Problems of Economic Transition

A JOURNAL OF TRANSLATIONS FROM RUSSIAN

AUGUST 1996

The Post-Soviet Economic Space

Russia's Long-Term Economic Prospects

Banking

Spanish reform: "Equally distribute the burden of reform to all strata of the population." It was not even advanced as a reference point and slogan. The lack of understanding of the importance of the population's economic behavior and research on the reasons for this behavior were serious shortcomings in economic theory.

However, it can be said on the whole that the first phase of the reform has been completed. Of course, this was not the stabilization phase. This was the phase of nominal transfer of property and the birth of the market infrastructure.

The next quite lengthy phase consists in the transfer of property from the hands of its nominal owners to the hands of effective owners. Even now it is clear that hopes for nomenklatura privatization have not proved justified. Large Russian banks or, more precisely, their affiliates claim the role of effective owner. The advent of such structures as financial-industrial groups should be welcomed in this regard.

In the second phase of the reforms, the creation of a maximally favorable climate for the emergence of the de facto owner for supporting and helping him in the effort to normalize and revive production is becoming a central problem of both federal and regional authorities. Defending the domestic producer in this phase of the reform in addition to protectionist measures to defend Russian products includes the protection of Russian capital, which today expresses a clear and, we hope, long-term desire to enter production.

V MAU, S. SINEL'NIKOV-MURYLEV,
AND G. TROFIMOV

Alternative Economic Policies and the Problems of Inflation

Throughout the past decade, discussions of variants and alternatives of economic policy have become extremely popular among our politicians and economists. Their logic remains practically unchanged: the government accuses opponents of adventurism, claiming that its policy is the only possible one; the opposition, however, condemns this policy and promises to change it radically if it comes to power. But it is not a question of the existence of alternative economic policies as such, but rather the degree to which an alternative exists and the latitude for maneuvering if the political victory is won by those forces (communists and/or nationalists) who are loudest of all regarding their intention to radically revise the country's economic–political reference points.

In answering mis question, naturally we cannot confine ourselves to political slogans and the principal demands of the radical opposition (although it is also hardly expedient to ignore them entirely). We must explore *theoretically conceivable and practically possible* variants of economic policy, that is, variants that consider the inertia of the economic system on the one hand, and the existence of real social groups that are interested in one or another course of development of events on the other.

 "Al'ternativy ekonomicheskoi politiki i problemy infliatsii," *Voprosyekonomiki*, 1995, no. 12, pp. 12-25. A publication of the Institute of Economics, Russian Academy of Sciences.

The authors are all affiliated with the Institute for Economic Problems of the Transition Period. V. Mau is a Doctor of Economic Sciences and a deputy director, S. Sinel'nikov-Murylev is a Candidate of Economic Sciences and a deputy director, and G. Trofimov is a Candidate of Economic Sciences and a laboratory head at the Institute.

The present article therefore analyzes only those economic–political alternatives in contemporary Russia that are fundamentally practicable. It will also discuss the actual logic of stabilization measures within the framework of a certain alternative and especially the problem of inflation as the central topic of current economic–political discussions.

The latter concerns not only general economic considerations (the level of inflation is a key indicator of the stability or weakness of the national economy), but also the balance of interests of various social forces.[1] Indeed, inflationary processes essentially are nothing other than processes of the redistribution of financial resources among various groups of economic agents that are interested or not in such redistribution. The level of inflation in Russia today has become not so much an economic as a political indicator that is the result of the efforts of different economic–political groupings.

In addition, the clarification of the nature of inflation is the key question of the actual logic of the formulation and interpretation of different economic–political programs. Is inflation only a monetary phenomenon or is it primarily generated by the structural-institutional peculiarities of the post-Soviet economy?[2] Different answers to this question are also responsible for diametrically opposite economic-political recommendations,

A practicable economic-political policy

The suppression of inflation is the principal direction of the government's current policy on normalizing the socioeconomic situation and inaugurating economic growth. This requires first of all the elimination of the budget deficit or at least its financing by noninflationary sources. The implementation of similar measures in several dozen countries throughout the world (including a number of post-communist states) has become the point of departure (with an approximately two-year lag) for rapid economic growth.

Another substantive element of this concept is the fact that the problem of overcoming the slump in production is viewed not in terms of supporting or restoring old economic organizations (enterprises), but in terms of stimulating growth on a qualitatively new production and technological base that makes it possible to effect deep structural reforms in the economy in a relatively short period of time. In other words, the task of stimulating growth, as part of the government concept, is not

only not identical with the task of overcoming the slump, but even contradicts it to a certain degree. The social consequences of economic (structural) reforms are cushioned by support for workers laid off by enterprises that are closed down (support of the social sphere, retraining, and assistance in resettlement), but not by financial aid for weak enterprises that have no future.

Finally, a fundamental role is played here by the preservation of the regime of economic liberalism and above all by the freedom of foreign economic activity. Given our country's strict monopolism, it is specifically foreign competition that is the most important mechanism for restraining the rise of domestic prices

Economic agents who have succeeded in adapting to a market environment in recent years, who are capable of competing in foreign and domestic markets, and who are ready for active investment activity, the basic obstacle to which is the high rate of inflation today, are natural supporters of current government policy. Its natural opponents are weak enterprises that require massive injections of "cheap money" to survive, as well as a considerable part of the commercial sector where inflation is a source of superprofits.

