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The Nature of the Depression in the Former Soviet Union

Several years ago, the Soviet economy reached a point where (1) the command economy system had been fatally damaged while (2) the minimal institutions required for a private sector market economy to function had not been put in place and (3) the state had made almost no progress towards creating for itself the public finance system of a mixed economy. Many things have changed in the interim but these three broad statements remain basically descriptive of the state of affairs. From a macroeconomic standpoint, this had all the marks of an unsustainable situation—and, of course, it has not been sustained. Russian industrial production has declined by more than 30 per cent at the same time as the economy is now entering hyperinflation.

To belabour the obvious: the depression in the Former Soviet Union fits neither Keynesian nor Monetarist theory and certainly not Real Business cycle theory. The ruble inflation also has features that make it *sui generis*. Western macroeconomics, whether traditional or modern, does not provide a ready-made guide to how the present FSU dilemmas should be dealt with. It appears that every economist and newspaper columnist around feels able to offer the Russians advice purported to be more valuable than the price charged for it. The truth is that we need to understand the situation better. While I have had some first-hand exposure to the problems,[1] the views expressed in what follows are not those of an expert.

I will sketch three themes: the first concerns the structure of industry, the second money and finance, and the third some of the legal and political aspects.

The Gosplan Inheritance

The manufacturing sector built up under central planning is characterized by a high degree of vertical industry integration and reliance

[1] Cf. 'Problems of the Socialist Transformation: Kazakhstan 1991', in Lazlo Somogyi, ed., *The Political Economy of the Transition Process in Eastern Europe*, London: Edward Elgar (forthcoming).

on very large plants. Individually, these plants tend to be technologically inflexible and so is the entire system consisting of such plants. The planners had exaggerated notions of the economies of plant scale and little understanding of the systemic economies of scale external to the plant. Their 'gigantomania' left a very vulnerable legacy: many large plants depend on a single, or at least dominant, supplier for some of their raw materials or intermediate inputs and, similarly, have one dominant customer. If one such gigantic plant ceases to operate, others are left without supplies or without customers. Failure in one part of the system, therefore, can cascade through a large part of it. Such failures are now occurring on a large scale and, in my judgement, constitute the most intractable part of the current crisis in the FSU economy and the aspect of it, moreover, that is not at all amenable to traditional macroeconomic prescriptions.

A large proportion of the final goods output of this industrial structure has been what we call 'defence production' when referring to the United States or 'armaments' when talking about other countries. Military production on anything like the old scale will no longer be sustained but conversion to civilian production is far more difficult in the FSU than in the US. In the United States, land, labour and capital trickle away from military into civilian uses via thousands of market channels. These markets have yet to develop in the FSU. Besides, the mania for gigantic plants combined with a mania for secrecy created a number of towns totally dependent on military production and utterly lacking alternative employment opportunities. The Russians, therefore, are more or less forced to convert existing plants to entirely different uses. Western defence firms have not been successful at this kind of conversion, although they have no difficulty changing the mix of inputs that they buy. The Gosplan input-output table is far more inflexible, making the difficulties of switching a particular plant from tanks to refrigerators all but insurmountable.

The Gosplan system was not only larger than Russia, it lapped over the borders of the Soviet Union into the 'satellite' Eastern European nations. The plan prices underlying the terms of trade between political units bore little relation to potential market prices. Trade was based not on mutually recognized gain but on Moscow's political hegemony. The loss of it, therefore, has a lot to do with the breakdown of the system. The collapse of CMEA trade already showed how vulnerable the system was. From early 1991 onwards, new tensions among the republics of the Soviet Union began to disrupt trade between them also. The threat to withhold deliveries became part of the political game between republics even before the break-up of the USSR and the creation of the CIS. The Gosplan legacy of vertically integrated industries of gigantic plants made such threats highly effective: cessation of deliveries from one republic could seriously disrupt production in others. When Yeltsin and Kravchuk torpedoed the Union, the result was a 'commonwealth' within which the relationship between republics came to be negotiated very largely through threat games of this sort.

The Gosplan legacy would have made rapid progress on market reform exceedingly difficult in any case. The basic problem is not political although it is greatly exacerbated by political disintegration. Consider the classroom example many of us use to explain the vertical-integration theory of the firm: If production is organized as an assembly line, why is not every workstation on that line a separate firm, buying its intermediate good input from the preceding station and selling to the succeeding one? Because (we tell our students) such firms would be without alternative suppliers for their inputs and without alternative customers for their outputs, and this creates a game with an empty core. The analogy likening the Gosplan system to a set of such assembly lines is easily overdrawn, of course. But one is more nearly right thinking of the Soviet manufacturing sector in terms of this caricature than in terms of the usual Cobb-Douglas one. Try it out:

(1) If one workstation on an assembly line breaks down or fails to receive required intermediate inputs, the whole line comes to a halt. *Check*. (2) The workstations on an assembly line cannot be made into individual firms, each one selling its output to the next, because no determinate set of equilibrium prices can be found for such a chain of bilateral monopolies. *Check*. (3) The physical assets that together make up the assembly line have little market value separately. The whole is worth more than the sum of the parts. *Check*.

