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in Russia

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## "Monetarism" and Monetary Policy in Russia

### Abstract

The so-called "shock therapy" of 1992 in Russia has been, perhaps, more therapy than shock. Despite many drawbacks, the therapy has been successful in certain ways. The new financial system has been established, there have been signs of a real unification of cash and non-cash money in the Russian economy, new principles of taxation have been put into operation in less than two years. These achievements are largely the result of macroeconomic and financial policies, but not of monetary policy. There have been numerous government interventions during the period of reform, and these have been subject to some controversy. So, in this sense, "monetarist" methods have not yet been implemented in Russia. In fact, the powerful monetary policy control mechanism was not fully used in Russia in 1992–1993. It was used mainly to overcome the drawbacks of the Government's policy, but it was not used as a primary tool. Perhaps true monetarist policy should be the next stage of the Russian reform process. Only then would there be a real shock. But this shock itself will not cure the economy. It can be only the initial step in long-run "occupational therapy" in Russia: the only remedy for the national economy.

# 1 "Shock therapy" and monetarism in Russia

"Shock therapy" and "monetarism" are the key words in many public discussions on Russian reforms of 1992. The liberalization policy implemented by the Russian Government in early 1992 was identified with "shock therapy". Economists opposing the government used monetarism as a "swear-word" and argued that there was no therapy only shock. Too little time has passed to say yet whether this therapy has definitely failed: therapy usually means treatment of long duration. This paper argues that in Russia there was in reality an attempt primarily at therapy rather than shock. Moreover, it appears that true monetarist policy has not been implemented in Russia; attempts by Russian reformers to manage the economy using monetarist methods were too harsh and were immediately neutralized.

Nevertheless, one of the greatest merits of the Russian reformers was that they had really started creating a new economy while their predecessors were mainly discussing the ways of reforms. Perhaps this real step to liberalize the economy covers all of the mistakes made by the reformers. Some of the drawbacks in the macroeconomic policy of the Russian Government of 1992 have been examined in [1]. But it is in reality impossible to judge the reformers and their opponents because two years is too short a time to achieve success: it took almost seven years (starting in 1985) just to dissolve the former communist system. But to establish a new economy and new relations among economic agents is a much more difficult problem. Moreover, due to political instability in the country, it was not even possible for the reformers to use all of the traditional levers of control for managing the economic situation in Russia. As there existed strong tensions between the Government and the Parliament, the Government had launched the reforms without having in place much of the legislation that is needed to establish the market mechanism. With strong tensions between the Government and the Central Bank, it was rather difficult to coordinate fiscal and monetary policies.

The general disorder that prevailed in Russia after the dissolution of the former command system could not be handled without greater discipline. In brief, it can be said that one alternative was to turn back and recreate a Soviet-type administrative command system with all its well-known elements – strong internal security service, political control, etc. The other alternative was to establish a mechanism whereby everyone is responsible for his own welfare. In general, this means that individuals must be prepared to work much more intensively and to accept certain new "rules of the game". In this case, it would be necessary for society to understand that following these rules is the only way to overcome the crisis. It should also be made clear that the State is not the generous "father", who can take care of everyone, as envisioned in Soviet propaganda but, rather each individual should take most of the responsibility for his own welfare. Individuals (taxpayers) are superior to the State; they establish the State and hire the government officials, who should maintain a democratic environment. As it seemed at the time, society had chosen the second alternative.

As mentioned, the reforms were launched at a time when the corresponding new legislation ("rules of the game") had not yet been established: there was no unity among the decision makers. The situation in Russia was just the same as in a well-known fable when the swan, the crawfish and the pike decided to move a

cart. The directions of their efforts were very different. One of them chose the sky, another the water and the third felt land much more comfortable on land than in the sky or water. The result of their efforts is easy to imagine. In this sense, Russia could benefit more if the above-mentioned Russian political Swan, Crawfish and Pike (i.e. the Government, the Central Bank and the Parliament) would coordinate their activities.

