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Economic Reform in the USS and the Role of Aid

BY JULY 1991 economists in both the Soviet Union and the West were converging toward an agreed economic reform strategy for the USSR. That pre-coup reform strategy rested on four pillars:

—*Macroeconomic stabilization,* which requires the virtual elimination of the budget deficit and tight control over credit to both the government and enterprises;

—*Price liberalization,* an essential step not only toward the creation of markets but also toward restoring macroeconomic balance in a situation in which subsidies are as large as the budget deficit;

—*Current-account convertibility of the ruble* at a heavily devalued exchange rate, accompanied by the removal of restrictions on imports and exports of goods and by rapid progress toward low levels of tariffs and other trade taxes;

—*Privatization of enterprises and property* as rapidly as possible, with immediate corporatization of large state enterprises as an intermediate step.

Implementation of such a reform program would have posed technical and political difficulties far greater than those now besetting Eastern Europe and would, in the short run, have imposed hardships on many people. The program also would have had to be undergirded by a fifth pillar, a social safety net, and by Western financial assistance, to limit the inevitable short-term declines in consumption and other disruptions that would have threatened its political viability.

Today, the premise of firm central control on which the consensus program was based is obsolete. Analysis of reform and aid plans must

I am grateful to Panel members for comments.

therefore start by examining alternative economic frameworks that may emerge from the terminal phase of Soviet history. Crucially, aid plans have to adapt to the uncertainties surrounding both the framework in which they will be implemented and the course of developments in the former Soviet Union.

After describing two alternative scenarios for the next few years, I discuss reforms that can be undertaken within those frameworks and the role of Western assistance. I argue that although many details of the reform plans will have to wait for greater clarity about the economic structure linking the successor states of the Soviet Union, there is much that the republics and whatever central authority emerges can do to implement parts of the pre-coup reform strategy. Similarly, although general balance of payments support from the West cannot be delivered until the recipients are identified, there is an important—and by now generally recognized—role for immediate Western involvement through the provision of humanitarian aid and technical assistance. I conclude by stressing the need for coordination of Western assistance and proposing a coordinating mechanism.

Two Scenarios

The struggle over the political and economic arrangements within which the successor states of the Soviet Union will operate will continue for years. The framework that emerges within the next few months is unlikely to be final: at this early stage of reaction against the strong centralization of the Soviet Union, the pressures of decentralization dominate; later, as the costs of fragmentation and the advantages of cooperation become obvious, the republics are likely to move toward more integrated and cooperative arrangements.

Logically, the possible frameworks range from a strong federal structure similar to that of the United States, to a Latin American solution of totally independent republics each pursuing its own economic policies within the world economy. I consider two less extreme scenarios that could develop in the near future.

In the first, the *union scenario,* the republics form an economic union in which there is a single currency, controlled by a single central bank, and free trade among the republics. (For basic data on the republics, see

Table 1. USSR: Territory and Population of Republics, as of January 1, 1990

Region	Territory: Thousand sq. km.	Territory: Percent of USSR	Population: In thousands	Population: Distribution (percent)	Population: Growth rate (percent)[a]	Population: Density per sq. km.[b]	Population: Percent urban
USSR[c]	22,403	100.0	288,624	100.0	0.66	12.9	66
Slavic							
RSFSR	17,075	76.2	148,041	51.3	0.43	8.7	74
Ukraine	604	2.7	51,839	18.0	0.26	5.9	67
Belorussia	208	0.9	10,259	3.6	0.58	49.4	66
Baltic/Moldavia							
Estonia	45	0.2	1,583	0.5	0.89	35.1	72
Latvia	65	0.3	2,687	0.9	0.26	41.7	71
Lithuania	65	0.3	3,723	1.3	0.64	57.1	68
Moldova	34	0.2	4,362	1.5	0.55	129.4	47
Caucasus							
Georgia	70	0.3	5,456	1.9	0.24	78.3	56
Armenia	30	0.1	3,293	1.1	0.15	110.5	68
Azerbaijan	87	0.4	7,131	2.5	1.32	82.3	54
Kazakhstan							
Kazakhstan	2,717	12.1	16,691	5.8	0.94	6.1	57
Central Asia							
Turkmenistan	488	2.2	3,622	1.3	2.49	7.4	45
Uzbekistan	447	2.0	20,322	7.0	2.09	45.4	41
Tadzhikistan	143	0.6	5,248	1.8	2.72	36.7	32
Kirgizia	199	0.9	4,367	1.5	1.79	22.0	38
Composition by regions							
Slavic	17,886	79.8	210,139	72.8	0.40	11.7	73
Baltic/Moldova	209	0.9	12,355	4.3	0.60	59.3	62
Caucasus	186	0.8	15,880	5.5	0.70	85.3	56
Kazakhstan	2,717	12.1	16,691	5.8	0.94	6.1	57
Central Asia	1,277	5.7	33,559	11.6	2.20	26.3	40