Privatization is no panacea when dealing with a productive structure of this kind and liberalizing prices will not automatically replace the arbitrary plan prices with market prices truly reflecting relative resource scarcities. The price explosion following the elimination of price controls was no doubt in large measure due to the government's inexplicable failure first to convert the pre-existing monetary overhang into illiquid securities. But it also demonstrated the monopoly powers of the *kombinate*, giving a first taste of the problems that privatization of these enterprises might bring.

It is obviously true that the inherited, utterly arbitrary system of prices offers hardly a clue to which enterprises are socially efficient or inefficient. It is a widespread opinion that rationalization of the FSU economies can only be achieved by (a) privatizing all enterprises and (b) letting the market weed out the inefficient ones. It is also argued that it is best to achieve this as rapidly as at all possible, before pressure groups can form to block the 'weeding-out' process. But the 'sink-or-swim' test of which enterprises deserve to survive can very easily go horribly wrong. It will go wrong not only because some plants will fail that would survive if prices were competitive, but because forcing individual loss-makers into bankruptcy may force a cascade of failures up and down the vertical chain of plants. The gain from eliminating the losses recorded at one plant can easily be completely swamped by the social loss resulting from a vertical cascade of failures.

Privatizing Gosplan, Inc. is a rather more complicated task than breaking up AT&T or deregulating the airlines. When dispensing advice to the former socialist countries, we should be quite careful not to oversimplify. More is involved than deciding how ownership is to be distributed and by which means ownership control may be exercised.

Money and Credit

Inflation over the last twelve months has been at least 1,200 per cent. Some Russian economists would put it at 2,000 per cent. Yet Prime Minister Gaidar fell prey to an opposition in a fury over his policy of 'monetary restraint' and supposed subservience to the dictates of the IMF. The Civic Union people, who are gaining increasing influence in the government, seem to have little idea about how to handle the present situation—except to print money faster. So the ruble zone is headed for hyperinflation.

High inflation has overtaken the Russian public finances before a modern tax system and administration could be put in place. We must suppose that real tax revenues are now significantly diminished by the Olivera-Tanzi lag effect. To govern without the printing press has become nearly impossible; the near-impossibility of governing by means of the printing press remains to be demonstrated. Already, the 'mafias' find it easier than the government to pay the police a living wage. Most of the Soviet leaders have been terribly slow to grasp the dangers of inflation. Accustomed to the command economy, they are trying to get used to a system where the government has to direct resources not by command but by spending money. Day by day, the power to control events is slipping through their fingers, but many of them still fail to see that the power to govern will be gone when the money they are printing becomes worthless.

High inflation has destroyed the financial systems of countries with long and unbroken experience with the market system. Russia cannot hope to create functioning intermediaries and securities markets under conditions of high inflation. The conditions are far off, therefore, under which capital formation in significant volume can resume. The efficiency with which existing resources are utilized (never very high) will also suffer. Standard accounting practices are little known in Russia and inflation-accounting is, I believe, totally unknown. Under high inflation, many Russian enterprises will have little or no idea of whether they are running at profit or loss.

Of course, they may not care. State enterprises have never operated under *hard budget constraints* in the communist past and have proved quite effectively resistant to such constraints in the non-communist present. With the help of the ministries that once controlled them, many of the vertically integrated industries try to keep going with the same plant-to-plant delivery patterns as before—transacting at arbitrary prices, but without settling accounts out of their own revenues. Instead, they turn to the government for subsidies to keep production going and unemployment from skyrocketing. If subsidies are denied, 'enterprise arrears' are allowed to pile up so that some money creation is postponed. If they are granted, the money presses roll at once. The subsidies that keep the manufacturing sector from total collapse have become the central crux of the inflation problem.

Why does the government not impose hard budget constraints on these enterprises? The answer, I believe, comes in three parts. First, Soviet enterprises never had to maintain a sound financial working capital position to operate. The present FSU enterprises are largely without financial working capital. Were the stream of subsidies (and/or permitted arrears) to suddenly dry up, many firms would simply lack the wherewithal to continue production. Secondly, the financial institutions or securities markets that might be able to provide the required working capital on business-like terms do not exist. Third, the government cannot credibly threaten large *kombinate* with bankruptcy, particularly not if it concerns the dominant enterprise in a particular location or if the failure would 'cascade'.

The Old Economy and the New

The discussion of the socialist transformation problem in the West seems to be stuck on the theme that one is to '*create the New economy by privatizing the Old*'. Two things tend to go wrong when the discussion proceeds from this simplistic slogan. First, it is only too easy to become cavalier about the preservation of the productive capital—both human and physical—inherited from the communist system. Not all destruction is 'creative'. Second, the insistent focus on privatization easily diverts attention from what needs to be done to put the minimal prerequisites for a functioning market order in place.