In reality, when the Government insisted on tightening fiscal or monetary policy in order to force producers to be more responsible for themselves and for the results of their own activities, it was opposed by either Parliament or the Central Bank. If the Government, despite that opposition, tried to carry out their policy by, for example, cutting government spending, it was blocked by the parliamentary decree or offset by the easing of monetary policy. Chaos in the economic and political arenas – the absence of responsibility for the results of economic activities, the absence of bankruptcies, inter-enterprise arrears, which exacerbated inflation and revealed the distaste for structural change in the economy, the low level of officially registered unemployment – all confirm the viewpoint that the Russian economy has not yet experienced any real shock.

It is totally wrong to say that the monetarist approach to the reform of the Russian economy failed. The main monetarist idea, that the market is superior to the government and that the market works best if government refrains from meddling [2], was not realized in Russia, as there has been only an embryo of a real market, with frequent government interventions, such as permanent changes in the tax system, permanent support of enterprises operating at a loss, etc. So, there has not even been an attempt to implement monetarist methods in Russia.

If there have not been any shock, then what about therapy? It seems that it has been more successful than is argued by the opponents of reform. One of the main achievements here is that during these two years (1992–1993) a new financial system has been established. During the Soviet era, household money (paper money and coins) were separated from enterprise money (non-cash money). From the macroeconomic point of view, there were different turnovers of cash and non-cash money, which were not correlated with each other, just as there was no correlation between the results of the economic activities of enterprises and the personal incomes of the employees. At the same time, as the enterprises were considered state property, their finances were part of state finances. The banking system was also part of the Soviet centralized administrative system: by printing non-cash money it was easy to subsidize enterprises operating at a loss, which allowed the enterprises to continue inefficient production.

It is apparent that the reforms of 1992 only partly separated the finances of enterprises from the state budget. It became much more difficult to support bankrupt enterprises, but nonetheless still possible. A real correlation between the non-cash and cash rouble has also developed and this is a feasible way to achieve the unification of cash and non-cash money in Russia. A new tax system (based on the value-added tax) has also been established in Russia, linking the government and corporate sectors. This system, of course, has some drawbacks and perhaps it should be modified [1], but it is necessary to understand that it has been established in just two years. All this could be regarded as true therapy for the economy.

## 2 Did the Central Bank's monetary policy help with the reforms?

The above-mentioned changes in the monetary system resulted from changes in the fiscal system and were not the result of any definite monetary policy implemented by the Central Bank of Russia (CBR). But were there any real monetary changes in Russia during the reforms? It is noteworthy that in a period of a few years a new banking system was established: many commercial banks have been established, and the system is operating. This institutional development is perhaps the most outstanding achievement of Russian reforms in the banking and monetary sphere. Hirvensalo [3] examines this system, focusing banking in on St. Petersburg. This paper does not touch on the drawbacks and positive features of the institutional side of the banking system in Russia. We concentrate mainly on the macrolevel and on the correlation between monetary and other macroeconomic policy in Russia.

The general disorder in the economy provided fertile soil for criticism of the reformers. The reformatory team of the previous Russian Government also criticized its opponents. In particular, they claimed that the CBR's monetary policy did not allow them to achieve the objectives of their macroeconomic policy (briefly, those targets were: structural shifts in the face of moderate recession, limited unemployment and limited inflation). Let us have a brief look at the CBR's monetary policy of 1992–1993.

It is reasonable to differentiate between several stages of monetary policy in Russia in 1992–1993. The first stage (since January–May 1992) was characterized by rather strict monetary policy, with the money supply increasing 9–14 per cent monthly on average. So, after the first five months of 1992, the money supply had increased by a factor of 1.7 times. Of course, such a monetary policy could be regarded as strict only against the background of a dramatic rise in prices (including energy prices, which were controlled by the Government, not liberalized). In fact, consumer prices increased nearly 11-fold compared with December 1991 and wholesale prices increased nearly 12-fold during the same five months. The existence of inter-enterprise arrears was one of the reasons why the limitation of the money supply in the first half of 1992 could not stop inflation: the lack of real money was immediately compensated by the delay of payments, which allowed producers to repeatedly increase wholesale prices.

