APPLIED ECONOMICS IN ACTION: THE INTERNATIONAL MONETARY FUND†

The IMF and Russia

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The collapse of socialism in the Soviet Union and East European countries and the accompanying deep economic crisis have created extraordinary and unprecedented tasks for the International Monetary Fund. They have inevitably turned this organization into an object of severe criticism both in postsocialist countries and in the world as a whole. If one ignores exotic rhetoric (''IMF is an instrument of imperialist conspiracy against mother-Russia'') and remains in a professional framework, it is possible to identify two main lines of criticism of the IMF's response to the situation in Russia:

(i) IMF lost time when it was possible and necessary to energetically support reforms and thus condemned Russia to prolonged crisis and stagnation.

(ii) In the postsocialist era, due to a special structure of the economy (highly monopolistic, lack of bankruptcy procedures, etc.), inflation has a nonmonetary character. This is why ordinary stabilization programs directed at slowing down the rates of money growth are not applicable in those conditions. Excessive tightness and dogmatism of IMF programs condemn them to failure.

By now the relationship between the growth rate of the money stock and inflation rates in postsocialist economies has become a clear statistically proven fact. Thus, arguments based on a nonmonetary feature of the postsocialist inflation have fallen out of fashion. However, complaints about the dogmatism of IMF programs continue. I will consider how true these claims are for the biggest postsocialist economy—the Russian one.

It is necessary to take into account the fact that the period from 1991 to 1996 was not homogeneous. The economic and political situation in Russia was sharply changing, and the attitude of the IMF was changing too. In this connection I will separate the postsocialist period into four subperiods: from November 1991 to June 1992; from July 1992 to September 1993; from October 1993 to December 1994; and from January 1995 on.

I. November 1991–June 1992

The failure of the coup attempt in August 1991, the de facto break-up of the Soviet Union, and the collapse of the socialist economic regulation based on ''tough rule'' placed postsocialist countries, and Russia first of all, on the verge of economic chaos characterized by orders which were not carried out and a currency that was not widely accepted. A week after the failed coup attempt, state procurements of grain decreased by 75 percent. The basis of the socialist administrative system, centralized distribution of material resources, was crumbling. In everyday life this was revealing itself in an acute crisis of food supplies in the cities.

An alternative market system of microeconomic regulation was urgently needed to make money work. Meanwhile, the outlook for success in solving this task was bleak. Rapid increases in the money supply, which undermined trust in the national currency, a budget deficit which reached about 30 percent of GDP in the fourth quarter of 1991, the lack of

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coordination between 16 banks (15 republican and one all-union) which were independently printing the common currency, the near absence of hard currency reserves, the country's inability to service foreign debt, and the lack of market institutions and traditions all contributed to an increased risk of catastrophic hyperinflation. In conditions of hyperinflation, the weak currency would have disappeared from circulation, and the crisis in microeconomic regulation would have paved the way for real full-scale hunger in a country bulging with nuclear weapons.

The Russian government which was formed in November 1991 fully realized the seriousness of this danger and proceeded from the concept that only a combination of a maximum possible speed of market reforms and drastic tightness of fiscal and monetary policy would allow the country to avoid that course of events. Meanwhile, the inevitable preservation of the common ruble zone at least until summer 1992 (serious technical work was required to dismantle it) made that policy highly vulnerable. Chances of its success to a considerable degree depended on energetic support for stabilization attempts by leading market democracies. The scale of the problems faced were comparable to those caused by the collapse of Hitler's Germany. The situation demanded urgent political decisions and political leadership. Due to a complex of reasons (the start of a presidential campaign in the United States, a confrontation between the Republican administration and the Democratic majority in the U.S. Congress, the fact that Germany was overburdened with the incorporation of East Germany, etc.), the main Western powers proved to be incapable of providing such leadership. Although there was mutual understanding of the need to help Russian reforms, real mechanisms to carry it out were not elaborated. Instead, there appeared the simplest, deliberately inadequate solution of shifting the burden of responsibility to the IMF.