An ambiguous attitude toward this policy is seen in the financial services sector. Until recently, banks have generally been opposed to it since the availability of "cheap money" made it possible for this sector to be one of the most profitable in the nation. In the banking sector today, however, there is a clear split. the largest banks, feeling the stability of their position, have altered political reference points and are already expressing their willingness to work in a stable situation, to invest in production, and to be oriented not so much toward the profit norm as toward the profit mass in realizing their income. Subsequent contradictions in the banking sector will more likely intensify because with financial stabilization it will begin to be restructured in the direction of increasing the number and strengthening banking institutions; the acute banking crisis at the end of August became the first indicator of this. (Similar crises and the restructuring of capital are also inevitable in the trade sphere.)

It is customarily believed that the present exchange rate is advantageous primarily to exporters, and since branches in the fuel–energy complex are our dominant exporters, they are usually viewed specifically as the principal source of social support for the Chernomyrdin government. However, events in May–October 1995 graphically demonstrated

the theoretically entirely predictable fact that in proportion to financial stabilization and the strengthening of the exchange rate of the national currency, there is a substantial lowering of the effectiveness of export operations with the subsequent deterioration of the national trade balance.

The situation is also complex for branches that produce import-replacing producer goods. The expansion of imports of competing goods may be placed in an exceptionally difficult situation by those Russian machine-building enterprises (especially those that have been converted) that are already trying to adapt to actual market demand, have tried to find their "niche" in the new economy, and have now begun reorganizing their production base with the aim of satisfying the potential investment demand of the raw-materials and processing branches. But at the same time, the situation of those branches and enterprises that have traditionally depended upon deliveries of foreign raw materials and equipment (including, incidentally, numerous exporters) is being eased.

Thus, the social base of current policy is formed as a result of the quite complex interaction of various groups of interests. Incidentally, this always *differentiates current policy from what is possible.*

Alternative economic policies

The policy *of open inflationism* may be an alternative variant of economic policy. The principal task of its advocates is to support existing production and to restore it at enterprises that are experiencing a deep slump and that are in a practically hopeless situation. Clearly, such a policy is principally advantageous both to objectively ineffective, unpromising enterprises such as mines whose resources are spent and to enterprises that are potentially competitive but in deep crisis because of the inability of their management to organize production at a level adequate to current requirements. The majority of managers of the traditional Soviet agro-industrial complex, as well as a considerable part of commercial and banking structures (primarily small), are active supporters of such a policy.

The inflationary "feeding" of the national economy makes the carrying out of practical restructuring of the economy impossible (the criterion of effectiveness on the part of demand is lost), and the policy of maintaining production is therefore identical to preserving the structural status quo.

Generally, such a policy is possible in principle: it was widespread

among Latin American countries (mainly those with military regimes) in the 1950s through the 1970s. The standard cycle of economic–political actions and reactions is practically inevitable here: support for economic growth; increase in injections of money into the national economy; deceleration of the decline of production (and in certain cases, the acceleration of growth as well); the deterioration of the situation in the currency market; lowering of the exchange rate of the national currency; sharp acceleration of the rise of prices; the attempt to tighten monetary policy in an economy that is already out of balance; and the sharp decline of production.[3]

Under our conditions, the leftist forces that are implementing such a policy will more likely supplement it with entirely comprehensible, ideologically familiar and customary price freezes on quite a broad range of goods and services and especially of the products of branches that produce raw materials and consumer goods. Theoretically, this course will be explained by the "nonmonetary" nature of inflation, that is, by the conditionality of the general rise of prices in the basic branches.

The result is a vicious circle that can again be broken by the standard, time-tested complement of "nonmonetary economic policy" measures. With respect to the concrete Russian situation, it is possible to forecast the following sequence of steps that the pro-inflation government will take in an effort to cope with mounting macroeconomic problems.

To begin with, there will probably be an attempt to introduce a plurality of exchange rates and/or to fix the ruble's exchange rate at an artificially high level for import transactions. This will have a number of consequences. First, relatively cheap currency generates higher demand for it and in order to keep the ruble's exchange rate stable, the government will be compelled to spend its hard currency reserves in a short space of time. Second, a shortage of hard currency will inevitably develop and hence the need for administrative organs to distribute it (which will only intensify corruption even more). Third, there will be a black market for hard currency. Fourth, imports will become unprofitable (due to the administrative, overvalued exchange rate of the ruble) and dangerous (if the state metes out drastic punishment for using the services of the black market for currency). Fifth, the curtailment of imports will lead to a sharp jump in domestic prices, especially the prices of consumer goods since foreign competition is presently the principal restraining factor for Russian monopolists. The rapid rise of inflation may confront the government with the need to establish state price controls that will result in the

well-known (but, unfortunately, already partly forgotten) dearth of goods at a time, moreover, when our currency reserves are practically exhausted.

Taking the present state of the Russian economy into account, it can be assumed that with the transition to a pro-inflation economic policy, its extremely negative consequences will become apparent not immediately (as was the case in 1993), but after a lapse of six to twelve months. The reasons for this are rooted in the general inertia of economic processes that typically have approximately a six-month lag between change in monetary policy and change in basic macroeconomic parameters. Moreover, the hard currency reserves that have been amassed to date make it possible to cushion the dangerous consequences of inflationist policy for a certain time.

We must also not fail to note that such a policy creates an exceptionally favorable milieu (much more favorable than the existing one) for corruption. And matters here do not reduce to the currency distribution problem mentioned above. At the center of the economic decision-making process here is an official who distributes resources (it is unimportant whether these are rubles, foreign currency, or the notorious "exchanges"), but in the line for scarce goods, there is always a place for money, that is, bribes.

