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**THE CURRENT STATE AND FUTURE
OF ECONOMIC REFORM**

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ABSTRACT

In this paper I give an impressionistic account of the situation in Russia in September 1994 and its implications for Western aid priorities. Considering the starting point, the progress of the reform has been remarkable. In the paper I discuss it under the three traditional headings: privatisation, liberalisation and stabilisation, which are listed here in descending order of success. I then add a section on the social management of the transition.

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1. Privatisation and Restructuring

As is well known, the programme of privatisation of large and medium sized industry has gone extremely fast. With a few exceptions the voucher privatisation programme ended at the end of June 1994 and by then 70% of workers in industrial enterprises were in privatised firms. The next phase of privatisation will be sale for cash, and will cover the remaining shares in already privatised enterprises as well as most of the enterprises not so far privatised.

There is some dispute about how 'real' the privatisation has been. In most enterprises the managers and workers have ended up with at least 51% of the shares. However, this will not be the final pattern of ownership, and there are already signs of secondary selling of workers shares either to managers or to outside owners. The GKI claim that in most of the privatisations a significant outside owner emerged in the process of exchange of shares for vouchers. But there are little data about how far these single owners are simply a front for the managers or genuinely external.

The main problem facing privatised enterprises is how to restructure. This requires two skills which are lacking: the ability and factual knowledge necessary to appraise the future market prospects for products which the enterprise could produce, and the ability to undertake financial planning and control.

Every single enterprise in Russia needs technical assistance. How is this to be provided? It cannot be done mainly by direct foreign aid. It has to be done by Western companies who are commercially engaged in the future of Russian enterprises. But a major obstacle to this is the difficulty which Russian enterprises have in finding appropriate Western partners with whom to trade or with whom to undertake joint investments. There would therefore be a huge pay-off to money devoted to marriage-broking to enable Russian firms to find appropriate Western partners. This would

also be of great benefit to the European economy where Western firms often know that somewhere in Russia there is the right producer for them to buy from or to invest in, but have no idea of who that producer is.

I would therefore urge the EC to consider devoting some money to sending industrial experts on short visits of a week or so to thousands of companies to:

- (i) make a quick and dirty appraisal of which parts of each firm are worth trying to market to foreign traders or investors;
- (ii) help the firm produce a brochure;
- (iii) give the firm some telephone numbers of Western firms; and
- (iv) make some telephone calls on their behalf.

The second huge difficulty is the complete absence of financial expertise in Russian enterprises. This suggests the overwhelming importance of commercial education in the Russian transformation. The absolutely first step is a crash programme of translation and distribution of Western material with a minimal amount of necessary adaptation, so that there is something available in hundreds of thousands of copies for Russians to study about business planning and financial control. At the same time a major programme of teacher training is needed to train teachers who will help to train a quarter of the Russian labour force to undertake commercial operations in the modern market economy. (This is about the proportion of people in the West directly engaged in commerce.)

I have not mentioned the small privatisation programme where again approximately 70% of small enterprises in retail, public catering, hotel and repair services are now in private hands. The process whereby these enterprises are being modernized is in many cases fairly slow. Some Western assistance to small business development is clearly helpful, and much is already being provided.

2. Liberalisation

The first step in creating a market is to free prices and the action taken on January 2nd 1992 was surely one of the bravest acts ever taken by any government. It was almost wholly successful and queues have steadily diminished to quite normal proportions, except where some local price controls continue. Markets for intermediate products have also developed quite well, though state orders still prevail to a considerable extent in trade between the FSU states.