Source: Adapted from International Monetary Fund and others (1991, vol. 1, table 3, p. 206).
a. Percentage growth in population 1989–90.
b. Number of people per square kilometer.
c. USSR territory includes the 127,300 square kilometers of the White Sea and the Sea of Azov, which are not included in the area of individual republics.

tables 1 and 2.) The central government has spending responsibilities, primarily for defense, but no independent power to tax and is financed by contributions from the republics. This arrangement is close to the framework of the Union Treaty that was to have been signed on August 20, 1991, the Tuesday of the coup.[1]

1. The key difference between the union scenario discussed here and the framework envisaged in most reform plans, and most explicitly in the Allison-Yavlinsky "Window of Opportunity" Plan (1991), is that in the union scenario discussed in this paper, the central government has no independent taxing authority. Although the Window of Opportunity provides a more coherent framework for reform than those discussed here, it does not currently appear to be a realistic option.

Table 2. USSR: Distribution of Population, Net Material Product, and Budget Revenue, by Union Republic

Percent

Republic	Population	Net material product: Total	Net material product: Industry	Net material product: Agriculture	State budget revenue retained by republic	Deliveries to other republics	Exports abroad
Armenia	1.1	0.9	1.2	0.7	1.4	63.7	1.4
Azerbaijan[a]	2.5	1.7	1.7	2.2	1.8	58.7	3.7
Belorussia	3.6	4.2	4.0	4.9	4.7	69.6	6.5
Estonia	0.5	0.6	0.6	0.7	0.8	66.5	7.4
Georgia[a]	1.9	1.6	1.4	2.1	1.8	53.7	3.9
Kazakhstan	5.8	4.3	2.5	6.1	6.1	30.9	3.0
Kirgizia	1.5	0.8	0.6	1.3	1.2	50.2	1.2
Latvia	0.9	1.1	1.1	1.2	1.3	64.1	5.7
Lithuania	1.3	1.4	1.1	1.9	1.7	60.9	5.9
Moldova	1.5	1.2	1.0	1.8	1.4	62.1	3.4
RSFSR[a]	51.4	61.1	61.9	18.0	55.3	18.0	8.6
Tadzhikstan	1.8	0.8	0.5	1.2	1.1	41.8	6.9
Turkmenistan	1.2	0.7	0.4	1.2	0.9	50.7	4.2
Ukraine	18.0	16.3	16.7	17.1	15.9	39.1	6.7
Uzbekistan[a]	6.9	3.3	2.3	5.2	4.7	43.2	7.4
Residual	...	...	3.0	4.4	...	...	...
Total	100.0	100.0	100.0	100.0	100.0	...	...

Source: IMF and others (1990, app. table 3, p. 51). Republican population is measured as a percent of 1989 total Soviet population. Net material product is measured at current prices and as a percent of 1989 totals. State revenue is measured as a percent of the total from the 1990 plan. Deliveries and exports are measured as a percent of net material product in current prices.

a. Azerbaijan contains one autonomous republic; Georgia contains two autonomous republics; Russia contains sixteen; and Uzbekistan contains one.

In the second, the *regrouping scenario,* the republics agree to maintain unrestricted trade but have the right to introduce their own currencies and their own armies.[2] As the scenario plays out, several republics including Russia form a weak federal structure (the Union of Sovereign States, or the USS), which would use the ruble and maintain common defense forces. Ukraine and perhaps other republics introduce their own currencies and operate as independent countries, while, at least initially, maintaining a common economic space. After contentious negotiations, the assets and liabilities of the Soviet Union would be distributed among the republics. Control over nuclear weapons would be assigned to the USS.

No matter what arrangements are made among the remaining 12 republics, the Baltics will have to negotiate transition and separation

2. The two scenarios are closely related to the economic-constitutional frameworks proposed in September 1991 by Grigory Yavlinsky and Stanislav Shatalin respectively.

agreements from the Soviet Union. They are likely to introduce their own currencies, establish their own common market, and attempt gradually to integrate into Europe.

Consequences with Union Scenario

Serious reform would be possible under either the union or the regrouping scenario, though each framework has built-in weaknesses.

