GETTING REALISTIC ABOUT RUSSIA

BY CLIFFORD G. GADDY AND BARRY W. ICKES

No Time for Illusions

The collapse last August of Russian financial markets and the dismissal of the Kiriyenko government is seen in Russia as the end of an era. Radical market reform is over. In its place is emerging a new "Moscow consensus." Now, adherents say, it is time to try a new course of government-directed industrial policy, including protecting domestic producers against foreign competition, and looser monetary policy.

According to the new consensus, not only did seven years of radical market reform fail to put Russia on the path to becoming a modern economy, it impoverished the country and left it defenseless. This harsh view is carried to extremes by radical elements who attribute Russia's troubles to a conspiracy by adversaries in the West, abetted by certain circles at home. Just as German nationalists in the early 1920s helped propagate the idea that Germany lost World War I because a small group of traitorous politicians sold out the nation, Russian nationalists today are blaming a small group of pro-market reformers for adopting an economic program that destroyed a strong industrial and military power. In Russia today, as in Weimar Germany, the treachery is being attributed to the Jews.

Western reaction to the new consensus has been to disengage. Some think that maybe Russia does need a brief retreat from reform—which can perhaps resume later under calmer conditions. Others are simply at a loss: what to do when nearly every individual and every policy that the West supported is now out of favor? Some hope the new policies lead to disaster—and thus galvanize Russians into serious reform.

We disagree. Now is not the time for illusions, self-delusion, or scapegoats. Now is the time to face the truth and tell the truth. The Russian economy is indeed in sorry shape. Many hopes have been dashed. But reformers did not force this fate on Russia. Russia never acceded to reform. Indeed, in its struggle to avoid reform, it created what we call "the virtual economy."

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The existence of the virtual economy now makes it harder than ever to reform successfully. The difficulties will only increase as time passes. But the disastrous state of the economy is not an argument for disengagement; on the contrary, it dictates a more pro-active attitude from the West.

Clifford G Gaddy is a fellow in the Brookings Foreign Policy Studies program. Barry W. Ickes is professor of economics at the Pennsylvania State University. They are the authors of Russia's Virtual Economy *(Brookings, forthcoming).*

What Really Happened

Russia was always more hesitant about market reform than the countries of Eastern Europe. For the Poles, for example, the alternatives at the beginning of transition were: "Reform and be part of Europe" or "Don't reform and be subject to Russia." No matter how painful the transition, few Poles would have opted for the latter. The incentives to make reform work were huge. Whatever backsliding might occur, whatever mistakes might be made, pressure to push ahead was continuous.

Few Russians saw market reform as a life-or-death matter. Many were opposed from the beginning. Most others were willing to accept some elements of a free market, particularly those that offered personal economic freedom. A passionate few adherents of the market economy excepted, most policymakers saw market reform as a way of correcting the old system, rather than a thorough rejection of it. They would reform to raise consumption standards and become competitive in the global economy. They would be greatly helped by the opportunity to shed the burden of massive military expenditures.

Russians quickly took advantage of reform's benefits—the expanded choice of goods, the new opportunities to choose jobs and careers. But they equally quickly began taking those opportunities for granted. Very early on, most Russians began to feel that further reforms meant, on balance, more pain.

Russia's less-than-wholehearted commitment to change was compounded by great objective difficulties. Eastern Europe's economy had not been nearly as distorted as Russia's by communism and hypermilitarization. Russia had been subject to central planning much longer than the Eastern European satellites. The foundations of its industry were laid under communism. Private agriculture was wiped out.

Thus if Russians were to be anywhere near as persistent as, say, the Poles in pursuing market reform, they would need huge incentives. The West did not provide those incentives. Instead, it provided just enough financial assistance to allow Russia to avoid making hard decisions—just enough aid to sustain the old system. Certainly the West did not impose real conditions on the use of the funds it did provide—if indeed conditionalities can be imposed on a nuclear superpower.

Neither the carrot nor the stick was big enough. Implicitly acknowledging that fact, the Western governments backed off and handed the International Monetary Fund the impossible task of pushing a nation that did not want to reform while being prevented from pushing hard.

The Russians quickly learned that the threat of failure was the most reliable way to get aid. Inside Russia, enterprise directors had been practicing that approach on a micro level. The best way to get a bailout was to credibly threaten dire social and political consequences if you didn't get it.

With no perceived incentive to change, the Russians simply tried to get all the handouts they could without any idea of what to do with the money. The absence of a vision of what to do to make Russia a modern and competitive economy was not regarded as a serious problem by liberal reformers. People are not required, or even supposed, to know where they are going in a full-fledged market economy. The proper macroeconomic policies would ensure "hard budget constraints," which by definition would enforce the correct behavioral changes, like it or not.

But this did not happen in Russia. The radical reform measures introduced by the Gaidar government in late 1991 and early 1992 were initially a shock, but they were soon buffered and absorbed with relatively little impact. To the extent that behavior changed, it was more to seek protection from the market than to embrace it. The set of peculiar mechanisms that provided that protection is what we have termed Russia's virtual economy.