The scale of problems brought to life by the disintegration of a superpower, political in their nature, were beyond the competence and scope of the IMF. In addition, Russia and the IMF lived in different time frames: in Russia time was counted by days and weeks during this period; yet the IMF took nearly half a year to admit Russia to IMF membership, given even maximal acceleration of bureaucratic procedures. By the time the bureaucratic obstacles to cooperation between Russia and the IMF were eliminated, Russia had already managed to overcome an acute microeconomic crisis, start market mechanisms, and solve the problem of supplying the cities. However, the political price for the conflicting policy of the first months of reforms (introduction of 28-percent value-added tax, a reduction in weapons purchases to one-third of previous levels, a sharp cut of agricultural subsidies, etc.) was high; internal support for stabilization reforms was lost.

That period was marked by the most serious technical mistake made by the IMF during all its work with Russia: the attempts to maintain the ruble zone on the post-Soviet territory. It was clear to the Russian government that any agreements about coordination of fiscal and monetary policy would not be effective. That is why the Russian government wanted to divide the ruble zone and to introduce its own national currency as soon as possible. The IMF, wanting to maintain a common post-Soviet economic space, obviously underestimated the difficulties of coordinating fiscal and monetary policies and could not make a final decision: what should be stabilized by common efforts—the common ruble or national currencies which were being introduced into circulation? Without clear understanding of this problem, it was impossible in principle to devise and implement a serious stabilization program. Only in summer 1992 was a decision made to support national currencies; by this time, there were no readily available political solutions.

II. July 1992–September 1993

This period was characterized by an increasing dyarchy crisis. The contradictory constitution inherited from the socialist era did not provide clear answers to key questions about the division of powers among the President, the Congress of Peoples' Deputies, and regional administrations. Uncoordinated activities of branches of power paved the way for legislative and economic chaos. It was impossible to carry out a serious stabilization policy in those conditions. Due to uncoordinated activities of the government and central bank, the

country remained balanced on the verge of hyperinflation (monthly rates of inflation were 20–30 percent). In that period the International Monetary Fund was gradually increasing its professional understanding of the real situation in the Russian economy; however, it showed reasonable reluctance in allocating credits.

III. October 1993–December 1994

The dramatic events of October 1993, including the resolution of the dyarchy crisis in favor of the President and the adoption of a new constitution in December 1993, cardinally changed the political situation in Russia. There appeared real possibilities for carrying out a serious stabilization policy directed at lowering inflation rates and establishing preconditions for economic revival. In autumn 1993, the government took measures (ending privileged credits, eliminating bread and import subsidies, increasing housing costs, and cutting money growth rates) which established a basis for the 1994 stabilization program. At that time, the Russian authorities actively debated a choice of course: whether it would be necessary to take advantage of opportunities to sharply cut the inflation rates or would be possible to pursue a slower, more cautious path, thereby avoiding conflicting political decisions necessary for the success of stabilization.

At the same time, the IMF found itself under severe criticism for excessive tightness and the dogmatism of the stabilization programs being implemented in the postsocialist countries. The newly formed STF (Structural Transformation Facility) program, while undoubtedly useful as an instrument of support for reforms in the postsocialist countries, also was unclear about the criteria for determining an economic policy deserving the support. In formulating the IMF's position on this issue, the struggle between two contradictory trends was transparent: a sincere willingness to assist nascent reforms in Russia was coupled with a hesitation due to concern about the viability of the stabilization efforts undertaken. As a result, the IMF was only a passive onlooker in the polemics on the crucial issue of choosing the 1994 economic and political course. At the very moment that the government's rejection of the radical disinflation program became obvious, the IMF issued a regular STF tranche.

The experience of the 1994 Russian economic policy is one more piece of clear evidence that any softening of requirements to a monetary program endangers the borrower. Over spring–summer 1994, the monthly growth rates of consumer prices steadily decreased (26 percent in August 1993, 13 percent in December 1993, and 4.5 percent in August 1994), resulting from the tight financial policy implemented in 1993 and early 1994. At the same time, beginning in April 1994, the monthly growth rates of the money stock approximately doubled. One can easily predict results of such a policy: beginning in the summer, there was a steady rise of demand for hard currency, along with a redistribution of banks' assets in favor of hard currency, leading to the depletion of the central bank's hard currency reserves, its exit from the currency market, a sharp drop in the ruble rate, and acceleration of inflation. By the end of 1994, the inflation rate was again around 20 percent per month, hard currency reserves were sharply reduced, and the inflation tide had worsened social problems: the poverty rate grew significantly, and all the results of the late 1993 stabilization efforts were wiped out. The de facto result of the ''softness'' of the approach to the monetary program was that the IMF had financed the capital outflow from Russia.