There is one more relatively realistic variant of economic policy that is connected with the position of nationalistic parties and that presupposes above all the *concentration of state resources in branches of the military-industrial complex* and the rendering to them (all of them or according to a certain list) of stable support in the form of investments and other financial means.

Foreign economic protectionism and the protection of domestic producers from foreign producers in the domestic market are a natural and necessary element of this policy. Both enterprises in the military-industrial complex proper and, more broadly, producers of import-replacing products are interested in it.

In the case of this macroeconomic maneuver, the military-industrial complex would become the national economy's "driving link." State support is a kind of motor that stimulates the growth of the sector, which in turn creates the demand necessary for the development of other branches in the production and social spheres. However, even in the most inflationary (and macroeconomically strictest) variant of the alternative under discussion, civilian branches and especially the social sphere are in an exclusively adverse situation since the demand for their activity will

inevitably be formed last, while state resources will simply not suffice and the financing of social spending from leftovers—a principle that is so well known to the Soviet economy—will thereby be reproduced.

We should not expect excessive economic populism here as compared with the "leftist alternative," especially at the outset. The populism of nationalists is mainly confined to the social sphere. In the economy, however, they try to adhere to quite a cautious macroeconomic policy, A nationalist government will hardly resort to large-scale price freezes, which will evidently initially affect only products of the raw-materials (and especially the fuel-energy) sector. At the theoretical level, this will be attributed to so-called cost-push inflation (that is, to the rise of prices in the raw-materials branches) as the principal cause of rising prices in the national economy.

A complex of organizational and institutional measures to form a number of very large monopolistic associations—financial-industrial groups (FIGs)—is an important element in this concept. It is assumed that they should be created primarily "from the top," that is, by the state itself, and should be analogues of corresponding organizations in Japan and South Korea. Since they support state industrial policy, FIGs are regarded as basic subjects of state regulation and simultaneously as the principal recipients of state aid.

Strictly speaking, this model has quite a great deal in common with the openly inflationary variant examined above. Because of the paucity of state noninflationary financial resources, all influential economic agents in the military-industrial complex will exert the greatest pressure on the bureaucratic apparatus that distributes these resources. The consequences here are quite obvious. On the one hand, there will be an inevitable increase in corruption of the state apparatus that will have understandable "stimuli" to distribute the corresponding resources. On the other hand, the country's political leadership, even if it is firmly resolved not to allow the economy to become inflated, will not be able to withstand the very powerful onslaught of the financial-industrial groups created by them, Since the state does not have the resources to satisfy the appetites of all politically significant lobbyists, it will be forced to switch on the printing press and will subsequently contribute to the increase in the inflationary spiral.

With regard to the medium-term prospects of this economic policy, two quite realistic scenarios can be predicted here. First, under an absolutely incompetent macroeconomic policy (in other words, if strong

political influence is exerted by leftist political forces that are open inflationists on the nationalist government), it is entirely possible that the inflationary financing mechanisms will be activated and will immediately become a part of the above-described "Latin American" vicious circle (from a mandatory exchange rate through price fixing to a commodity shortage). Second, it can be theoretically assumed that a nationalistic government will also adhere to a more cautious exchange rate in the monetary-financial sphere. This will, of course, generate additional social tension, but by no means will it present an immediate danger to the authorities who may for a certain time attribute social difficulties to the legacy of the "damned liberal marketeers." But historical experience shows that the policy of nationalistic populism that has been implemented for a certain period of time nevertheless leads to an inflationary dead end. To be sure, this does not happen as quickly as when events develop according to the "leftist" variant.

Finally, we cannot disregard the extremely low but nevertheless existent probability that economic populism will be almost entirely abandoned within the framework of the economic–political model under examination. However, such a turn of events will place the country in a very difficult political situation. To count on the military-industrial complex as a source of national economic growth is to assume the existence of sufficiently high demand for military products, that is, we will either have to dramatically expand our arms trade in the world market or begin military actions ourselves. The former is hardly possible for economic reasons: the scale of arms exports by the Soviet Union was attained by virtue of the fact that the majority of these were in the nature of loans (but were in actuality gratuitous), while in terms of the level of actual sales, the indicators are comparable with analogous current indicators for Russia. In other words, we cannot particularly count on actual (monetary) demand in the world market. With regard to the orientation toward launching military actions (Germany in the 1930s followed just such a path in reviving its economic growth), commentary is hardly necessary. In a word, without the inflationary pump, even if such economic logic has certain prospects, they are very sad.

It hardly need be argued that the prospects for one or another variant of economic policy at the present time depend to a considerable degree upon purely political factors and above all on the elections to the State Duma, as well as on the personality of the future president of the Russian Federation.

The autoregressive model: its verification and its use in forecasting

In order to analyze the variant forecast, it is necessary to examine a simple autoregressive model of inflation that takes the inertia of prices into account. The inertia of inflation in Russia was especially graphic in 1995. It was explained by two factors: high inflationary expectations that continued until the third quarter of the current year, and the insufficient flexibility of prices. The model links the rate of monthly inflation to the rise of prices in the preceding month, to the growth of M2 money supply, and also to other, nonmonetary factors. Retrospective and prospective forecasts of monthly inflation based on the given model are presented below

In general form, the autoregressive dependence appears as:

$$p_t = a_1 p_{t-1} + a_2 m_{t-1,\,t-6} + \varepsilon_t \qquad (1)$$

where p_t is the consumer price growth index during month t, $m_{t-1,\,t-6}$ is the geometric mean of monthly growth rates of the M2 money supply for the preceding six months, s, represents other (nonmonetary) inflation factors, and a_1, a_2 are regression coefficients.

