Is Russia Threatened with Hyperinflation?

Oleg Bogomolov

The liberalization of prices at the beginning of 1992 has been interpreted as the first real step toward a market economy. Indeed, without free prices determined by supply and demand, there can be no market; just as there can be no market without competition, private property, sound money, and strict state regulation of accounting practices and taxation. It is too late now to give advice on the sequencing of market reforms in Russia (privatization, demonopolization, and budget reform first, followed by price liberalization or vice versa). Clearly, the Russian government had neither the time nor any real opportunity to make a better choice. The central control structures were breaking up and being abolished. Many prices already had broken free since the summer of 1991. A sense of the inevitability of another jump in prices had deeply penetrated into the public consciousness, leading producers to delay deliveries of goods in anticipation of the price increases. There was clearly no hope of stemming the rising tide through administrative barriers: the result could be the opposite to the one desired (a further worsening of supplies to cities and an explosion of speculation and other abuses). Even the rationing of basic foodstuffs sold at fixed prices became a problem in view of the insufficient funds at the disposal of the authorities and the fact that the authorities themselves were too weak to force producers to deliver goods to centralized reserves at unprofitable prices.

In a word, arguments over the best theoretical path to a true market have taken a back seat to the dangerous effects of a new jump in prices and to the need to counteract these effects.

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The Price of High Inflation

The most serious threat is posed by high inflation, that is, a back-and-forth race between prices and wages in which everything becomes more expensive by 10–30 percent every month. Such inflation is dangerous because it deprives the economy and its individual participants of any stimuli for accumulation and investment, engendering a desire to expend earned income immediately and avoid the risk of investments, since it is absolutely uncertain what profit could be derived from them. What is the use of expending effort when additional earnings are instantly consumed? The indexation of incomes and deposits based on the rate of monetary devaluation does not fully insure against losses. Financial relations become more and more confused, the standard of living falls, social disparities grow, and production stagnates or even drops. This is the price of high inflation.

History provides examples of hyperinflation and of overcoming it. Tackling this problem is uncommonly difficult, but not impossible. The point is that high inflation sets in motion a mechanism of self-acceleration: the producer, in anticipation of growing costs and devaluation of revenues, calculates prices that are higher than required at the present moment well in advance. Thus the inflationary spiral continues to ratchet to higher and higher levels. It is true, however, that the rapid devaluation of excess demand held by the population (deposits at savings banks and cash holdings), as well as of the assets of enterprises and organizations in bank accounts, makes the solution of the problem of balancing the money supply and the supply of goods easier. The two- or threefold price increases effected by Valentin Pavlov, their further growth even before the onset of liberalization, and subsequent new jumps in prices following liberalization effectively soaked up at least 500 billion accumulated rubles from the pockets of the population, to say nothing of the nearly twofold reduction in consumption. A high price to pay for the economic policies of the years of perestroika.

Curbing Inflation

In recent years Yugoslavia, Poland, and some Latin American countries have to some extent managed to curb excessive inflation. Will Russia be able to do this? What new sacrifices will it require?

I think that one should not set great hopes for an elimination of the numerous deficits or the appearance of an abundance of goods on shop shelves. This was the result of liberalization of prices in Poland after January 1, 1990. The possibility of a similar result in our case is problematic, since the severely tight fiscal policies and wage freezes of the Polish case would be extremely difficult to implement in our case, and the more so, since no such measures are envisioned in respect to wages. In Poland, price liberalization was from the very start accompanied by internal convertibility of the national currency (free exchange of zloty for dollars at the rate set by the state for both the population and enterprises). In this manner the market had a reliable and real anchor to which prices could fix themselves. There is nothing of the kind in Russia. Moreover, the state monopoly on agricultural purchases, trade, and the manufacture of many goods will most likely in our case act to further push up prices, rather than lead to an expansion of the supply of goods. How can we fight inflation in this case?