In principle, the government was responsible for the general level of prices and for the policy of exacerbating the inflation, as it increased the energy prices in January 1992 and again in May 1992, much more than 10-fold altogether. The above-mentioned contradiction between monetary and price policy has been pointed out in [1] as the main macroeconomic mistake of the Russian reformers. So it was quite natural that enterprises would try to protect itself from that mistake by reverting to the payment arrears mechanism. The arrears crisis was not only a result of this protective reaction. It was also a sign of the reluctance toward changes in the direction of increasing productive efficiency. It also meant the absence of any positive structural changes in the economy, as the government was not strong enough to allow bankruptcies, unemployment, etc. The only result of this controversial macroeconomic policy was the elimination of any correlation between commodities turnover and money turnover.

But the government continued to restrict the money supply, especially that of paper money. As a result, inflation (measured by consumer prices) was kept low - less than 10 per cent in July and August - but this was also the result of the delays in wage payments.

The next stage of monetary policy (June–November 1992) can be characterised as a compensating period, during which the Central Bank increased the money supply by 27–31 per cent per month. This is understandable because, in order to re-establish the correlation between money and commodities turnover, it was necessary to "legalize" the price level, which had been established by the producers during the first five months of reform. It was a period of money supply expansion, which corrected the situation in the economy. High inflation at the end of 1992 was a visible result of the correction.

It can be said that to some extent this monetary policy of adjustment helped to achieve certain targets of the Government's macroeconomic policy, such as low (officially registered) unemployment, alleviation of the recession (tighter monetary policy would have exacerbated the decline in production, the first signs of which had appeared after the advance payments mechanism was introduced in July 1992. At the same time, monetary policy did not allow for the start of structural adjustment in the economy. So, perhaps not only governments interventions, but even the macroeconomic policy objectives were contradictory from the very beginning.

The whole of 1993 (the third stage of monetary policy) can be characterized as a year of moderate monetary policy. As mentioned in [1], the statistics for 1993 show that the arrears in real terms did not increase in at all 1993. This means that the policy of moderate money supply expansion was not destabilizing in this respect. Moreover, it seems that this policy was quite correct, as the government was still not ready to allow bankruptcies and society was not ready to accept unemployment. In this sense, the moderate policy of adjustment pursued by the Central Bank was, perhaps, the most rational policy. It is also necessary to emphasize that interest rate of the Central Bank has been permanently increasing step by step (mainly under the pressure of the finance minister) moving towards its market value.

Moreover, in 1993 the economy started to perform quite adequately and its response to changes in the money supply have been quite natural. The well-known argument (see, for instance, [5]) is that inflation follows the money supply with a 3–4 months lag. but this was not the case in the first half of 1992. So, the economy has become more controlled, but not in the sense of direct administrative control. But, unfortunately, strong tensions between the Central Bank and the reformers in the Russian Government (as well as tensions within the Government itself) did not allow for the coordination of macroeconomic, fiscal and monetary policy in either 1992 or 1993. It is clear that such a system as complicated as a national economy can be successfully controlled only through a combination of policies. One alone cannot do the job.

To substantiate the above conclusions, it would seem useful to look at some other statistics. Table 1 provides macro data showing the correlation between money supply and GDP in the Russian economy. In 1991, as seen from this table, the money supply increased at the same pace as GDP (the slightly higher pace of money supply growth compared with nominal GDP can be explained by the deposit compensation given to households in April 1991 and frozen until 1992). But in 1992 the situation was quite different: the pace of nominal GDP growth was almost twice that of M2 growth. The situation was more or less the same in

1993 also. This phenomenon can be explained in part by the acceleration of money velocity. In 1992 the main reason for this was inter-enterprise arrears which compensated for the lack of money in circulation and which were cleared at the end of the year. In mid-1992 the overall arrears in the economy amounted to more than 3 trillion roubles, which exceeded M2 more than 1.5-fold.

