rate is causing difficulties for the more promising firms both in developing export markets and in competing with imports.

János Kornai (1993) analyzes "transformational recessions" as a process initially dominated by the contraction of the old enterprises. Over time, capital formation by new firms will counterbalance the decline in economic activity. The aggregate outcome depends on the interplay of the two segments, as the new private sector reaches critical mass, aggregate growth rates turn positive.

To this, we may add a third category, "restructured" firms. By this we mean simply firms inherited from the old system which have managed to raise their productivity. Some of the old socialist firms will be able to survive the sink-or-swim test. But in order to do so, most such firms will have to change their product mix and production technology, restructure distribution systems, and indeed, alter their entire managerial approach. Both corporatization and privatization are intended to increase the share of restructured enterprises in the economy (and both are often castigated for having failed to do so), but old, restructured, and even new firms may in principle still be state-owned.

The underlying mechanics are simple (Rühl and Viatcheslav Vinogradov, 1996). If the

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three categories can be ranked by the productivity of the firms which comprise them, the performance of a transforming economy over time will reflect the interplay of these three segments of the population of firms. The higher the share of new firms at any point in time, the higher will be aggregate output, whereas unrestructured old firms drag output down. Moreover, rapid growth of new firms and successful restructuring of old ones serve to break up the monolithic industrial structure created under central planning, as new production networks fill the gaps and provide the redundancy of components which was missing in the old system. Once the average productivity of all three segments become more or less the same, the transition can legitimately be said to be over.

For the composition of the firm population to change in ways that are conducive to high growth certain conditions must be met—almost all of which have been missing in Russia. The growth of the new firm sector can only take place through capital accumulation financed either domestically or through foreign direct investment. Restructuring will require not only sound working-capital positions, but new (equity) investment. Whether it will even be attempted depends on the incentives as perceived by managers. Left to themselves, the old firms have, with few exceptions, only two alternatives: bankruptcy or restructuring. But it is this, the least productive segment of firms, that the subsidies are sustaining. And the anticipation of subsidies will reduce not only the transition rate from old to restructured firms, but also the entry rate of new firms since the subsidies obviously reduce the prospective profitability of entry as well as of restructuring.

Even many enterprises that have access to capital see little incentive to upgrade productive capacity. Real rates of interest at the level now prevailing discourage it. The speed of restructuring is low, therefore, and the stock market is still widely seen as undervalued, despite the recent ''surge'' in capital inflows.

The same factors slow down the growth of new firms by blocking the translation of savings into investment. Russia is said to have a high saving rate (estimated at about 20 percent, if hard currency holdings are included). Yet gross investment has fallen dramatically since the transition began, and the decline still continues. Both domestic savings and foreign capital inflows go to meet the government borrowing requirement. This keeps working capital scarce, and investment finance even more so.

Today, therefore, the dilemma is the following: Now that there is freedom for funds to flow where the return is highest, they do not flow into productive use. And government absorption of funds supports capital structures that cannot be sustained in the long run.

The principal macroeconomic problem of many of the Commonwealth of Independent States republics has often been seen as the choice between printing money to keep industry going, thus fueling inflation, and imposing hard budget constraints to beat inflation, whatever the consequences for output, employment, and living standards. Theoretically, there is a third way. *Hard budget constraints do not mean cash-in-advance constraints.* Hard *intertemporal* constraints would do. Cash-starved enterprises unable to pay inputs today can be provided with cash today—on the condition, of course, that they repay with appropriate interest tomorrow. In principle, therefore, working capital could be provided in such a way that inflationary money creation is avoided.

In principle, it is possible; in practice, not very probable. Russia lacks the financial markets and even the financial instruments needed to supply the amounts of working capital required. Long-term investment finance is even more scarce. Genuinely strong institutions of a size adequate to meet the total credit needs of the economy have yet to emerge.

The very idea of transforming the socialist economy into a market one is to escape the tutelage of government. But if private institutions and financial markets cannot yet carry the burden, ironically, one would have to look to government to take the lead. If it could convert its various subsidies into ''sound'' credit programs requiring repayment at positive real rates of interest, a large part of the problem would be solved. Unfortunately, the Russian government is in no position to supply credit to the market. It is itself absorbing virtually all the credit, foreign and domestic, in the system. It is doing so because it is unable to collect

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taxes. This puts its ability to collect loan repayments in doubt.

Much depends on whether a Russian credit market capable of enforcing hard intertemporal budget constraints will develop in the next few years. If it does, a reflux of flight capital and increased foreign private-sector financing can be expected. If it does not, vigorous Russian growth will not happen, because it cannot be financed.

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