The Virtual Economy

The virtual economy is the result of efforts of enterprises and households to survive when the market value of the things they produce is smaller than the value of what is needed to produce them. In the virtual economy, enterprises make pretty much the same products they made under the Soviet system and in pretty much the same way. The enterprises can continue to produce these goods because they have a guaranteed set of "buyers" (to use the term loosely) and because they avoid the use of money. Avoiding money, through barter and other forms of nonmonetary exchange, allows the goods to be overpriced, giving the appearance of more value being produced than is the case.

These overpriced goods are then delivered to the government in lieu of taxes, or to value-adders, mainly energy suppliers such as the natural gas monopoly *Gazprom*, in lieu of payment, becoming the means for continued subsidization of unprofitable, even value-destroying, production in the Russian economy. As much as 70 percent of transactions among industrial enterprises involve no money. Similarly, offsets, barter, and the like account for 80–90 percent of tax payments by these major industrial enterprises.

The Privatization Program

An important force behind the emergence of the virtual economy was the nature of the Russian privatization program, which was essentially a giveaway to insiders—that is, the directors and workers. The country's manufacturing dinosaurs, the enterprises that needed to change the most, were captured by those who had plenty to lose if they were restructured. Meanwhile, government shares in valuable enterprises went to the large banks and other political insiders.

Privatization was supposed to have—and alone would have—spelled doom for weak manufacturing enterprises. But the enterprises continued to be subsidized, though not directly by the government, but by *Gazprom*. To better understand that, it is worthwhile considering *Gazprom*'s place in both the Soviet and the Russian economy.

The Soviet economy was characterized by value creation in the resource sector and value destruction in manufacturing. But because the preferences of the leadership were biased toward defense and heavy industry, it was important for these sectors to appear to be producing value, and the price system was adjusted accordingly. (Because all property was state owned, the returns to specific assets were irrelevant.)

Privatization in Russia involved demarcating assets into specific bundles and assigning ownership to them. But because individuals could have little idea of the market value of their assets, human or physical, in the vastly different economy of market reform, privatization was tantamount to giving every Russian a lottery ticket. In the lottery, to simplify a bit, *Gazprom* was the winning ticket. *Gazprom* shareholders received valuable assets, while everyone else ended up with assets with no market value.

The virtual economy is the Russian democracy's way of making the winner-take-all privatization lottery more equitable. Redistributing *Gazprom*'s value gives other tickets value. Essentially, *Gazprom* must pay off other parts of society in a bargain to retain its share of the value that is produced. But because the winner-take-all distribution reflects the market value of the assets, redistributing value in the virtual economy postpones reform.

Reform: Harder Than Ever

As early as 1994, the virtual economy had become consolidated, and the possibility of reform was becoming ever more remote. The Russians had to be arm-twisted into nearly every single positive change they made at the central policy level. Meanwhile, at the micro level, enterprises, households, and local governments continued to develop and to perfect ways to protect themselves from the market.

By now, reform has become nearly impossible. Kiriyenko's tenure made that clear. While there will undoubtedly be renewed attempts at reform, they are almost sure to fail. Each time, the task will become more difficult.

In the first place, the system that needs reform is not the same as it was in 1991–92. The virtual economy has evolved and adapted over time. It has not been imposed from above. It grew from the bottom up and is therefore very robust. The key elements of the virtual economy that have been carried forward from the Soviet economy could not be dismantled by the conventional methods of macroeconomic stabilization and nominal privatization. The Russians want this system; it protects people, and they will protect it.

And even if enterprises were willing to change and adapt and become competitive in the market, the technical challenge is greater today than it was six or seven years ago. Investment has fallen to next to nothing. In the productive sectors of the Russia economy, in 1997 investment was only 17 percent of 1990 levels. In the core areas of machine building, engineering, and metal-working industries, it was 5.3 percent of 1990 levels. Russia's economy needs massive modernization. It has not had it. A physical plant that was old and noncompetitive to begin with is now even older and less competitive. Even by official Soviet standards, more than one-third of the equipment in Russian industry was physically obsolete when reform began in 1992. It was quite literally junk. In 1996 the share of junk reached 50 percent. It will be 60 percent in 2000.

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Russian enterprises have also lost human capital. Workers in the weak industries who felt they had a chance in the new market economy have left. Those who remain behind are the least productive.

Finally, Russia is in a permanent debt trap. Debt builds up, not down—and not just financial debt. At every step along the path to the market, reform will be encumbered by society's cumulative nonpecuniary, unpaid costs, especially damage to the environment and the undermining of public health. These costs, unlike the financial debt, have to be paid some time, somehow. They cannot be erased by a default.

Dangerous Consequences

The continued existence of the virtual economy has implications for Russia's economy in four areas: economic growth, the national integrity of the economy, development of the private sector, and the ability of the public sector to fulfill its tasks.

In the short term, the virtual economy appears to grow while it actually contracts, thus fatally compromising the future competitiveness of the economy. For the short term and middle term, the system is likely to remain stable. But at each stage of the journey, the economy will be less competitive than it began. Where will it end?