Regression equation (1) does not include an intercept. This, however, agrees with certain theoretical models of inflation with insufficiently flexible prices. They [the models] explicitly describe the process by which firms set prices under conditions of monopolistic competition among producers that do not have complete information on the state's monetary policy.[4] This direction is based on the well-known model of imperfect competition proposed by A. Dixit and J. Stiglitz.[5] Another approach to the explanation of price inertia is based on bilateral labor contracts that are concluded for a fixed period of time and take inflation into account.[6] The theoretical level of prices is expressed (on a logarithmic scale) as a complex linear combination of the level of prices set in the preceding period and the money supply in the current period.[7] Taking into account the lag in the impact of the money supply on aggregate demand, as well as the influence of nonmonetary factors, we obtain the autoregressive dependence (1)

Evaluation of autoregression yields the following results:

$$p_t = 0.65 p_{t-1} + 0.4 m_{t-1,\,t-6} + \varepsilon_t \qquad (2)$$

The significance of the t-statistics for the evaluated parameters is: 7.2 for parameter a_1 at p_{t-1} and 3.9 for parameter a_2 at $m_{t-1,t-6}$. Thus, the evaluations obtained are statistically significant. Multiple determination coefficient R^2 is equal to 0.81. Accordingly, the contribution of nononetary factors to the dispersion of the growth of prices is 19 percent.

We note that the sum of linear combination coefficients in (2) is close to [that of] (1). This property is also characteristic of all other specifications of the model with a more complex lag structure. On the one hand, this fact corresponds to the theoretical dependence that was discussed above, and on the other, it reflects the neutrality of money in the long term.

As the evaluations show, price inertia is a weighty factor that determines the dynamics of monthly inflation. Other things being equal, change in the rate of inflation by one percentage point in the current month predetermines change in this rate in the following month by an average 0.65 percentage point. The forecast of changes in prices in 1995–96 based on the autoregressive model is graphed in Figure 1.

Figure 1 presents a time series of short-term forecasts of inflation for a month ahead based on dependence (2). Short-term forecasts are calculated on the basis of factual data on inflation in the current month and the dynamics of the money supply during the preceding half-year. The influence of nonmonetary factors on inflation is not considered in this calculation. Beginning in September 1996, forecast data on the dynamics of the money supply based on the draft budget for 1996 were used In this time interval, information on actual inflation is not used and monthly price indexes are recalculated iteratively according to dependence (2).

Figure 2 presents a long-term retrospective forecast of inflation intended to illustrate the forecasting properties of the model. It makes no use whatsoever of the actual price dynamics, but rather uses inflation rates calculated for the period from July 1992 through June 1996 based solely on information on the monthly dynamics of the money supply. In this instance, monthly inflation rates are iteratively recalculated from the very beginning according to formula (2). As Figure 2 shows, the proposed model does a good job of discerning inflation trends; deviations of forecast figures from actual figures are attributed to changes in the real demand for money that are not considered in the model.

In particular, these calculations do not take into account the decline of the rate of circulation of the money supply in the second half of 1995 due to the Central Bank's policy and the situation in the financial

Figure 1. [Results of Autoregressive Forecast: Price Changes for 1995–96]