Despite the effective liberalisation of most prices other than housing and utilities, there is still a completely inordinate amount of regulation on a national and local level. Permission has to be sought to produce a particular good, a quota has to be obtained to export oil, and so on. All the time the amount of regulation is being reduced. We are promised that by

the 1st of January the remaining export quotas will have been abolished except for a few strategic goods. But this is an area where continuous pressure is necessary. From this point of view Russia is fortunate to have as a deputy minister of economy responsible for economic reform Sergei Vasiliev, and it is also expected that he will be secretary to Mr Chernomyrdin's new commission on economic reform. He is certainly the most radical of all the ministers. He almost single-handedly achieved the deregulation of coal prices last year, and he can be relied on to keep pushing for deregulation on all fronts. For this policy to be successful, however, it becomes necessary to have an effective system for maintaining the necessary regulation of natural monopolies, and this is an important area where western experience can help. The rest of anti-monopoly policy is a more difficult area and strong interests come into play. Probably the best form of anti-monopoly policy is free trade, where reciprocal arrangements with the EC are vital.

The Russian approach to international trade has of course involved a move from the control of exports to the control of imports. However, the import tariff has not yet become excessively high, and it is important that external pressure be maintained to keep it down. The foreign exchange market functions fairly effectively, and the exchange rate has been unified for some time. This is a major achievement.

3. Stabilisation

The main area in which progress has not been continuous is monetary control. This was quite good in early 1992 and inflation fell to 10% per month by August 1992. But there was then a surrender to the industrial lobby, and inflation was around 20-25% per month up to August 1993. However the ground for dis-inflation had already been laid earlier in 1993 by Boris Federov, and inflation has come steadily down since August 1993 to an estimated 6% in July 1994.

Forecasting is difficult in this area. But no one should underestimate the dryness of the Russian Ministry of Finance. They have a strong commitment to not borrowing more money from the Central Bank than has been provided for in the Budget, and therefore not spending more money than that amount plus whatever they happen to manage to collect in taxes. It is therefore not surprising that the gloomy prognoses put out at the beginning of this year have turned out to be false. It is most unlikely that inflation will again become very high unless there is a change of government.

Real interest rates in Russia are now among the highest in the world (6% or more a month) and this has led to a sensible value for the rouble, giving a dollar wage of approximately \$100 a month. Since Russia has

extraordinary natural resources we can expect that over the next few years the dollar wage will increase further. But the balance of payments is not likely to become a major issue in Russia.

In the meantime output in Russia has continued to fall. Nobody knows the true path of the GDP and almost certainly the measured fall in industrial production exaggerates the true figure. In addition, it's hardly likely to be true that in the last year output in services in Russia fell by 9% and in industry by 25%, making a 17% fall in GDP. The strongest evidence against this is the independent evidence that real consumption has risen by about 5% over the last year, which seems consistent with common sense impressions. Since Russian measured GDP has already fallen by 50% since 1989, compared with something like 10% in Poland, 20% in Hungary, 30% in Bulgaria and 40% in Romania, it seems unlikely that the Russian GDP has much further to fall. While it is true that Russia was more militarized than the other Warsaw Pact countries, it is also true that Russia has more natural resource potential and scientific potential than most of the other countries and this gives an ability to finance investment which is not everywhere possible.

Probably, the Russians have now something like \$50 billion in fairly liquid form: \$15 billion in enterprise deposits at Russian banks, \$15 billion in currency, and \$20 billion overseas. As soon as it becomes evident that political stability is real and financial stability is real, there will be an investment boom (which has already begun to some extent in private house-building). Once such a boom begins, foreign-owned money is likely to come in quite strongly as well. Given the degree of Western interest in Russia, there is no reason why the Russian economy should not be growing well above the world average in the second half of this decade.

The Russian finance of investment will of course occur in numerous completely unorthodox ways and not exclusively via banks. However, the role of the banking system is critical. The Russian banking system has progressed remarkably quickly and is the highest-prestige employer in Russia. It has received a good deal of technical assistance. But this will not prevent a number of bank failures. However, bank failures (just like the failure of MMM) are not likely to slow down the progress of capitalism in Russia.