IV. January 1995–December 1996

At the end of 1994, the economic and political situation in Russia changed once again. The government and the new central-bank administration had been taught a lesson. By their own experience, not from the books, or by anyone's advice, they realized that one has to pay a high price for a soft monetary policy. The new constitution delegated both to the President and the government broad powers for an implementation of the chosen economic and political course. The IMF had also learned a lesson from the 1994 experience and started to collaborate actively with the government in working out a serious and tight stabilization program. It called for a complete rejection of direct credits to the budget at the expense of the central bank's loans, and a sharp decrease of net internal assets rates. The program bore a clear orthodox character: it did not utilize a

''nominal anchor,'' either in a form of fixed hard-currency exchange rate, or in a form of regulating salaries and wage increments.

Implementation of the program started under extremely unfavorable conditions: the failure in carrying out the 1994 economic policy had undermined economic agents' trust in the seriousness of the government's stabilization efforts. The Chechenya war, started in December 1994, did not bring about more optimism about the success of the disinflation program. In January 1995, the government, which had previously declared its objective to decrease inflation rates to 1 percent per month by the end of that year, had to borrow at the rate of 200–250 percent annualized. In spite of that extremely unfavorable background, the results of the 1995 economic policy indicate an indisputable and serious victory. By the end of 1995, monthly inflation rates dropped to 3 percent, gross hard currency reserves grew more than fivefold, and the financial stabilization allowed some improvement in terms of crucial social indexes, including a decrease in the poverty rate.

It is the hard-currency policy which became the most crucial problem in the course of the program's implementation. The program did not provide any regulation of an exchange rate. During January–March 1995 economic agents were still sure that the ruble would depreciate sharply against the U.S. dollar. Therefore they were caught unaware by the sudden change in the hard-currency market that happened during April–May (which was an inevitable result of the tightening of monetary policy). The ruble started strengthening, engendering further speculative pressures for appreciation. In the dollarized economy, this process became very intensive, and both the central bank and the government were confronted with rather complicated problems. The U.S. dollar depreciated against the ruble by more than 10 percent over May–June, while the drop in the real rate was 25 percent. With major players in the currency market continuing to move out of the dollar into the ruble, there was a danger of exchange-rate overshooting, which could have led to a new speculative play, this time against the ruble.

The government and the central bank, together with the IMF, analyzed the situation and made the undoubtedly right decision of introducing a new element to the program, the introduction of a currency board, which allowed a rapid stabilization of the currency market and brought about stability and predictability to dynamics of the ruble exchange rate.

The year 1996 has been influenced by the powerful impact of the economic and political cycle linked to the presidential election. This imposed its imprint on the dynamics of interest rates, on the share of taxes in GDP, and on the demand for currency. Nevertheless, even considering all the major mistakes of the year, its main result has been to maintain and strengthen monetary stability. The inflation rate decreased from 130 percent in 1995 to 22 percent in 1996. A sharp decrease in the interest rate on state treasury bills at the end of the year testifies to the fact that the most painful economic costs of the presidential election have been left behind.

V. Conclusions

A few lessons from the experience of Russia's collaboration with the IMF may be summarized as follows:

(i) It is senseless to set up essentially political tasks for the IMF and require the latter to resolve them: the IMF, by its nature, does not fit in this role.

(ii) It is necessary first of all for the country-borrower to maintain the tightness of criteria applied to a monetary program as a core element of financial stabilization. Whatever serious political reasoning is used to justify softening of such requirements, the result is the same, namely, a capital outflow, at the expense of the external debts.

(iii) Given even an ultimately unfavorable situation, the coordinated and gradual work of the government and a central bank with the IMF allows inflation rates to be cut sharply by applying orthodox monetary methods.

(iv) An essential prerequisite for success is a joint creative analysis of economic and political problems arising in the course of stabilization, followed if necessary by an introduction of adequate changes to stabilization tactics.