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The Russian Transition: the Long Road Out of Hell

1. Introduction

About ten years ago, the word «transition» got a new meaning. Initiated in April 1985, the Gorbachev's perestroika opened the communist regime to the world, gave to the East European countries independence of the Soviet communism, and the nations got a chance to move toward the new world order. It happened a decade later that the former communist countries got various experiences and ended the century up in completely different states. While Poland, Hungary, Czech Republic, Slovenia, Slovakia and the Baltic countries have already reached growth and social stability, Russia, Ukraine, other East European and the former Soviet republics fell in the political mess and deep recession, yet Uzbekistan, Turkmenistan, and Kyrgyzstan among the other Asian former-Soviet republics give a pretty nice example of poor but relatively stable crony economies.

Which social and historical circumstances underline these different patterns of transition? To what extend the initial conditions determine the evolution of the post-communist countries? Have ones reached the sustainable efficient growth and what can happen to others who enjoy only the wasteful growth or fell in the complete demise?

Russia, the former hegemon setting the rules, possessing fantastic deposits of natural resources and demonstrating an overwhelming growth of economic and military power, came to the shit, while almost every Polak can say a good word about the democracy and the liberal economy that made him better off in comparison to how he or she was doing in the communist era.

Now we are starting a series of articles which, as we believe, could help to understand these issues. Like in Poland, the economic reforms in Russia have been designed as a liberal program toward effective monetary control, restructuring, and institutional innovations, moreover, the Boris Yeltsin's team have been studying the shock therapy successfully implemented by the government of Leszek Balcerowicz in a close cooperation with IMF. Nevertheless, the Russians failed from the very beginning. Now we can say that, unlike in Russia, the liberal economic program in Poland becomes successful because the most of the Polish people have saved the Weber's spirit of capitalism, because the worsening situation in Russia made the Polish people worry about the newly emerging threat and easier accept the Western influence, because the government has created a coalition of support and effectively suspended any pro-communist extremism, The story about success or failure of reforms is mostly about the politics and the social tensions. However, having said this, we have to go back to the economics of the society we are talking about.

Our central message is that the Russian turmoil of 1990th has intrinsically been predetermined by the social and economic performance over the Soviet period: the 70-years long wasteful growth came to its anticipated dead end by mid-1980-s. The Gorbachev's perestroika within the well-organized social institutions and the communist power monopoly has just accelerated the meltdown and by 1991 brought the economy to the rubbles. Furthermore, the Soviet heritage added by the institutional adjustment and redistribution of economic power during the years of perestroika became strongly responsible for the failure of the liberal economic reforms attempted by the Yegor Gaidar's government in 1992 and by the Sergei Kirienko's government in 1998 under the Boris Yeltsin's presidency.

2. The Soviet meltdown

2.1. The Gorbachev's economic proposal

Over the decades of the communist rule, the socialist economies experienced growth largely due to a relatively low individual consumption and literally destroying use of the natural resources, for instance, by keeping low prices for energy and other inputs disregarding long-term investments. From mid-1970s the lack of investments, especially in the oil and natural gas industry, became obvious, in late 1980s the net capital accumulation became negative and the growth ceased. Outdated technologies because of isolation from the world economy, inefficiency of resource allocation such as an excessive share of intermediate production, extensive military and protected sector, the rent-seeking motivation of the individual behavior and economic activity were amongst the factors contributed to the economic decline of the Soviet Union of 1970-s – 80-s.

In early 1985, Michail Gorbachev and some other Communist Party leaders realizing stagnation, managed to get the power and claimed for reforms in order to improve economic and social performance. Gorbachev passionately vowed for perestroika - political democratization and economic liberalization limited to reforms allowing more individual initiative and responsibility. Following the communist-style political economy, the government offered the so-called "Acceleration plan" which was created by the leading Soviet experts like Leonid Abalkin in accordance with the postulates of the communist political economy and managed by Nikolay Ryzhkov and Yury Masliukov.

From the very beginning, the Soviet leaders as well as the majority of public believed in uniqueness of their home country: Western economics cannot help Russia because the economic and social organization of the society is completely different to a typical Western society, yet many Russians followed the communist political economy insisting on the point that the rich developed countries enjoy the growth due to extermination of the natural and human resources of the third world and now, as the latest is completely exhausted, the Americans and NATO are looking forward to extract the resources from the poor Soviet block. So, the reasonable question arisen at this point is: if the Soviet Union was falling more and more down, does it mean that its economy was really different to the rest of the world or just it was something wrong with the economic policy? And why seemingly adequate microeconomic and political measures have led the country to a deep macroeconomic crisis?

In both the Polish and Russian societies was growing anti-communist tension, however, only a little number of people in Russia and, perhaps, in Poland were ready to accept the norms and other institutions of the liberal economy. Neverhteless, while Poland was moving toward decommunization and efficient market, the Russian leaders defined reforms as "more socialism" implying the strengthening of the social position of the Communist party by improving economic performance. The motivation and the general setup of the reforms in Russia and Poland were absolutely different from the beginning. So, it is not a big surprise that the Soviet-style partial economic liberalization actually made the things even worse and soon pushed the country to a deep macroeconomic crisis.