It is already clear that after the deregulation of most prices and wages we must decisively implement a whole package of well-known measures without which the economy and, in the first instance, its monetary system cannot be stabilized. Some of these measures should have been effected even prior to liberalization; for example, the privatization of state property, the dismantling of monopolistic structures, and the creation of a competitive environment including a liberalization of foreign trade, the elimination of the budget deficit through a reduction in government spending, an improvement of the taxation system, and strict control over credit and monetary emission. We must decisively restructure the economy, orienting it toward the needs of the population and toward providing all possible assistance to entrepreneurship. The above measures require time for their preparation and an experienced and strong administration for their implementation. Then they will be capable of containing liberalized prices and restoring confidence in money.

Privatization

Unfortunately, we have neither a surplus of time nor an effective executive power that would be obeyed without objections. Under these conditions we must shy away from complex bureaucratic forms of privatization and return a part of the property confiscated by the state to the ownership of private citizens in order to lessen social discontent, localize spontaneous civil unrest caused by low living standards, and curb the growth of crime, bribe taking, and large-scale theft of property. One cannot simply rob the population through taxation and inflation (which is, in fact, a kind of indirect tax) and compel people to buy property that already belongs to them. Savings are insufficient for this. We must immediately privatize state apartments free of charge (or for a nominal symbolic price) for those who live in them and distribute land to those who are capable of efficiently working it. This would compensate, even if only in part, the enormous material losses of the population. All inequalities resulting from such free distribution could be corrected later through taxation on the sale and inheritance of this property.

Later, when it comes to the privatization of large-scale state property, the adult population should be issued certificates (vouchers), as is being done in Czechoslovakia (now the Czech Republic) and Poland, for a free acquisition of shares.[1] The state owns an enormous wealth, but the population is poor. Thus a certain portion (30–40 percent) of so-called "people's" property could be returned to the people as private property. With the appearance of markets in housing, land, and shares, total supply in the market will expand and the value of money will again be reliably supported. In view of the high inflation and bacchanalia of prices, it is very urgent to create some anchor to stabilize the monetary system and the emerging market economy.

A Parallel Currency

A currency parallel to the ruble (chervonets) with solid commodity backing (for example, land, natural resources, and other privatized property available on the open market) and freely convertible into foreign currencies might serve as such an anchor. Unless this is effected, the dollarization of the economy is inevitable, as is a dollar exchange rate that would leave the country open to carpet bagging. The growth in attractiveness of the dollar as a stable currency easily convertible into any goods will whip up the demand for it and, hence, its exchange rate. For this reason, it is better to tackle the problem of creating our own hard currency that will gradually displace the existing one.

A Supply-Side Approach

The weak point of the economic stabilization measures undertaken by the Ryzhkov and Pavlov governments and even those of the present Russian government consists of the fact that the emphasis has been on the fiscal side: the use of taxes to restrict the demand of the population. This restriction undermines the motivation for productive and conscientious labor. The main reserve for healing the economy and its monetary system lies elsewhere: in the growth of production and entrepreneurship. True incentives will appear and then, on the same land and with the same production capacities, we would be able to increase output 1.5 to 2 times. In my opinion, such incentives could be encouraged by two things: stable money and actual ownership of

[1]The voucher program has now been initiated in Russia—ED.

property, which together would lead to a rise in entrepreneurial initiative and guarantee economic freedom. State revenues should mainly increase through the stimulation and expansion of production, profits, and personal income rather than through comprehensive increases of the tax burden.

An Independent Monetary System

Of course, we must question the feasibility of overcoming hyperinflation and restoring a healthy monetary system within the boundaries of the Commonwealth of Independent States (CIS). To succeed, it is at a minimum necessary to ensure such indispensable prerequisites of recovery as the elimination of the budget deficit, strict control over monetary and credit emission, and severe restrictions on the growth of the internal debt of some members of the CIS. To date there are few convincing arguments that such is feasible. One might rather expect that Ukraine and some other CIS members would prefer to create their own national currencies and resent the idea of a unified ruble zone. Russia, for its part, can hardly tackle the problem of ruble stabilization if the ruble zone includes states that are not willing to waive their sovereignty and accept the still somewhat questionable price, credit, taxation, and monetary emission policies imposed by Russia.