4. Social Protection

In the Russian transition a huge number of people have to change their jobs. Can this be achieved without mass unemployment? Russia has in fact already achieved a massive redeployment of labour with a tiny increase in unemployment (unemployment only rose by 1.5% between 1992 and mid-1994). In 1993 no less than 20% of Russian workers were

hired into jobs. Unemployment has been avoided through a massive fall in productivity in industrial enterprises, which has not led to the bankruptcy of the enterprises because of one of the highest degrees of wage flexibility ever recorded in history. Thus wages in the textile industry have fallen to one eighth of those in the gas industry. In this way firms have been enabled to satisfy the earnest desire of workers to remain in their old enterprise until a better job comes around. This is in many ways a quite efficient method effecting the transition, provided the workers retained in the old industries are genuinely and actively looking for new work. This appears to be the case. In many enterprises there is a system of work-sharing, whereby a fraction of workers are sent home on involuntary leave (currently about 2% of the total workforce at any one time) and another group are on reduced hours (currently about 4% of the total workforce). This amount of hidden unemployment seems far more desirable than open unemployment of the long-term variety which has developed in Poland. Whether Russia will be able to continue such luck with lowish unemployment after bankruptcies become more common remains to be seen.

The Federal Bankruptcy Agency is instructed to sell insolvent enterprises, but how widespread bankruptcies will become is rather doubtful. It seems much more likely that there will be continued slimming, and spontaneous break-up of enterprises rather than major closures. The biggest problems will not be in the big cities but in the cities of around 50 thousand where there is a single dominant enterprise employing say 5 thousand workers.

It is crucial that in all these cases there is adequate provision of retraining, and public works to keep active those workers who have to be made redundant.

- (i) The development of retraining facilities has been very slow, largely due to the deplorable absence of teaching materials. A recent survey of training centres shows that all the courses in strongest demand were in commercial subjects where there are barely any teaching materials and any teachers qualified to teach. This should be one of the top priorities for all the foreign aid agencies.
- (ii) Public works. The development of a coherent strategy for the local economic development of some areas, including useful public works, has now become a top priority. It is extremely important to bring to bear whatever experience has been developed in Western Europe for rejuvenating areas whose industry is declining. This is especially important in Russia where physical mobility is particularly difficult due to the housing situation.

A major problem in restructuring are the social assets of enterprises. All the forces of the tax system weigh against the devolution of these assets to local authorities. For example, the maintenance of these assets counts as a cost which an enterprise can set against profits tax. If that cost was not there higher profit tax receipts would go from the local area to Moscow, thereby making the local area worse off. Equally, if the enterprise increased wages to enable the workers to pay for their social facilities this would attract massive wage taxation, which is avoided by the direct payment of benefits in kind. We should not therefore expect to see any very rapid reduction in the social assets of enterprises. This in turn exposes those people who leave enterprises to dangers of major deprivation.

Perhaps the most worrying thing of all in Russia is the health care system. This was never very strong and is in a state of severe crisis, which is surely one reason why the death rate in Russia rose in one year by 20% (1992-1993), and is still rising, though less sharply. The problem here is connected with the general budgetary crisis and could be considerably improved if the government were strong enough to cut industrial subsidies (the "national economy" line in the Budget currently receives 9% of the GDP).

Studies of income distribution show that pensioners are not on average as poor as the Russian population as a whole. The greatest poverty is in large families (as in most countries) and can only be tackled by a restructuring of child benefits with some kind of means testing.

Apart from the health care situation, there is no sense in which the social safety net in Russia has failed so far. In fact, it is remarkable how smoothly the transition has gone, with remarkably little social tension. It is interesting that those who voted for Zhirinovskiy averaged incomes higher than the national average, and their average age was below the national average. They voted against crime, not against poverty.

5. Conclusion

The Russian people have very little faith in the ability of politicians to do very much for them. This is an excellent background against which to build a market economy. The West can provide invaluable help precisely in those areas which involve the development of market capabilities - above all, contact with effective business partners and the development of skills to operate in the commercial occupations where opportunities are virtually unlimited.