Table 1. **Nominal Gross Domestic Product and Money Supply**  
(billion roubles)

	1990	1991	1992	1993
GDP	626.3	1300.1	18093.0	162500.0
in % from previous year		208	1392	898
M2 (at the end of the year)	431.6	928.4	7143.3	36718.0
in % from previous year		215	769	514
GDP/M2	1.45	1.41	2.53	4.43

Source: Goskomstat and Central Bank of the Russian Federation.

As can also be seen from table 1, the gap between nominal GDP growth and money supply expansion was too wide in 1993 as well as in 1992. If arrears, which compensated for the lack of money in circulation, did not increase in 1993 in real terms in, as was the case in 1992, there should be another factor explaining the acceleration of money velocity. It does not seem that in reality there was an acceleration of money velocity in Russia. The average time for payments transactions did not decrease in 1993. The conclusion as regards 1993 is that the widespread phenomenon of hard currency transactions among enterprises compensated for the lack of national currency (the official M2, provided by the Central Bank of Russia, does not include hard currency accounts).

Table 2 provides some interesting information. Only about 20 per cent of financial resources is allocated to industry and about 3 per cent is allocated to the agricultural sector. These sectors are the main recipients of state credits. This shows that money given to "producers" (the main slogan of the opponents of liberalization is to "support producers") sooner or later appear in the "other" sector, where it can be used much more efficiently for speculating on hard currency exchanges, for intermediary services etc. This well-functioning pump will continue to operate and the "necessity to support producers" will remain the same. But it will take more and more money to feed the entire economy.



Table 2.

**Accounts of Enterprises and Organizations  
by Sector of Origin (million roubles)**

	August 1, 1993		September 1, 1993	
Total	4 946 853.2	100 %	5 598 705.2	100 %
of which:				
Industry	1 017 356.3	20.6 %	1 056 809.4	18.9 %
Construction	172 293.0	3.5 %	193 700.2	3.5 %
Agriculture	148 612.7	3.0 %	173 671.0	3.1 %
Procurement	117 890.4	2.4 %	67 955.2	1.2 %
Transportation	642 689.7	13.0 %	696 072.1	12.4 %
Trade	96 996.5	2.0 %	115 747.7	2.1 %
Consumer services	82 613.7	1.7 %	89 354.0	1.6 %
Materials supply and Sales	46 966.4	0.9 %	43 823.7	0.8 %
Other	2 621 434.5	53.0 %	3 161 571.9	56.5 %

Source: Central Bank of Russia.

Table 2 also leads one to believe that it might be better for the reformers to concentrate on these kinds of macroeconomic problems rather accusing the Central Bank of exacerbating the inflation. It is certainly useful to have an understanding on the micro level of the institutional side of the roots of this outflow. Perhaps it would be better to increase the taxation norms for the "other" sector than to print more and more money. At junior school, pupils are usually asked to solve the problem of a pool with two pipes, one for inflow and the other for outflow. The volume in the pool and the flow velocities are given. The question is how long it takes to fill the pool. In the case of the Russian economy, where the volume of the monetary pool is not fixed, the answer is: forever.

Until the problem of the money outflow to permanently subsidized producers is solved, it will not be possible to speak of tight monetary policy, monetarist methods and "shocks" in the reform of the Russian economy. The coming shock should provide the background for long-run occupational therapy for the Russian economy. Economic welfare is the result of day-to-day hard work by the whole of society, including the president and the janitor. In order to prevent the rise of a dictatorship, the only real way to make individuals work more efficiently is further liberalization and a tightening of economic policy in the sense of monetarizing the economy. The State need only continue the liberalization of the economy, refuse to grant the various privileges and provide the necessary guarantees of protection to legal business.

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