It seems more realistic to assume that Russia will form its own independent monetary system, perhaps in cooperation with some other successor states.[2] If Russia succeeds in restoring sound money, the Russian monetary unit may serve as a tender for inter-republic settlements.

The Difficulty of Reform

The road to restoring strong real money will clearly be rocky and difficult. Undoubtedly the most important factor will be to increase the supply of goods and services on the market as a counterweight to the money supply. Since it is unrealistic to expect an expansion of production in the short run, the most available reserve for saturation of the market is privatization of state property.

Another important prerequisite is reducing expenditures and increasing revenues in the state budget. This problem must be solved against the background of a general decline in production and, consequently, tax revenues. The liberalization of prices will obviously reduce the cost of state subsidization of prices for coal, foodstuffs, pharmaceuticals, passenger transport, and residential rents, but at the

[2]In 1993, Russia, Kazakstan, Belarus, Armenia, Azerbaijan, and the middle Asian republics signed an agreement to establish a common ruble zone.

same time it will force the government to increase salaries of state employees and to raise pensions.

In the race between prices and wages, of course, prices will lead. The additional profit associated with sky rocketing prices tends to be absorbed by the government (to a considerable extent, if not fully) to support the budget. The hope here is that the lag between the growth of prices and personal incomes in favor of the budget will make it possible to reduce the budget deficit and decrease the circulating money supply. The trouble, however, is that tolerance for a further lowering of personal incomes is close to the breaking point, after which one can expect wide-scale popular unrest and demands for higher wages and pensions.

In a word, it is too early to determine how great the increase in state revenues caused by price liberalization will be. In my opinion, it is best to err on the side of caution.

Of course, strict spending limits are necessary across the entire budget, but the greatest effect should come from reductions in military expenditures, large-scale capital construction projects, and agricultural subsidies.

The level of defense spending in the Russian economy is enormously hypertrophied (up to 40–50 percent of all machine building and roughly 20–25 percent of GNP), which will make the process of conversion extremely painful and costly. Sharp reductions in government purchases of military hardware have already begun. Left without contracts, military factories and R&D organizations have been compelled to either shift production to civilian needs or lay off personnel. Both options require additional expenditures for retooling and unemployment benefits. For this reason there will be no immediate peace dividend. This will only come after a significant lag time. The same applies to troop reductions. These will in all likelihood require several years and will result in the formation of a relatively small professional army. Maintenance costs will be higher for the latter than for a conventional army of comparative size. In other words no large-scale reduction in expenditures should be expected for this item of the military budget.

The Russian government can cut budgetary outlays for capital construction (including housing), provided that big banks will take over this function. But the latter are very reluctant to do so, given their limited resources. As regards the repeal of the bulk of state agricultural subsidies, this is quite realistic with the introduction of free prices. Producers will recoup their losses through price increases provided consumers have enough money to buy foodstuffs, which is unfortunately not the case.

In view of relatively limited reserves for reducing budgetary expenditures, greater hopes are placed now on increasing tax revenues. Because of the decline in production and its ever-decreasing profitability, the budget is deprived of considerable income. Through tax reform the government intends to increase the burden laid on the population and enterprises. In comparison with the leading countries of the West, higher rates are envisioned for income taxes, profit taxes, and value-added taxes. All this, unfortunately, has a dampening effect on the economy, suppresses entrepreneurial and labor activeness, and any desire to earn more. No reasonable compromise between the desire to increase revenues through taxation and the need to encourage economic activity by easing the tax burden has yet been found. In the final analysis, the most optimal variant would be growth in tax revenues as a result of an expansion of production.