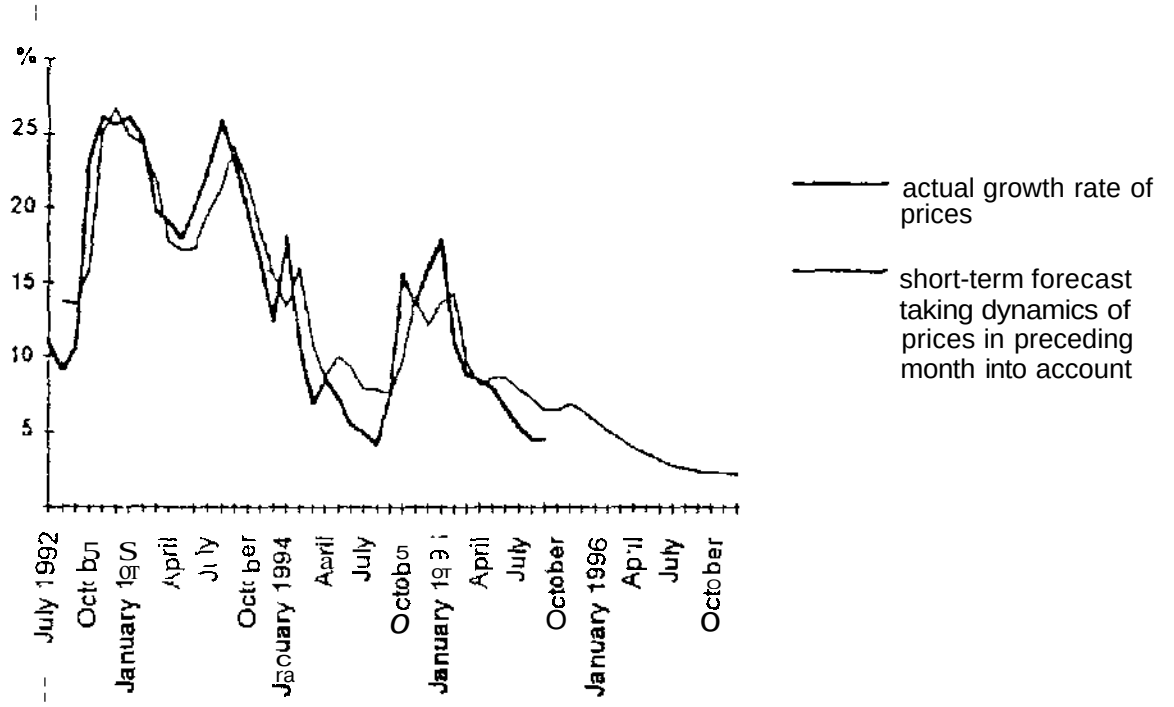
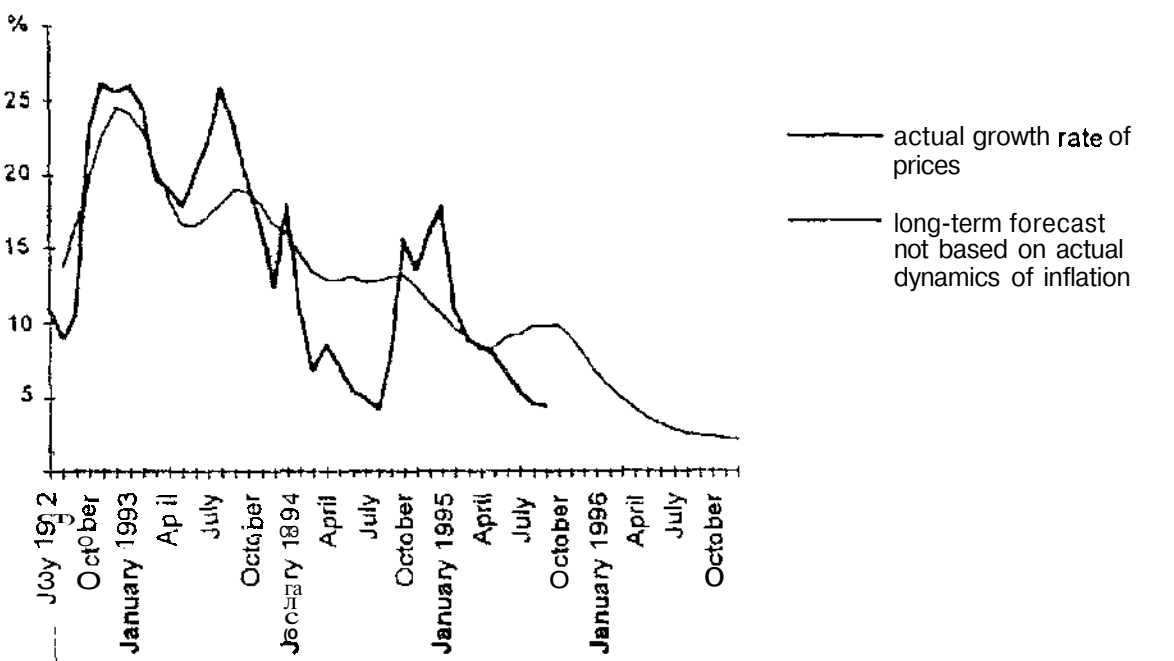


Figure 2. [Long-term Inflation Forecast Based on Monthly Changes in the Money Supply]



markets. The forecast for the end of 1995 and beginning of 1996 should therefore be corrected when concrete political scenarios are examined. In reality, the natural growth of the real demand for money under the conditions of stabilization began in the third quarter (see Table 1).

Thus, in the summer months, the cumulative money supply in the GDP [gross domestic product] increased by 3,5 percent. This increase

Table 1

[Money-Supply Dynamics]

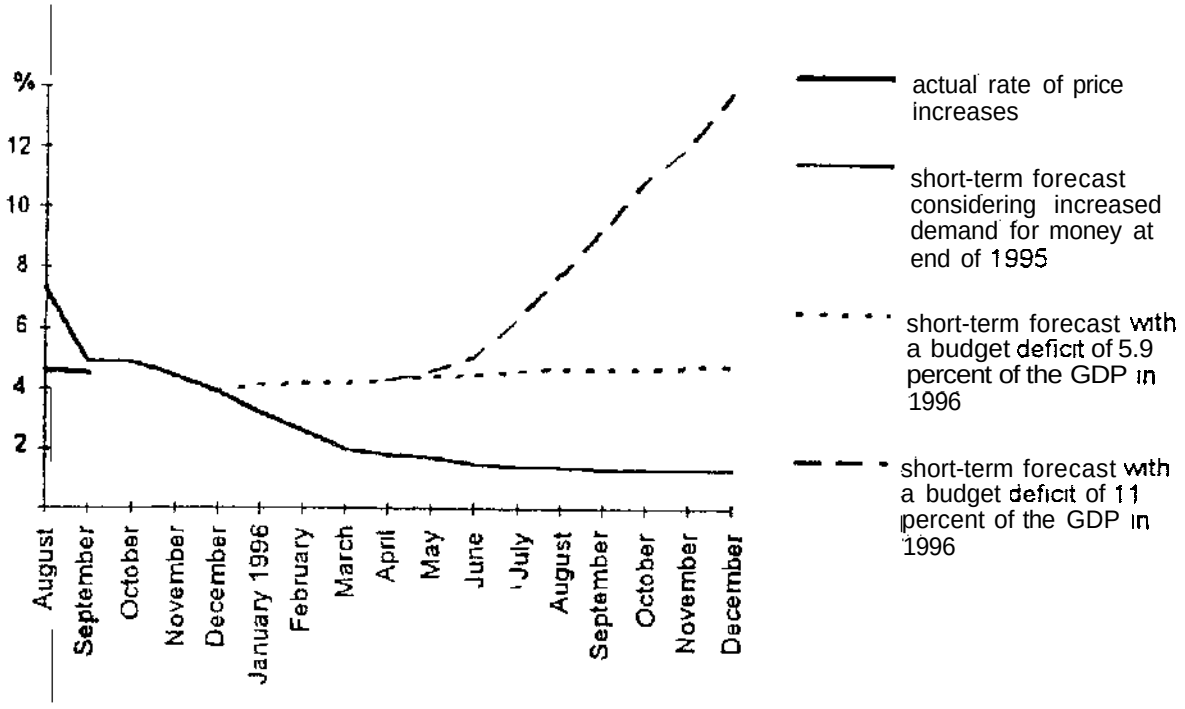
	Jan	Feb	March	April	May	June	July	August
GDP, trillions of rubles	73	83	96	106	118	130	136	148
M2, trillions of rubles	94.5	102.8	107.3	123.2	136.2	156.8	164 9	174 3
M2/GDP	1 29	1.23	1.12	1.16	1.14	1.15	1.21	1.18