In a successful union scenario, a strong, independent central bank keeps tight control over the quantity of money, rapidly establishes convertibility at a fixed exchange rate, and thereby provides essential elements of both macroeconomic stability and price reform. At the same time, the republics contribute enough revenue to the center to keep the central government budget close to balance, reducing pressures to print money or to borrow. In this scenario the republics quickly develop fiscal frameworks that allow them to balance their own budgets. They maintain free trade, imposing no restrictions on movements of goods or on interrepublican payments.

Within this stable macroeconomic framework, both the central and the republican governments implement structural reforms. The bulk of the structural reforms, especially in the areas of privatization and price liberalization, are carried out at the republican level, as they would have been even under the pre-coup strong-center reform plans.

Although all this could happen, it is not likely. The weakness of the union scenario is the weakness of the United States under the Articles of Confederation: the republics are unlikely to provide the central government with the resources needed to meet its mandated expenditures. In evidence, note that the republics refused to give independent tax authority to the center during the pre-coup negotiations over the Union Treaty—a time when the center was much stronger than it is now. At the same time, the draft treaty assigned an extensive range of responsibilities to the center, including defense. An optimist might argue that a tight revenue constraint would produce a massive and rapid reduction in military spending, but the political and social consequences of a rapid disintegration of the military make this unlikely.

What would happen next in the union scenario depends to some extent on the strength of the central bank. Most likely the central government would find a way to draw on the central bank to finance the budget deficit, a process that ends in hyperinflation. However, hyperinflation is possible even if formally defined money growth could be controlled: treasuries lacking fiscal resources tend to emit money-like instruments. Or perhaps trade taxes would be imposed. At some point, the budget problems of the center would become overwhelming, economic disorder would again intensify, and a new economic framework would have to be created. Some republics might choose economic independence, while others that wanted to remain could negotiate the formation of a new union with a stronger center.

The republics too would face major budgetary difficulties in the union scenario. They do not now have adequate tax systems and would very likely have to borrow to cover expenses. Some of them also lack the managerial capacity to implement the structural changes, including privatization, contained in the reform plans.

Consequences with Regrouping Scenario

In the regrouping scenario, successful reform requires each issuer of currency to maintain control over the quantity of money and to refrain from restricting interrepublican trade. As in the union scenario, the bulk of the structural reforms—privatization and price liberalization—would be carried out at the republican level.

If each republican central bank were strong and independent, with clear policy guidelines—for instance, maintenance of a fixed exchange rate for each currency against the other republican currencies and against a basket of Western currencies—the regrouping scenario could provide monetary stability. But newly independent republics that have insisted on the right to issue their own currencies as symbols of their sovereignty and that have weak tax systems are likely to print money to cover budget deficits. They are also likely, for two reasons, to interfere with interrepublican trade and thereby to destroy the common economic space. First, if they inflate but also seek to maintain fixed exchange rates against a relatively stable currency, they will find the current account worsening and will tend to impose import restrictions. Second, the natural inclination of political systems is to protect domestic industry, and that is particularly the case for newly independent states emerging from a prolonged period of state intervention in the economy.[3] Thus, the tendency to destroy the common economic space is the inherent weakness of the regrouping scenario.

Where does the regrouping scenario lead? If the USS can maintain a reasonably stable currency and pace of reform, then some smaller republics that chose full independence might eventually join an economic union with the USS, thereby giving up their currency and agreeing to maintain unrestricted trade. Ukraine and others of the smaller republics might attempt to negotiate a separate economic union with the USS, pledging to allow unrestricted trade. More likely they would move away from the USS, becoming more independent, maintaining their own currencies and trade restrictions, experimenting with import-substitution policies, and repeating many of the disappointing experiences of Latin America.

Reform within the Regrouped Soviet Union

Although the State Council is supposed to choose the economic framework before the end of September, its decision is unlikely to end the contest between the center and the republics. At present, regrouping seems a more likely outcome than the union scenario. Regrouping would produce a USS of six to nine republics (with Russia at its core), an independent Ukraine, and republics like Azerbaijan, Georgia, and Moldova wanting independence but without much external support.

The USS, the unit built around Russia and perhaps even consisting solely of Russia, would be the largest and most important of the successor states to the Soviet Union. Reform in the USS could proceed along the lines envisaged in the pre-coup reform plans and summarized in the introduction. There would be rapid moves toward budget balance within the Union and its constituent republics, convertibility of the ruble at a fixed exchange rate, price liberalization, the beginnings of privatization, and the introduction of necessary social safety nets.

3. Logically, the collapse of the centrally planned economies should incline policymakers toward free markets, and in a general way it does. However, there is also clear evidence that some republican leaders regard the breakup of the USSR as the occasion to substitute local centralized control for centralized control from Moscow.