Finally, the government of Russia is counting on augmenting the budget through the sale of property at its disposal that was previously declared to be the property of the people. It is very difficult to estimate potential revenues here, not only because of the absence of a real market evaluation of the worth of state property, but also because of the uncertain mechanics of privatization itself. At present it is spontaneous and uneven and accompanied by the expropriation of the state property by lower-level authorities or economic organs. This adds virtually nothing to replenishment of the state treasury. On the other hand, the employees of the state enterprises are showing an interest in buy-out options.

However, this is only possible on borrowed resources, since all residual personal savings have been consumed by the price liberalization. In short, the state must provide credits initially and then only after several years anticipate repayment. Considering hyperinflation, these payments will actually amount to virtually nothing. Moreover, the absence of real market assessments on state production assets means that the transaction itself is frequently completed at prices so low as to make them merely symbolic.

Presumably "small" privatization (the sale of small and medium-sized shops, restaurants, and other outlets) will enable the state to absorb the amassed cash resources (acquired legally or illegally) of the growing stratum of entrepreneurs and trade mafia. This might be several dozen billion rubles. The devaluating money can be profitably converted into real estate. However, on the other hand, it is obvious that the new Russian authorities at all levels show great hesitation in the privatization of state property, since they understand that with its sale or distribution their power is destroyed. This is especially true on the question of land, natural resources, and large-scale industrial enterprises. Very little is being done to assess the real value of the property to be privatized. Serious efforts in this direction are taken only in the event of a partial sale to foreign investors. There is no competent administration at the different levels capable of taking on privatization. The bodies formed for this purpose do not have any property at their disposal, and must privatize the property of others.

Western capital also displays caution in the acquisition of enterprises. It is frightened away most of all by political instability, the lack of a normal market environment, and the bureaucratism of the authorities.

In principle, it is precisely a rational and socially just privatization of the enormous wealth that the state possesses that is the key to recovery of the monetary system and transition to a healthy market. Unfortunately, currently there is not the required decisiveness, clear conceptualization, or administrative mechanisms to make privatization an effective tool for stabilizing state finances or for ensuring the stability and internal convertibility of money. For this reason, during the coming year privatization will have a relatively modest role in fighting inflation and in the creation of a sound currency.

The Role of the West

Up to now foreign loans have been used as a life preserver for the floundering economies of Russia, Ukraine, Kazakstan, and the other states that have emerged on the ruins of the former Soviet Union. The transition to a market economy will undoubtedly be made easier by debt rescheduling and the provision of new credits. But today nobody harbors any illusions that the inflow of money from outside, even uncompensated aid, can be the main factor in financial stabilization and in the market transformation of Russia. The West does not command such resources and does not want to take the risk in view of the instability in Russia.

It is difficult to foresee the granting of large credits to Russia during the coming years for the purpose of balancing its current international accounts. The inflow of credit will be directed to projects in very specific areas with the greatest potential for stabilizing the Russian economy and repaying debts.

The next few years will bring major outlays for servicing outstanding debt. At an artificially low market rate of exchange for the ruble, the purchases of hard currency for these purposes by the state from Russian exporters will lay a heavy burden on the budget. As regards the obligatory sale of 40–50 percent of export revenue to the state at its artificially low exchange rate, this source of hard currency revenues is becoming ever less reliable. It is undermined by the emerging market, which encourages exporters to conceal their hard currency incomes.

Despite all these caveats, the West can play an important role in Russia's transition to a market economy and in the stabilization of its monetary system. Of course, this assumes the mutual political will for large-scale economic cooperation. Especially necessary is a resolute orientation on Russia's part toward attracting Western expertise and investments and a rapid creation of the appropriate legal and economic conditions and guarantees.

I would argue that the West should offer major loan assistance in the interests of accelerating military conversion, eliminating a part of our nuclear arms, carrying out a monetary reform, and establishing convertibility of a new currency. Without the formation of an adequate hard currency reserve (spent gold reserves should be restored as soon as possible), the success of the monetary reform cannot be guaranteed.