2.2. The dead end of the Soviet Union: micro steps toward a macro crisis

The plan proposed to achieve higher output and final consumption by stimulating productivity in the intermediate production and machinery. But instead, with the additional investments, those industries swelled more up and in fact their productivity fell further down as the enterprises had neither investment strategies nor economic incentives for productive growth, so the new funds had simply been sank. As a result, the share of individual consumption started decreasing even more.

Since all these investments was provided in expense of borrowing in the international markets and extending net credits (that is simply by printing money), the mismanagement in the industrial policy directly contributed to the macroeconomic disbalance.

Realizing inefficiency and high costs of the central planning, the government laid a part of responsibility for financial management and marketing directly on the producers, the enterprises were pushed to run arenda, that is the long-term leasing of the capital and productive assets (though without any right for further privatization). Economical (instead of administrative) methods of management, and profit-seeking strategy under a strict budget constraint (that is without any opportunity to get free money from the government) became the newly developing area of both practical and theoretical research. In 1989, referring to the new economic policy implemented by Lenin in 1922, the government also legitimized private economic activity: it allowed private (cooperative) use of capital goods and private labor contracts.
However, in practice the government lost control over the profit which was the main source of the budget income, yet it failed to collect enough tax revenue. For instance, in 1989, the state sector showed the total profit 9% higher than in the previous year while the consolidated budget revenue was 3.5% less compared to the previous year, that was even below the figures for 1985.

The logic of economics would suggest adjusting public finance, implementing the relevant institutional reforms and starting privatization favoring economically efficient resources allocation, but instead, the Soviet authorities were carrying out optimistic income policy and continuing funding the industries. In result, the de-jure national resources soon had been reallocated to the de-facto private ownership of the near-communist party officials, directors of the state companies and some lucky entrepreneurs, who got either friends in the power or a gun in the pocket.

The shrinking balance of payment caused by deterioration of the terms of trade in the oil market made another contribution to the developing macroeconomic crisis: the current account fell from its highest +6.7 billion dollars in 1987 to -10.7 billion dollars in 1990, doubling the foreign debt up to 54 billion dollars in 1989. Didn't the Soviet Union survive for a decade more due to the thanks-to-OPEC consequences of the oil crisis of 1970-s?

Enormous budget deficit, steadily rising from 16% of GDP in 1989 to 31% in 1991 (IMF methodology), was covered by rather-illegal sellouts of the national gold reserves, the external borrowing and printing money: in 1991 money growth was 4 - 6 times higher than in 1986 - 89. Since 1990, the economy experienced a permanent commodities shortage in the state sector, where the prices were mostly fixed, and a growth of prices in the commercial sector and the black market that by 1991 reached 10 - 20% monthly. The Russians got much more than the Polish people experience with consumer vouchers (talons). Currency substitution with barter, dollar, and vodka became the way the individuals tried to avoid the inflation tax burden. By the end of 1991, the Soviet economy had nearly reached hyperinflation and full stagnation: the exchange rate dropped down 4 times over about three months, the industry was about a collapse because import of some essential intermediate goods had practically stopped, none made any deal with the domestic currency if it was not a full advance payment in cash, the shops were getting completely clear... The anti-economics Gorbachev's concept of "the market socialism with a human face" remained the mist.

In August 1991, the top Communist Party bosses who were aware of the failure of the perestroika and, at the same time, couldn't adopt any democratic perspectives, attempted to dismiss Gorbachev but failed in four days due to the strong and effective actions of the Russian President Boris Yeltsin and his supporters. The defeat of the putsch put the end to the Soviet Union. Boris Yeltsin moved to the Kremlin as now the sole legal leader of Russia and began with formation of his new government.

3. The mix

The new government had to manage the emergency situation preventing the economic crash and hyperinflation, yet it should launch the market by implementing complex institutional reforms, privatization, restructuring industries, developing banking and financial sector, adjusting social policy. The total stagnation and hyperinflation threat pushed the government to begin with the full price and exchange liberalization that put monetary policy onto the central place of the reform.

From the beginning, believing in the Western democracy, Yeltsin choose the liberal economists from the team leading by Yegor Gaidar and Anatoly Chubais, who claimed for the active restructuring, opening markets, and decommunization. The hot debates coming through TV and newspapers concerning the electoral system, bribes, developing loan markets, and the national anthem lyrics were all about the same: which of the various interest groups and newly emerging political factions could get the power and, therefore, the opportunity to survive in the new economy. And the point is that the liberal reform aiming the radical restructuring of the economy toward the efficient competitive market would go against all the strongest interest groups such as the oil and natural gas exporters, military and agricultural producers, who used to be called the basis of the Soviet economy.