is an indicator of the increased confidence of economic agents in the stabilization policy, that is, the beginning of the decline of inflationary expectations. As Figure 1 shows, the model does not discern changes in the share of money in the GDP relative to the dynamics of the real demand for money, which is determined by economic agents' expectations, fluctuations of the volume of the real product, and so forth (i.e., factors pertaining to the demand for money). To the contrary, changes in the share of money in the GDP due to the actual dynamics of supplying the money supply are quite well reflected in the trajectory of the retrospective forecast in Figure 2. Therefore, for forecasting future inflation, we exogenously correct the growth rate of prices in accordance with proposed changes in the real demand for money.

As the experience of last year shows, the elasticity of demand for real cash balances from inflation is approximately 0.25. By the second half of 1995, the monthly rate of inflation in annual terms declined by more than 50 percent as compared with 1994. Accordingly, the real demand for money from fall 1995 to the end of 1996 can be expected to increase by 20-22 percent. We assumed that the real demand for money in the last three months of 1995 would increase by 5–6 percent. The corrected variant of the forecast is presented in Figure 3. According to this forecast, inflation will be 3.9 percent by December, 13.8 percent during October-December, and about 133 percent in the current year as a whole.

The forecast of inflation for the rest of the current year and 1996 is predicated on the assumption that executive power will remain in the hands of the Chernomyrdin government. However, it is obvious that economic forecasts for 1996 can only be made on the basis of a certain set of political scenarios. The results of the State Duma and presidential elections will entirely determine the character of economic policy in the future.

Figure 3 [Alternative Inflation Forecasts August 1995–December 1996]



We have already examined above a favorable variant of development in which the balance of power in the State Duma after December 1995 will not change too much in favor of the communists, the agrarians, and the national-patriots. In this case, the Chernomyrdin government will probably continue its financial stabilization policy at least until the presidential elections in June.

We predicated this political scenario on the premise that the government will try to fulfill the reference points of monetary policy set forth in the draft budget for 1996 and in the plan for Basic Directions of Monetary Policy for 1996: growth of the money supply by 20–25 percent for 1996, that is, by 1.5-1.9 percent a month. The government program presupposes an increase of 12-15 percent in the real demand for money (0.9-1.1 percent a month). Based on the 1994-95 experience, our calculations assumed an increase of 15-16 percent in the real demand for money in 1996.

According to government projections with the indicated parameters of the monetary program, inflation will be 1-1.2 percent a month. This forecast could be correct if growth rates close to 1 percent a month are attained by the end of 1995. However, as shown above, this is unlikely. Moreover, the growth rates of the money supply in the fourth quarter of 1995 will probably be higher than those necessary to attain the indicated goals (approximately 3.3 percent a month). Consequently, con-

sidering the inertia of inflationary processes, the parameters in the draft budgets and the monetary program will lead to an increase in prices in 1996 by 1.7 percent a month, or 23 percent for the year as a whole (see Figure 3).

The reality of this variant depends to a certain degree upon the reciprocal influence of monetary and exchange-rate policy and the reaction of economic agents. The experience of financial stabilization in 1995 showed how difficult it is to control the money supply in a dollarized economy with a high degree of mobility of capital flows. The Central Bank can restrain the growth of the money supply in the spring and summer only by permitting a significant increase in the actual exchange rate of the ruble.

The de facto rise of the real exchange rate of the ruble by approximately 60 percent since the beginning of the year led to a significant increase in the cost of domestic production. To be sure, by introducing the currency corridor the Central Bank averted a still greater increase in the actual exchange rate of the ruble, which slightly eased the plight of the real sector. However, this measure, which is feasible from a macroeconomic point of view, was reflected in the state of the banking sector. The banking crisis that has been experienced since August fits the logic of financial stabilization. The first to suffer were those banks that did not fully consider the effect of the policy that had been implemented since the beginning of the year and did not reduce the size of the currency positions. The underestimation of credit and interest risks, the inability to coordinate the time structure of assets and liabilities, high administrative costs, and so forth, also played their parts. The banking crisis should normalize Russia's financial system and change the style of management in this sector. The Central Bank's purchase of state short-term bonds from certain banks with their subsequent resale to other market participants has made it possible to rationally redistribute liquidity and to avoid more serious consequences.