The rebirth of the Russian economy should be based to a great extent on foreign investments. The USSR artificially isolated itself from the process of transnationalization of production. Multinational companies had no presence on its territory, and the largest Soviet industrial enterprises had no investments abroad. Now Russia must actively integrate into the world economy, open its doors and create all the necessary internal preconditions for the activity of transnational corporations of the leading countries of the West. This presupposes the outright sale of some enterprises to them, or the sale of shares, in some cases even a controlling interest. Concessions to foreign companies in the exploitation of natural resources, transport facilities, and communication lines should also be encouraged. Broad attraction of foreign investment demands guarantees on possible repatriation of capital investment and a reform of mortgage law to allow the use of land plots and real estate as collateral for credit.

It seems to me that the West should tie its assistance in stabilization of the Russian monetary system and in establishing ruble convertibility to the formation of all other favorable preconditions for foreign investment.

Other Prerequisites for Monetary Stability

Among the important prerequisites for healing the Russian monetary system we should mention reform of the credit system, its expansion and technical modernization, as well as bringing rather neglected systems of bookkeeping, accounting, and auditing into order. The activity of the central bank and state and commercial banks should be subject to legislative regulation that would forbid offering loans in the absence of reliable means of repayment, various forms of currency and securities speculation, and exceeding permissible limits of liquidity. Monetary emission should also be subject to the rules of banking and not the instructions of the government.

Finally, any credible monetary reform must restore confidence in the state that prints the money and guarantees its solvency. Currently this confidence is undermined by the actions of the government, which has consciously devaluated almost fully the savings of the population and pushed inflation. In order to halt the flight from money and make its accumulation and deposit attractive, it is necessary to not only halt inflation, but to strengthen the authority of the state as a representative and protector of the public interest.

Russia's Informal Revolution

Paul Craig Roberts

Oleg Bogomolov reports, correctly I think, that the key to a sound monetary system and transition to a market economy is the privatization of the wealth that is in possession of the state. He also reports, again correctly, that prior to price liberalization, property should have been privatized, monopolistic structures demolished, foreign trade liberalized, the budget deficit reduced, and the money supply controlled.

He then reports, again correctly, that there was no time to do these things, no effective executive authority to carry them out, that ñumerous prices became free de facto in advance of official reform policies, and that privatization is also following a de facto course in which state property is simply seized by authorities and lower-level economic bodies. The kind of privatization that Bogomolov recommends, and that I also favor—consisting of large-scale gifts to the people of apartments, land, and shares in enterprises converted to joint stock companies, as partial compensation for the enormous material losses of the population—is blocked by the restraint of the Russian government at all levels, because those in control of government understand that the sale or distribution of state property among the population diminishes their power.

The Case for Optimism

Faced with the facts reported by Bogomolov, we can become pessimistic or optimistic. Let me make the case for optimism. The transition to capitalism in Russia is too big a problem for politics. Informal social processes will lead the transformation, and official state-led reforms will lag. Considering the weakness of the government, there is a good chance that its role will be to follow along

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afterward, giving its sanction to most of the transformation and overturning only those parts that are most strikingly unfair. This means a lot of turmoil and many false crises along with some real ones while things sort themselves out.

Another reason for optimism is that Russian economics, as practiced by Bogomolov, is a great improvement over the old Soviet economics. Bogomolov's analysis embodies the role of expectations in inflation and hyperinflation. Unlike some of the Western advisers to the Soviet and Russian governments, he understands that so-called stabilization measures directed at the "ruble overhang" merely restricted the effective demand of the population and wiped out its savings, thus undermining the motivation for productive and conscientious work and financing for entrepreneurs. He understands, better than the bureaucrats in the IMF, the Congressional Joint Committee on Taxation, or the U.S. Treasury, that the tax measures designed to address the Russian budget deficit are a package of disincentives that will suppress the entrepreneurial and labor activities that the economy most desperately needs. He arrives at the supply-side prescription that the most optimal policy for the growth of tax revenues is the expansion of production. Unlike Western development economists, he understands the critical role of foreign investment. Unlike so many of our own professors, he understands that it is necessary to strengthen the authority of the state as a representative and defender of the interests of the population, by which he says he means the provision of sound money and guarantee of economic freedom.