REMARKS MADE IN PRESENTING THE PAPER

I am grateful to the Commission for giving me the opportunity to be involved in this programme which has certainly been an extraordinarily worthwhile experience for me. The paper "The Current State and Future of Economic Reform" is a very broad brush one and I will speak in an even more broad brush way which might be appropriate to get us started.

On the General Russian Economic Situation:

I have always been optimistic about the Russian economy which is the reason why I was there at the beginning. I think that on the whole this optimism has been justified. What I felt at the beginning, even before the coup, was that most Russians had become disenchanted with the State and the ability of the State to organise their lives. They had been impressed by the fact that there was something better in the West which they basically felt had to be copied. And in order to copy it they also started realising that they would have to join the West. This was the fundamental thought which has been driving the situation all along and the factor which explains why, despite all the various crises, actually things have been moving forward.

A very important issue, certainly for the Commission, is whether it is likely that at any point in the future this underlying state of mind of the Russian people may change and the door may shut. I think this is most unlikely. I think that the "magic" of the dollar is extraordinary in Russia at the moment; a lot of people have dollars and for them it is some sort of symbol of the new life. Surely they don't want to get cut off from that source of prosperity. So I think that it is very unlikely that we shall see a closing up of Russia or a reversal of the move to the market.

This however is a very different issue to the question of whether Democracy will survive in Russia. There is surely at least a 10% chance of some kind of autocracy. But I don't believe that economic policy would be any different under one regime or the other.

It is interesting to see the results of a recent survey of the army officers; 95% of them said that they would prefer to have a dictatorship and I think that a very high proportion of the Russian population would as well, the main reason of course being crime. They want a leadership which can effectively deal with crime. But when the officers were asked who they would like to be their leader, Zhirinovskiy was way down in their preferences at around 10%. It became obvious that they don't want someone who would cut them off from the West.

So if one asks what could reverse the economic reform, I think that the only thing that could really do it would be some *provocative reform*

action, which would have some damaging short term effect and thus unite the opposition against the reform process. The basic objective of economic policy of all the Governments in Russia over the last couple of years has been to avoid a provocative action. It was absolutely clear from early on that what was to happen would be *gradualist*.

I will offer two illustrations of this gradualist process and the highly political way in which things happen; the first in relation to the process of disinflation and stabilisation (or the lack of it) and the other in relation to unemployment.

It was clear to me in early 1993 when inflation was very high, that it couldn't be reduced by any of the "normal processes". And it seemed to me quite likely that it would be reduced by a gradual disinflation. Nearly all economists were saying then that gradual disinflation was a very unlikely remedy; there was only one precedent - that of Chile - which was not considered a very desirable one. However, this is what has been happening. There is no appetite for macroeconomic shocks and for declaratory statements. If you have a macroeconomic shock you have to have declaratory statements in order to try and generate credibility.

I came to understand all this at the very beginning because there was a lot of feeling that the Government wasn't explaining what it was doing, particularly to the Western community. We were asked to provide advice in the compilation of a document to be sent to President Bush in January 1992, before Yeltsin went to see him to explain the Government strategy. It was a terrific document, very persuasive, which described a sound and coherent strategy. Having been involved in the preparation of the document we asked our Russian counterparts why they did not publish it in Russian. They answered that anything that you put out provides somebody with a stick to beat you with. Their intention not to give any precise statements of what they were doing was thus clear.

Another experience I had which is also relevant to the disinflation issue had to do with wages policy. Again around the same time we were asked to do some work at the Ministry of Labour on an incomes policy which would aim at reducing the rate of growth of wages. Perhaps not surprisingly we came up with a proposal on the lines of the Polish "popivek" but we also discussed the alternative of an excess wage tax - not where you have a norm for the rate of growth of wages, but where you just have some tax on wages that lie above a cut-off point. We said that of course it would be better to have a norm for the growth of wages which would also have a welcome declaratory effect. That was precisely what Gaidar's administration rejected. They chose instead the excess wage tax that they have now and they were right! Surely the one way to have created conflict in Russia would have been actually to do what Western

economists, including myself, thought that it was a good thing to have, that is a declaratory statement about the rate of wage growth.