If the tendency for the real exchange rate of the ruble to rise rapidly continues in the coming year, it will be possible to foresee the *sharp* deterioration of the plight of the economy's export sector. At the same time, the policy of the currency corridor or the fixing of the currency exchange rate stimulates the further de-dollarization of the economy. De-dollarization is also intensified by the existing high interest rates for state securities which are very difficult to lower

Stretching the growth process of the ruble's actual exchange rate

in time (the reduction of differences between domestic prices and world prices) will make it less painful to the economy. If we proceed from the necessity of securing the more stable dynamics of the ruble's real exchange rate, several directions of economic policy are possible: first, the growth of currency reserves with the aim of increasing demand for foreign currency and the devaluation of the ruble to a certain degree. However, it is difficult to predict the inflationary effect of the increase in the monetary base due to the growth of reserves as well as the higher cost of imports. As a result, the gain from the deceleration of the real growth of the ruble may be less significant than supposed.

The second direction reflects measures to lower inflation that make it possible to decelerate the real growth of the ruble when the ruble's exchange rate is fixed. This presupposes control not only over net domestic assets but also over increases in foreign reserves. In particular, the government should lower the rates for state short-term bonds and other securities in order to slow down the de-dollarization process and reduce the supply of foreign currency.

The draft of the monetary program developed by the Central Bank of Russia contains objectives pertaining to the growth of the money base and does not include individual restrictions on pure/net domestic assets Thus, the Central Bank will have greater freedom to maneuver in implementing an interest rate policy that is coordinated with objectives pertaining to the money base In particular, in order to stabilize the ruble's actual exchange rate, the Central Bank will have to even out changes in the demand for ruble assets using one or another form of control over money-market rates. While allowing internal assets to grow at certain times, the Central Bank will be able to effectively contain a speculative onslaught against the dollar without a significant growth of external reserves. (As shown by the experience of financial stabilization in 1995, the growth of external reserves may be very appreciable under the conditions of extremely tight self-constraints on the dynamics of net internal assets.) In the process of implementing a concrete vanant of monetary policy, it will be possible to choose an optimum combination of measures to control the money supply and manage interest rates.

Considenng the quite high level of inflation at the end of 1995, it appears that the Central Bank of the Russian Federation should try to raise the dollar's exchange rate to the upper value of the established corridor (4,900 rubles to the dollar). In 1996 a more rational policy would be either

to fix the dollar's exchange rate (with a one-time ruble devaluation of 5-10 percent) or to establish a "creeping" (downward) currency corridor that ensures the lowering of stimuli of rapid de-dollarization. At the same time, this policy, which is associated with the growth of external reserves, requires tightening control over net internal assets of the monetary authorities.

Forecasting the consequences of "nonmonetary" stabilization

The forecast of inflation for 1996 cited above is predicated on the assumption that there will be no serious changes in the structures of executive power (that the Chernomyrdin government will remain in power) Let us now try to forecast the dynamics of inflation in the event of more or less serious political change.

The strengthening of the positions of leftist and nationalistic parties as a result of elections to the State Duma may in itself have a substantial negative impact on economic policy And this at a time when the constitutional potential for the legislative branch to influence the executive branch is extremely limited But the presidential elections will be of decisive importance for Russia's economic policy for quite a long time to come.

Under a moderately negative political scenario (a "leftward shift" of the Duma while quite a cautious executive branch remains in office), our premise was that the government would strive to meet the reference points that were included in the draft state budget and the draft of the Basic Directions of Monetary Policy for 1996. However, within the framework of the given political scenario, it is possible that events will lead to the adoption of a less strict budget for 1996.

If we assume that the budget deficit will grow from 3.9 percent of the GDP to 5.9 percent of the GDP (by 2 percent of the GDP), which must be financed by internal borrowing, this will mean a serious change in macroeconomic policy. The fact is that additional internal borrowing at the level of 2 percent of the GDP (40–45 trillion rubles with a GDP of 2,100 trillion rubles according to budget projections), in our opinion, cannot be realized with the existing state-securities market. In the event such a decision is made, it will become necessary either for expenditures to be sequestered or for additional money to be issued by the Central Bank of the Russian Federation, for example, in the form of the purchase of state bonds in the open market.

Based on the experience of adopting and executing the tight 1995 budget, deputies will do everything possible to avoid the sequestration of budget expenditures (while approving them at a higher level than envisaged in the draft) Thus, the growth of the money supply in 1996 will not be 20-25 percent, but 60–65 percent, that is, about 4.2 percent a month. Therefore, in contrast to the preceding scenario we propose that in 1996, as a result of successful stabilization, there will not be a growth in the real demand for money. Consequently, according to our forecast, inflation in the coming year will be slightly more than 4.2 percent a month, or 63.5 percent for the entire year (see Figure 3).

This variant means the inevitability and feasibility of the systematic indexing of incomes and other nominal parameters in accordance with the rise of prices, which will mean a transition to permanent inflation with an annual rate of 80-100 percent. R. Dornbusch had already envisaged such a possibility in 1994 [8]

The thesis that prices and price policy are rigid in the short term serves as the theoretical substantiation of the high probability of permanent inflation. It was specifically this factor, which was vividly manifested in 1995, that diminished the effectiveness of monetarist stabilization methods that yield small returns in the short term In this case, stabilization requires strong political will. Otherwise, there will be permanent inflation with systematic income indexing.

Let us now examine another political scenario that presupposes the relative defeat of democratic forces in the elections to the State Duma and (more importantly) in the presidential elections. (All subsequent assessments naturally will be purely illustrative and their negative macroeconomic consequences may be viewed as minimally possible.)

