November 2004

Socio-Economic Transformations in the CIS: Prospects and Challenges

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Ladies and Gentlemen:

One cannot speak in Russia at this time without thinking of the tragedies that have befallen your country and people in recent weeks as a result of terrorism. I would like to express my sympathy and that of my organization, Citigroup, to the victims and their families, who have suffered so much, and to the Russian people who have to contend with such events.

I would like to start by saying how grateful I am for the Honorary Professorship I have just been awarded by the Academy of National Economy under the Russian Federation Government. It says a great deal about the changes in Russia in the last fifteen years that Ann Krueger and I have been chosen for these Honorary Professorships. It is an honor and a pleasure for me to become an Honorary Professor of the Academy of National Economy. It is a also a great pleasure to receive this award together with Ann Krueger, who was my predecessor as Chief Economist at the World Bank and my successor as First Deputy Managing Director of the IMF. And it is also a pleasure to be given the award by Yegor Gaidar, for whom I have such great respect, and by Vladimir Mau, whom I have known for well over a decade, and whose academic writings are of such enormous interest.

The subject of my lecture today will be "Economic lessons from the transition process". I will briefly describe the starting point of the transition process in the 25 transition countries of the former Soviet bloc, and then drew eight lessons of varying degrees of generality and depth about what we have learned from the transition process. I will then reflect on two political economy questions about reform that remain very difficult. And I will conclude with a few comments on the challenges confronting Russia's reforms at present. Since both Deputy Prime Minister Zhukov and Ann Kruger have already discussed the Russian reform process, I intend to be brief at that point – and I am sure you will appreciate that.

The transition process in the former Soviet bloc began somewhere between 1988 and 1992. You can if you want discuss whether Hungary started earlier, and whether there are not important

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* Citigroup. This is the text of a lecture delivered at the Academy of National Economy under the Russian Federation Government, in Moscow, September 13, 2004. Views expressed are those of the author, and not necessarily of Citigroup, Inc.

insights to be gained by studying attempts at economic reform in the Soviet Union as far back as 1962. But the fundamental fact is that market reform processes began in 25 transition countries at roughly the same time as the Soviet bloc began to dissolve.

As it became clearer that there would be a transition process, there was a great deal of thinking about what needed to be done. Much of that thinking took place in the Soviet Union itself, and later in Russia, where a large number of reform plans were put together, most famously the "Five hundred day" plan. The IMF together with the World Bank, the OECD and the EBRD undertook a major study on the Soviet economy and on the reform process towards the end of 1990.

There was not much experience on which to base the plans. Of course, you could study the Chinese reform process, maybe Hungary, maybe the USSR itself, but you did not have a precedent for reform on the scale that was about to take place. Part of the problem of not quite knowing what and how to think about the transition process was evidenced in the fact that so much of the advice took the form of metaphors, such as "You can make omelets out of eggs, but you cannot make eggs out of omelets" or "You can make fish-stew out of fish, but you cannot make fish out of fish-stew" and so forth. You could draw on what had been learned from structural adjustment programs elsewhere in the world, including in Latin America, but those were not system-wide reforms. And you could also draw on economic theory, which was a very valuable source of advice and guidelines to thinking.

Indeed, some of the simplest things in economics were the most valuable. Most notably, one of the most courageous acts of economic policy – though perhaps also one that was almost unavoidable – was the end of price controls in Russia in November 1990, a decision taken when Yegor Gaidar was Finance Minister. It took a great deal of courage and intellectual conviction to say: "We can do without these price controls, and allow the market to work". The economy was not working when the controls were taken off. It did not begin working for a few weeks after the controls were removed. And it was the middle of winter. But then before the end of January 1991 the markets did begin to work.

In this and other instances, very simple economic theory had a profound role in driving the reform process forward. One of my former MIT colleagues, Martin Weitzman,[1] used to say that economics is the field in which the frontier is closest to what you learn in the first course. The really important things you learn in the beginning are that supply curves slope up, demand curves slope down, and prices equilibrate markets. Then you study for seven years in order to

[1] Персональная страница - http://post.economics.harvard.edu/faculty/weitzman/weitzman.html

understand and believe what you learned in the first course. But beyond studying, you also have to see basic economics work – and it has worked in Russia and all over the transition economies.