Similar reforms could be introduced and implemented in Ukraine and the other independent republics. Those republics would have to decide on their exchange rate system and exchange rate peg, if any. The presumption is that republics would prefer to peg to a Western currency or a basket of Western currencies; if the ruble is stabilized, however, there are likely to be advantages for some republics in pegging to it. In considering the regrouping scenario, it is only realistic to expect that some republics will show virtually no interest in reform and to note that others lack the capacity.

One of the key lessons of the Eastern European reform experience should be heeded in reforming the Soviet Union: if possible, existing trading relationships should not be destroyed too rapidly. The abrupt end of Council for Mutual Economic Assistance trade at the start of 1991, and the shift to hard currency payments, has been a major contributor to the recessions now besetting Eastern European countries. Therefore, some transitional arrangements are needed to deal with existing inter- and intrarepublican trade. A variety of mechanisms, including a temporary payments union,[4] have been proposed and urgently need further study.

One possibility is to phase out existing barter arrangements gradually—for example, by maintaining existing trading partners for three years while, over that period, reducing to zero the quantities scheduled for delivery under each contract. In addition, any such existing contract to deliver goods could be terminated by agreement of both parties. All new contracts would be negotiated at new liberalized prices. Attempts to maintain existing contracts have been breaking down in the past year, however, and this approach may not be workable in practice.

If abrupt adjustments in quantities are disruptive, what about price changes? Should price reform and convertibility also be introduced only gradually? The basic answer to both questions is no. At the margin, prices on all contracts should be liberalized, and new trades should be free to take place at those liberalized prices.[5] In addition, the currency should be convertible on current account. Tariffs and trade taxes could be used to bring domestic prices in line with world prices gradually; but,

4. See, for instance, the discussion in Kenen (1991).

5. Experience with U.S. oil price controls that tried to distinguish between new and old oil is not encouraging, but no clean solution is available.

in any case, this process should not last more than three years, with a large share of the adjustment being made immediately.

In brief, economic reform along the lines outlined in the introduction is possible in each of the successor units of the Soviet Union. Maintenance of open trading links is less likely the greater the number of successor states, but the desirable directions of reform are in any case clearly independent of the particular political solutions that eventually emerge—and many of the reforms would have had to be undertaken at the republican level whatever the final degree of centralization.

The Role of Western Aid

The argument for Western aid before the failed coup was that it would support the forces of reform against its enemies, particularly in the army and the KGB. With the opponents of reform totally discredited, what reasons now remain for providing aid?

The West still has an interest in a peaceful transition from communism to a market economy and democracy in the successor states of the Soviet Union. In the short run, chaos in the region brings a threat of Yugoslav-type civil war, further economic difficulties for Eastern Europe, and immigration to Western Europe. Chaos also raises the question of the disposition of nuclear weapons, an issue that has been handled very delicately in analyzing the coup attempt.

In the longer run, the rest of the world will benefit from Soviet integration into the international economic community. The Soviet Union is extraordinarily rich in raw materials, is the world's largest producer of oil, and will be a massive market for the West. It is the next economic frontier. Further, most Western economies, especially the United States, will benefit from the peace dividend that is already accruing as the Cold War disappears.

Three types of aid have to be considered:

—*humanitarian aid* comprising food and medicines;

—*technical assistance* for activities that will be republican responsibilities;

—*general purpose financial aid,* such as currency stabilization funds and balance of payments loans.

Humanitarian assistance can and should be provided to Soviet citizens whatever the ultimate economic arrangement among the republics. Besides the humanitarian reasons for providing such aid, it is a highly visible form of support, which will have a large political impact. Food aid can go directly to the republics, through mechanisms that are being worked out now. Distribution of food is an important problem, which will be much easier to handle if food prices are decontrolled and some state trucks are privatized: it is amazing to see how food can move when there are incentives for it to do so. In addition to food, the Soviets themselves emphasize their need for medical supplies.

Some economic reforms will have to be undertaken at the republican level no matter what the final political arrangements. Most privatization will be a republican and municipal task, as will the decontrol of prices. Tax systems have to be created or improved at the republican level; so too do legal systems and the framework for foreign investment; much agricultural reform can be done at the republican level; the same holds for financial system reform. Technical assistance is urgently needed in all these areas. Reports are that while foreign experts are falling over each other looking for work in Moscow, they are very thin on the ground in the republics.

Technical assistance to the republics can and should begin soon. The European Community is ready and willing to move. So is the World Bank, whose board has approved a $30 million fund for technical assistance. Bilateral Western assistance is also expected. Some of the technical assistance may need to be accompanied by financial assistance, but this will be on a small scale. Some of the technical assistance should take the form of advisory teams that are placed in the capitals of the republics rather than in Moscow. These teams should be available on a continuing basis to help set up the new economic framework and to assist in the implementation of reforms.