As the basic variant of the development of political events, we shall assume that prior to the presidential elections, the current opposition will be unable to block stabilization. In other words, a budget variant for 1996 will be adopted that is close to the variant examined above with a deficit of 5.9 percent of the GDP and will be carried out as a so-called moderately tight monetary policy (the growth of M2 at the rate of 4.2 percent a month). However, after the elections, according to this scenario, the situation will change for the worse: the new procommunist and/or national-patriotic president will change the government and the Duma supporting him will begin passing laws that will radically alter economic policy. In order to illustrate the possible

consequences of such a change in economic policy, let us assume the implementation of only a few (in a minimum variant) decisions that are contained in the pre-election rhetoric of communist and national-patriotic leaders.

One of the top priority measures in the area of price policy will most likely be the freezing of prices for basic foods. Let us assume that fixed prices will be established for approximately one-third of goods in retail trade. Then, with average monthly inflation, which, according to the forecast based on these and the following assumption, will be 10 percent a month in the second half of 1996, the volume of subsidies necessary for keeping the level of prices stable will be about 25 trillion rubles.

The fixing of prices for products of the basic branches—the fuel and power industries—will evidently be the next solution of the price control problem. Communists will fight so-called cost-push inflation in this way. The requisite volume of budget subsidies will be about 22 trillion rubles.

In the area of currency policy, the introduction of a plurality of exchange rates together with their fixation will be most probable. Such a decision will inevitably necessitate the subsidization of the exchange rate for exporters. Twenty trillion rubles in subsidies will be required to stabilize the real exchange rate for exports and to keep the incomes of exporting enterprises at the level of summer 1996 Another 15 trillion rubles will be required to subsidize imports of food and equipment in order to maintain stable internal prices for them.

In addition to these measures, it is possible that defense spending will increase by a minimum of 1.5 percent of the GDP and that there will be an increase in spending on the national economy (basically for investments, for subsidies to unprofitable enterprises, and for agriculture) at 2 percent of the GDP. Naturally, the escalation of expenditures cannot be confined to the federal level. It will therefore also be necessary to take into account the increase in spending on aid to regional budgets at 1 percent of the GDP. As a result, the federal budget deficit will reach 11–12 percent of the GDP.

Within the framework of the new economic policy, it will hardly be possible to keep external and internal borrowing within the prescribed amounts, with the exception of Central Bank of the Russian Federation credits as sources of financing the deficit. The monetarized

part of the deficit for the second half of 1996 will therefore be about 275 trillion rubles, or 10–11 percent of the annual GDP (the estimated GDP is 2,600 trillion rubles), which means an increase in M2 money supply in the second half of the year by 110 percent (average monthly rate: 13 percent). For the year as a whole, the money supply will increase by 165 percent (average monthly rate: 8.5 percent).

Under these conditions inflation, according to calculations based on the model described above, will be about 80 percent in the second half of the year, which averages 10 percent a month—from 6.4 percent in July to 13.8 percent in December. For the year, however, inflation will be approximately 130 percent (see Figure 3). At the same time, we are assuming quite a sharp drop in the demand for money, which began in May, increased in summer-fall, and slowed down by winter 1996. During May-December 1996 as a whole the demand for real money will decline, according to our estimates, by approximately 30 percent.

We note that with the unlikely premise that the demand for money will stabilize at the 1995 level, according to our estimates prices will rise about 95 percent in 1996 (55 percent in the second half year). In this case, for a certain time the new government will reap the fruits of stabilization policy and increase expenditures still more while inflation is relatively low. Then, considering price inertia, the principal "surge" of inflation will be in 1997.

Notes

1. We should, however, define more precisely the groups of interests that are being discussed. Here, we may identify several criteria for classifying interests into such groups Groups that are based on different criteria in concrete economic life may intersect. First of all, we should identify economic agents (enterprises, firms, etc.) that may or may not be able (for various reasons) to adapt to a competitive market economy. Close to this critenon is the division of enterprises into those that do not require the creation of special, hothouse financial conditions (i.e., general financial stabilization is sufficient for their development) and those that cannot survive without being continuously fed preferential credits, budget subsidies, and so forth.

2. See, for example, V Pugachev and A. Pitelin, "Rossiiskaia infliatsiia: traktovka, modelirovanie, metody bor'by," *Voprosyekonomiki*, 1994, no. 11; B Granville, *The Success of Russian Economic Reforms* (London: The Royal Institute of International Affairs, 1995); and a block of articles on problems of inflation published in *Voprosy ekonomiki*, 1995, no. 3.

3. For more detail see *The Macroeconomics of Populism in Latin America*,

edited by R. Dombusch and S. Edwards (Chicago and London: The University of Chicago Press, 1991).

4. S. Fischer and O. Blanchard, *Lectures on Macroeconomics* (Cambridge, MA: MIT Press, 1990), pp. 388–401.

5. A. Dixit and J. Stiglitz, "Monopolistic Competition and Optimum Product Diversity," *American Economic Review* 67, no, 3 (June 1977): 297-308.

6. J. Taylor, "Aggregate Dynamics and Staggered Contracts," *Journal of Political Economy* 80, no. 1 (January 1980): 1-24; J. Fuhrer and J. Moore, "Inflation Persistence," *Quarterly Journal of Economics* 110, no. 1 (February 1995): 127-59.

7. Fischer and Blanchard, *Lectures on Macroeconomics*, p. 392.

8. R. Dombusch, "Ia investiroval v Rossiiu, chtoby imet' kusok ee budushchego uspekha," *Kommersant*, no. 48, December 20, 1994.