The virtual economy has a natural tendency to fragment a national economy into smaller, self-contained local economies. Local government budgets are already more "virtualized"—demonetized—than even the federal budget. Local governments protect the local market for the benefit of their local virtual economy. In the current crisis, regional and local governments have intensified the tendency toward localism by introducing measures to hoard goods locally and ban exports, especially food, to other regions.

The virtual economy will not eliminate the private sector; indeed, it needs a private sector as a source of a minimal amount of cash. But the dominance of the virtual economy is incompatible with a genuinely independent, prosperous private sector. Small businesses will be permitted to exist, but they will be hobbled in the market, neither allowed to supply to public-sector customers or to develop as subcontractors. More seriously, because they generate cash, they will be subject to a heavy tax burden.

The virtual economy will continue to shrink and impoverish—and demonetize—the public sector. The federal government budget is key. The federal government remains woefully short of cash, real money, to meet its obligations. In 1997, with the world mesmerized by its booming stock market, Russia collected less than 60 percent of its taxes in monetary form. Its cash tax revenues came to barely $23 billion at 1997 exchange rates. Even counting other sources of monetary revenues—privatization sales, customs duties—the government was able to raise no more than about $40 billion, not counting borrowing at home and abroad.

With the highly publicized tax collection campaign last winter, the government raised slightly more cash. But as the virtual economy model predicts, the extra cash to the budget came at the expense of the rest of the economy—and helped precipitate the default on August 17. Kiriyenko concluded truthfully: "We can't pay both the bankers and the people. I choose the people." He defaulted on $40 billion of short-term treasury bills, known as GKOs—the equivalent of the entire cash receipts of the federal government for 1997.

Since the default, tax collection has been disastrously low. Even if the new Primakov government is able somehow to collect as much cash in real ruble terms in 1999 as in 1997,the devaluation of the ruble against the dollar puts the government in much worse straits for repaying foreign debt.The dollar value of the government revenues would likely be less than $20 billion, and the foreign debt repayment obligation facing the Russian federal government in 1999 is $17 billion. Inevitably the payments will have to be postponed.

What Can Be Done?

The temptation to disengage from Russia in these circumstances is seductive. But one need only consider the long-term consequences of allowing further deterioration to realize that something must be done. The question is what? We have no magic bullet, but we do believe that the concept of the virtual economy suggests the general outlines of a policy to save Russia. Completion of the task will take decades,not years.But it must begin now.

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It is crucial to address all three root causes of Russia's economic problems: destruction of value within the system, "leakage" of value out of the system through corruption and looting, and, as a consequence, the need to infuse value from the outside—that is, through borrowing.

A four-step strategy would target those root causes. The first step is to abandon all pretenses. Russian leaders must lay bare the reality of the economy—now. They no longer have reason to fear that "telling the truth will only make things worse."

Policymakers must not only stop concealing the fact of value destruction, they should try to quantify it. By all means, they should also speak openly about the benefits—social and political stability—of continuing the value-destroying enterprises. But admit the costs.Then people can decide.

In the same spirit,leaders should be more realistic about the potential of the Russian economy. It is much lower than has been acknowledged,which makes it clear that the cost of sustaining the value-subtractors is high in the long run.

The second step is to reduce the value destruction—not suddenly and comprehensively, but systematically. The mechanics are simple: enforce bankruptcy of genuinely nonviable enterprises. But the political will is the key issue. Step one—disclosing the costs of maintaining the virtual economy—is a precondition to gaining support for a reasonable program to reduce value destruction.

The third step is to eliminate leakage. Stop the sweetheart deals. Tighten government; reduce waste. Improve the tax code. Perhaps go as far as nationalizing *Gazprom*. Impose exchange controls. Some of these reforms are already demanded by the IMF. Others may challenge the standard recommendations.

Finally, write off the debt.To give the country the breathing space to make the first three steps meaningful, Russia's more than $70 billion of post–Soviet era debt must be radically restructured. The model will be the agreements Russia reached with the London and Paris Clubs of creditors about its Soviet-era debt. In those cases, the debt was stretched out over a period of 20 years, and a grace period of 6–7 years was granted on repayments of principal.

Only in combination can these four policies work. If not undertaken together, and consistently, they will not work and indeed may be counterproductive. Clearly, the second step—reducing value subtraction—cannot be carried out without the foundation laid by the first. The third step—stopping leakage—makes sense only if done in conjunction with the second. Otherwise, it only makes the virtual economy (or its more transparent variant) more sustainable. The second step, vital as it is, will not be able to save Russia unless the country can be extracted from its debt trap—the fourth step. And yet,conversely, the West should not grant debt forgiveness unless it knows that both the destruction of value and the leakage of value are going to stop.

The central element of any policy must be eliminating the virtual economy. Only then can real reform begin. But it must be immediately apparent that eliminating the virtual economy is a much greater task than stabilizing the currency, reducing inflation, or privatizing industry. It will involve a greater Western financial commitment to reform and greater intrusion into the affairs of Russia than either we or the Russians have hitherto considered. The critical question is whether such a program is at all politically viable.The real cost of our illusions about Russia's progress toward the market, and the inevitable crushing of those illusions in the recent crisis, is the loss of the political capital required to undertake real reforms. ■