Thus important Western assistance—namely, humanitarian aid and technical assistance to the republics—can begin immediately, should begin immediately, and is likely to do so. This aid does not have to wait for clarity about the economic and political future of the Soviet republics.

However, large-scale general financial assistance cannot be provided until it is clear to whom the assistance should go. For instance, there is no point setting up a ruble stabilization fund when the future currency arrangements of the USS and its successor states are still uncertain. Similarly, typical International Monetary Fund (IMF)–type balance of payments loans that support macroeconomic stabilization cannot be provided until it is known which governments will have the power to bring macroeconomic stability.

Should the West attempt to shape the transition in the Soviet Union through the leverage of large-scale financial assistance? Yes, in the sense that aid should flow only to governments reforming in a democratic and market-oriented direction. Yes, in that the West has an interest in arrangements that reduce the risk of chaos. Beyond that lies a question for politicians rather than economists to answer: whether it is in the interests of the West to attempt to maintain a large centralized state in the former Soviet Union by announcing that balance of payments support would be available only to an all-union government. My judgment is that the West should avoid that temptation, except to the extent that it believes it can help keep the transition to the new arrangements more peaceful than it otherwise would be. It is difficult to see a Western interest in maintaining a single successor state; nor would an announcement that aid would be available only to an all-union government be credible, since the same motives that justify aid to the union justify aid to the successor states.

Because general financial assistance cannot flow until a new economic framework is in place, Soviet leaders have strong incentives to agree on their economic constitution. Reform plans, including the details of Western assistance, can be worked out as soon as an economic constitution goes into effect. The USS and those republics that become fully independent should gain full membership in the international agencies, through which much of the needed financial aid will flow.

Although the Group of Seven (G7) has held back on aid on several key occasions, Western inhibitions about economic aid are fast disappearing. Food and medical aid and large-scale technical assistance are about to begin flowing. The West will have to show flexibility in dealing with different levels of government, and quite possibly with changes in governmental structure. It will also have to preserve flexibility in considering balance of payments support and in deciding when such support is warranted. But since it will take time to figure out the dimensions of the needed support, work should begin now, even before the West knows the political framework in which it will be delivered, or whether it will be delivered.

Preliminary calculations about aid suggest two important conclusions. First, the West can put together a large aid package without the United States having to provide a great deal of direct aid. And second, because Japanese aid will be crucial, Soviet and Russian leaders have very good reason to reach a territorial understanding with Japan.

Aid Coordination

A serious Soviet assistance program will be on a much larger scale than any aid effort mounted by the West since the early fifties. Technical and financial assistance will be supplied by a host of Western institutions: the multilateral institutions, Western governments, the commercial private sector, and nongovernmental organizations. A multiplicity of contacts on both sides is essential if Western engagement is to succeed in penetrating deep into the Soviet economy and society.

There are many overlaps in the responsibilities of the IMF, World Bank, other United Nations agencies, European Bank for Reconstruction and Development, Organization for Economic Cooperation and Development, European Community, and the governments providing direct bilateral assistance. These agencies are already competing for influence over the provision of Soviet assistance, and the competition will intensify as technical and financial assistance to the Soviet Union grows. Some of this competition is healthy, but most will be counterproductive, leading to duplication of effort, bureaucratic infighting, and turf battles. In addition, experience in Eastern Europe has shown that the competition confuses policymakers in the recipient country and absorbs attention that would be better focused on economic reform.

The West needs a mechanism to coordinate official assistance. The need is temporary and requires no new permanent agency. A modest office, the Office of Soviet Aid Coordination (OSAC), headed by an experienced, authoritative, and widely respected individual, could provide the coordination needed.

OSAC would chair an international coordinating committee of representatives from the major donor nations and international financial agencies. It would report regularly to the G7.

OSAC would not be asked to approve the activities of others, but would do the following:

—assure that information on programs, policies, and funding is shared;

—assure that duplication is identified and avoided;

—assist recipients in identifying alternative sources for technically suitable support;

—assure that the policy framework and reform program, as defined by the recipient states (USS and the independent republics) in agreement with the international community, is the framework within which programs are developed; and

—monitor implementation of programs and report regularly to the major donor governments and the heads of agencies.

For their part, the Soviet republics will also have to coordinate their aid requests. The Inter-Republican Economic Committee, which, under most reform plans, will be the coordinating body for implementing reforms, is the natural counterpart of OSAC.