The result of this gradualism has been an extraordinary degree of industrial peace. Russian strike-days are at 1% of the OECD average, which is amazing given the difficulty of the transition. I think that it is very difficult for Westerners to say that it should have been done very much differently.

A second example of this gradualism is reflected in unemployment. Most Western economists expected a sharper rise in unemployment and some thought that this was even desirable. In fact, unemployment has been rising and it continues to rise at a rate of 1% per annum. There have been extraordinarily few lay-offs (1.5% of the workforce in 1993 - possibly slightly more than that now). But basically there has been a huge re-deployment of labour through massive wage cuts in the unsuccessful enterprises. Workers have chosen to stay in these enterprises until they could find something else. They have accepted these wage cuts and eventually they have moved out to better jobs. This is of course exactly what the OECD jobs study on the European economy said should be happening in Western Europe; it has been happening in Russia instead. But it is partly of course a matter of policy decision by the oblast administrations in particular, reflecting their desire to avoid social conflict.

These two episodes, the disinflation episode and the unemployment episode, reflect the very tight interrelation between politics and economics. There is no point in saying that it is undesirable; it is the reality. This raises obvious issues about the role of Western economists in Russia.

On the Role of Western Economists in Russia:

There are three important areas of activity for Western economists in such a heavily politicised environment. The first is simply what might be called the basic economic education of politicians and the general public. The second is foreseeing issues which will arise - which is easier to do to some extent if you come from outside - and making suggestions as to what should be done. The third is responding to very specific requests for policy development by politicians. As it is a little difficult to discuss these three areas in abstract, I shall give some illustrations of our particular experience in these respects.

1. Provision of basic economic education

On basic economic education we have been trying to do four things. First, through our work with the Working Centre for Economic Reform, to assist its members - and particularly Sergei Vasiliev and Andrei

Illarionov to sharpen their ability to make their case. The main way we have done this is by getting a clear and well documented account of what has been happening. They have found the Russian Economic Trends a very useful tool in their political battles. One of the most dramatic examples was when Chernomyrdin became Prime Minister at the end of 1992, with lots of negative ideas originally in his head. But fortunately he continued to rely on Vasiliev and Illarionov who had been introduced to their positions by Gaidar. They were reportedly spending a considerable amount of time sitting with Chernomyrdin together going through graphs from Russian Economic Trends.

A second thing that one can do in working with our partners is to answer their questions as they face several conceptual difficulties. I remember being asked, how come IMF lending is not inflationary. Taking someone through the way foreign finance works in a budget is an example of important things that Western economists can do. Russians very often want to know what is the foreign experience in a particular issue. The transfer of this knowledge is an obvious task for us to perform.

Policy makers we have been working with have wanted us also to participate in the economic education of the Russian public. So there have been a series of on-going monthly press conferences at which we make a report on the situation with an implicit interpretation of events that is supportive of what needs to be done, without however lecturing people. These press conferences have been reported widely in the press and on Russian television. We have also been encouraged to write articles in the Russian press, give interviews etc. On our side the distribution of material in Russian has not been as good as it should have been until recently. Now we are distributing the Russian version of Russian Economic Trends to the Federation Council and shortly to the Duma.

Outside the European Expertise Service, we have been involved in the organisation of summer schools for students and teachers in economics and we are now going to be involved in reforming the curriculum (through the TEMPUS programme), which is also a very important activity.

A fourth form of service we have also helped to provide has been to educate the Western public about Russia as there have often been grave misunderstandings in the past.