Instead of starting directly with the intricate and difficult problems of how to privatize so as to create corporations with a workable governance structure, I think it is useful to begin by considering two sets of questions: one concerns what to do with the various elements of the Old Economy, what can and cannot be salvaged, and how that may be done. The other concerns how to make the New Economy grow. Privatization of state assets will be *part*—but only part—of the answer to both questions.

Salvaging the Old. It is only too easy for Western visitors to declare all Soviet plant and equipment hopelessly outmoded and uncompetitive. But it is the only industrial capital they have, and most of the former Soviet republics cannot look forward to capital inflow from abroad on the scale that East Germany or even Poland or Hungary are receiving. A 'big bang' privatization of the various enterprises in a vertically integrated Gosplan industry risks causing a cascade of failures. The unemployment and capital destruction that would ensue would be of a kind, moreover, that cannot be remedied through macroeconomic stimulus.

I am not of the 'privatize everything as fast as possible' school, therefore. I do believe that enterprises that produce final consumer goods should be privatized as soon as possible. But Most of FSU heavy industry should, I think, first be converted to state-owned corporations with their privatization postponed, in some cases indefinitely. It will be difficult enough, without privatization, to keep these industries going in all those instances where the vertical chain of enterprises crosses the new inter-republican borders.

The prerequisites of the New. The proper functioning of a market economy depends on well-defined property rights, on a comprehensive commercial code and on the impartial and dependable enforcement of these laws. Well, the FSU republics are passing economic legislation at a tremendous rate, but the bodies of law that result are full of lacunae, ambiguities and contradictions. The new laws assert all sorts of rights to private property. But for these private rights to be meaningful and dependable the agents of the state must also relinquish sundry powers to intervene, to prohibit, or to control. It is far from clear that they are doing so. The omissions and ambiguities of the new laws and the lack of an independent judicial power give officialdom plenty of room where it can continue to thrive. Private economic rights have seen little dependable enforcement since *perestroika* and law enforcement is now deteriorating in a very serious fashion. In the big cities, private rights cannot be dependably defended against the 'mafias'.

The term 'privatization' carries the misleading suggestion that the assets removed from state control are put into the legal and institutional context of a free market economy. But 'destatized' wealth is more likely to end up in some sort of insecure legal limbo. The framework within which a private enterprise economy can grow is still largely missing.

The Chinese have hardly allowed market reform to touch the 'Old' state enterprises that are their Gosplan legacy. They have kept them producing, however inefficiently. Meanwhile, they have concentrated on providing the conditions under which their 'New' market sectors are able to grow at extremely impressive rates. Soviet conditions were not right for emulating the initial Chinese successes in agriculture. But they might emulate the Chinese in not tearing the 'Old' economy apart before the 'New' has got under way.

A Political Reflection

Finally, I have come to doubt the common wisdom also on a political issue. Let me emphasize that I am expressing doubts, not claiming to know a different truth.

The 'industrial managers' of Russia are routinely portrayed in the Western press as the enemies of economic reform. On economic matters, they have been the most effective opponents of Gaidar as they were of Gorbachev. Economists writing on the transformation problem routinely assume, it seems to me, that the industrial managers criticize policies of privatization and monetary restraint purely out of personal self-interest: that because a free market would threaten their present powers, they will not support economic reform.

This view of the managers as party hacks that would not be able to compete in a free market (and know it) is no doubt true of a fair number of them. But making it into a cliché makes us forget that it is also in this group—and for present purposes virtually nowhere else, I would say—that we find 'the best and the brightest' in the FSU. Brezhnev-era corruption was so widespread that it has made us all but forget the meritocratic aspects of Soviet society. But it is worth recalling that men like Yeltsin, Gorbachev, and Nazerbaev rose to the top from very poor backgrounds and did so by merit. They proved their merit, moreover, in economic management. Some of the present managers are simply first-rate people—and many of them clearly want the transformation to a market economy to succeed.

When they express opposition to the policies by which the transformation is being attempted, therefore, we should not be too quick to dismiss their criticisms. They do understand the system in which they have been operating. Consequently, it may well be that they sometimes understand the immediate economic consequences of certain policies better than we newcomers do. A Russian manager with an engineering degree and some schooling in Marxist economics, let us say, will not express himself in the terms we use. But he may still understand perfectly well that pell-mell privatization may wreak havoc with vertically integrated industries and that the sudden imposition of 'hard budget constraints' will simply shut down enterprises which have no working capital and cannot raise it in any credit market.

On this political matter, the coming months will test our differing perceptions of the Russian managers. The increasing influence of Volsky's Civic Union in the government has been seen by an almost unanimous Western press as presaging defeat for the entire reform effort. I am very much afraid that it spells the end, for now, of any serious effort to contain inflationary pressures—and hyperinflation is likely to prove disastrous. But I do not expect to see a general retreat from pro-market reforms.