Eliminating the Source of the Inflation

Where then can we criticize this free-thinking Russian? I found two places. He urges a commodity-backed ruble to anchor the monetary system. I do not object to a commodity-backed currency. Rather, the problem with the ruble is that too many are being printed in order to finance state deficits. As long as there are state deficits that must be financed with money creation, a new currency would be subject to the same inflation—commodity-backed or not. The design of a new currency is a big challenge that would divert effort, perhaps without effect. It would be better to privatize and, thereby, eliminate the state deficits that are the source of the inflation.

Bogomolov recommends that the West back a new Russian currency, and he suggests that the West tie its assistance in stabilizing the Russian monetary system and ruble convertibility to an opening of Russia to foreign investors. Again, a currency cannot be stabilized if it has to be printed in great quantities. Moreover, tying foreign aid to foreign investment could be politically risky for a weak government with a nationalistic opposition, who could then accuse the government of selling out the country to foreigners.

In fairness to Bogomolov, he came up with these proposals because he sees inaction in large-scale de jure privatization and settled on strengthening the ruble as the only feasible plan. There is no doubt that Russia and the other republics face enormous challenges. But we should remember that these peoples or their ancestors survived Lenin, Stalin, forced collectivization, state-inflicted famine on more than one occasion, World War II, paranoid leadership, and 75 years of the worst economy the world has ever seen. With all this under their belts, I think they can survive the transition to private property and a market system. However threatening a free-price system might seem to some, it is nothing compared to the gulag.

Informal Processes of Transition

We should keep in mind that there is a great difference between the official reform model and the informal processes of transition. The Russian government may, or may not, be following the Polish model, but the informal privatizations, evolution of de facto private property rights, day-to-day transaction prices, and so forth are moving on their own paths. In a sense Russia is a wide-open frontier society. People who have the confidence to act are acquiring rights by exercising them. Bogomolov reports that the central government lacks power and that its policies are wrong, and he sees this as a problem. But it might be an advantage. If the policies are wrong, it is just as well that the government lacks the power to implement them.

We have heard a variety of complaints, which paint a hopeless picture but look less disturbing when put in context. For example, the Russian budget deficit is said to be 14 percent of GNP, which puts it in the same league as the Italian one, and Italy remains a pleasant and entertaining place to live. Russian monetary policy is said to be impaired because the ruble is supplied to most of the former Soviet republics. However, the dollar is supplied to the whole world, and the United States enjoys corresponding reserve currency privileges. Official statistics show collapsing Russian GNP, but these data do not measure the unofficial economy or the more efficient use of resources as they are shifted from meeting gross output targets to real needs. The monetary situation is deplorable, but South American countries have lived with higher rates of inflation for longer periods of time, and even demoralized POWs fashioned a monetary instrument out of cigarettes to facilitate trade. Russia will do no less.

Even in its heyday, the Soviet economy never worked. People learned long ago from necessity how to get around it, and a large percentage of the resources has always been allocated unofficially. This unofficial economy is the basis for the new economy, and it is misleading to see the decline in official production as collapse if unofficial production is growing.

Avoiding a New Bureaucratic Class

In our efforts to aid Russia and the other republics, we should be careful not to empower a new bureaucratic class that would create incentives that would divert entrepreneurs away from profit-seeking into rent-seeking activity. The history of our foreign aid to the Third World is largely one of subsidizing the rent-seeking behavior patterns of the mercantilistic economy. It would be better not to help the Russians at all than to underwrite a rent-seeking system.