2. Looking ahead and providing advice

Making forward suggestions for issues that need to be addressed is very important. For example in early 1993, after privatisation had been dealt with, it was obvious that the post-privatisation problem of how to get finance for investment of a long-term kind, how to import know-how etc,

would emerge. We were very much involved in the drafting of proposals to Finance Ministers in this direction.

3. Responding to requests for policy advice by politicians

Illustration of this kind of activity is, for example, helping to develop the plan for the reduction of credit growth, looking at implications abolishing export quotas, and so on. It is important in all those cases not to be disheartened by the fact that things generally happen long after the advice is supplied. There is a long-term element inherent in the provision of such advice. But many of the things that Western economists have suggested have happened. A lot of them have happened six or even twelve months after the time they were originally suggested, but they have happened.

For instance, we are now faced with two urgent requests for provision of specific advice: (i) to work on the problem of weak enterprises and provide advice on how to help their localities support useful economic activity and how to organise the run-down of the old employment in some kind of co-ordinated fashion with the stimulation of new and more productive employment; (ii) to assist in tackling the huge problem of output measurement. As you may know, consumption is estimated to be rising by 10% per annum and industrial production falling by 25% per annum (!). There is a bit of a problem there, and work needs to be done in collaboration with Goskomstat in order to reconcile the various measurements.

On the whole, in all of the above areas, advisors become more and more able to contribute the longer they have been there. It is partly the issue of "Russian specifics", which we have often been accused of not knowing. It is true however that the more we come to know them, the more we find out that we can be useful, not least because they are instrumental in helping us build trust with the Russians we work with.

I have been asked to address the question of how can we as economists function in a situation where there is a change of Government. This question is hinting at the difference between the experience of all of the Europeans present and that of J. Sachs and A. Aslund. My view, looking into the future, is that Russians expect policies to be made by experts. I remember when Gaidar was sacked and I asked a couple of taxi-drivers what they thought of Chernomyrdin, they both said: "he is a chemist! how can we have a chemist in charge of the economy?" Russian people like good specialists. And good specialists are at the moment the relatively modern group of economists which would include the Gaidar - Shokhin groups but also the Sabirov group and the Yavlinsky group but not the old guard (ie Petrakov etc). It seems to me very likely that Russian

economic policy will be made by a changing cast from the "modern group". It is not terribly critical to us who these people will be. What is critical is that we ensure an affiliation to an institution rather than to individuals.

On Priorities for TACIS:

In my paper I mention two hobby horses I have been trying to promote which are not strictly EES related issues. I would wish to raise them however as possible priorities for other parts of TACIS. Areas where there is a very high rate of return are those areas which Russians know very little about. Two such areas are: (i) commercial practise in a formal sense (accounting, banking etc); and (ii) the position of Russian businesses in the world market. Finding ways of using economies of scale to help educating them in these areas can maximise the returns.

It seems to me that there would be a huge pay off in enabling people to educate themselves in modern commercial practise. There is a total lack of written material in modern commercial practise. The translation and necessary adaptation of Western texts on basic commercial practise would cost very little and produce spectacular results.

Activity in the second area will help Russian businesses to define a future for themselves. We can't transfer the know-how of what is the situation in the world market, in products related to what Russian firms produce, on who might be interested in investing in particular firms etc. This cannot be done through detailed consultancy. Such know-how has to be channelled through the normal way, which is none other than ordinary commercial interchange. The people who will carry the knowledge of the world market, the best technological practise etc into Russian firms, are Western commercial partners. I feel that the Commission should be putting some resources at least into helping the Russians to find the Western partners who will then do the teaching. Russian firms are desperate in that they don't know who to ring up; at the same time western firms don't know who to contact in Russia either. I think that a *marriage broking* service organised by TACIS will bring incredibly high yield.

To conclude, the future for economic policy advice is there; we can operate in any likely political context; we are needed; and we each have different kinds of comparative advantage to offer. Of course, in the end, our chief aim should be to do ourselves out of a job.