What did we say in the transition economies and in the international institutions and in the academies of the West as we thought about the reform process? We said there are four essential elements:

- You need to create a stable macroeconomic framework;
- You need very rapidly to undertake price and trade reforms, reforms that can be implemented rapidly;
- You need as rapidly as possible to implement the structural reforms that will help create markets, including labor market reform, agricultural reform, financial sector reform, and privatization, even though completing these reforms may take a long time;
- And finally you need to develop the institutions that are necessary for the market system to work, the institutions that Ann Krueger mentioned: the legal system, the system of corporate governance, including the commercial code, modern accounting methods, and the governmental institutions that are necessary for the economy to operate efficiently, like a Central Bank and a Treasury

Now, all these things are easy to write. And they are easy to say. But they are very hard to do. Nonetheless, you needed to keep on saying these things again and again, because they are true, and because they set the overall framework in which to think about the reform process. When I reflect on what the IMF and other international institutions did in this period, I think that as much as anything, their key contribution was to stand consistently for a particular policy framework, for a particular view of what it is that enables an economy to operate in the interests of its people. The Fund stood firm at a time when so many others were seeking new ways, third ways and fourth ways for solving problems, ways that did not exist. And by standing by those principles, the Fund and the other institutions made a major and fundamental contribution to reform.

What have we learned? I will focus on eight lessons and two questions.

Lesson number one: the augmented Washington consensus works.

Lesson number one – a very big lesson – is that broadly the consensus about what needed to be done was correct. You can call it the Washington consensus though that is a very controversial term; more accurately it is the "Augmented Washington consensus". The approach is basically pro-market, and emphasizes the four key elements set out above. It also says that the more rapid

are structural reforms, the more rapidly the economy will grow. Of course, in practice there are many problems that need to be solved, and many variations that are possible, provided the basic orientation of policy is appropriate.

In one sense this lesson is reassuring, but in another sense it is disappointing. It is reassuring to know that things you believed turned out to be right; it is disappointing because you wish there was something really exciting and new and much easier that could be done to deal with the fundamental issues. Maybe one day we will discover alternatives to the market system that work much better. But in the meantime centuries of evidence and the evidence that emerges from the transition experience confirm the basic approach to growth and development that the textbooks set out.

Second lesson: policies need to be adapted to each country's circumstances.

The consensus is by no means a sufficient guide to policy. Because, *what actually needs to be done depends on the specifics of the situation in each country.* No one from outside can understand as well as the insiders what is possible to do at the particular moment and what is impossible to do at particular moments. It takes a political sensitivity and political sensibility to figure out what is possible. But that does not alter the fact that if you cannot make the changes quickly, you will pay a price. If – even for the best of political reasons – you cannot establish a stable macroeconomic framework, you will pay a price, as Russians know from 1998. One key lesson drawn from that period is summarized by what Leszek Balcerowicz said, in essence that when there is a policy opportunity to move in the right direction, you should take advantage of it.

Third lesson: integrating into the global economy is key.

Of all the elements of the consensus the most important guiding principle for reform, beyond the need to create markets, is that a policy guided by a desire to integrate into the global economy is essential for rapid growth. Even countries as big and as powerful as Russia do not do well on their own. Small countries absolutely can not do well on their own, because they cannot possibly develop all the industries that they need to become modernized. However even a country as large as Russia or Brazil or India or China needs to integrate into the global economy if it is to grow rapidly.

We have tended in the past to emphasize that countries need to expand their exports rapidly, and it is true that no country has developed rapidly without its exports growing fast. Some now say that the real need is to expand imports – particularly of capital goods and other inputs – rapidly and that that is why exports need to grow rapidly. Either way, countries that have grown fast have had both imports and exports expand at extremely high rates. .

Fourth lesson: the investment climate matters, particularly to encourage domestic investment.

Creating an investment climate that welcomes foreign direct investment is important. It is important because foreign direct investment itself brings foreign technology and foreign methods of doing business and foreign capital. But it even more important for another reason. The reason is that an investment climate that is good for foreign direct investment is good for domestic investors too. There is no country that has grown primarily through foreign investment. Domestic investment is always critical, it always accounts for most of investment, and the same factors that encourage domestic entrepreneurs to invest in their country and not to engage in capital flight will generate foreign direct investment.

Fifth lesson: inflation stabilization

Many lessons about inflation stabilization were learned in the 1990s, in the transition economies and elsewhere. Using a pegged exchange rate to disinflate is probably the most rapid way of disinflating from high inflation, but it is also very dangerous. Using a temporary peg to bring inflation down fast is fine. But – and this is the hard part – you have to be prepared to exit the pegged exchange rate before you are forced to exit.

I knew that in 1992, as I had studied the Israeli stabilization experience, and the experiences of Latin America. And by 1994 we had seen Poland exit successfully from its peg. But it turns out that the political economy of exiting a peg is much harder than I thought then. This is a simple political fact, which I used to think was interesting, and now understand is critical as well. The problem is that when the peg is easy to maintain, the policymakers say "Well, why should we exit this peg when things are going so well?" Then as pressure begins to mount and the exchange rate becomes overvalued, they say "Well, we cannot exit now, because that will create a mess". And then they wait, until they cannot hold the peg any longer, and are forced to exit, typically in great disorder.

Lesson five, from Russia and elsewhere, is to be cautious about using a pegged exchange rate to disinflate, and to be ready to make the exchange rate flexible well before a crisis becomes inevitable.

I would like to add a footnote to this discussion. We talk in macroeconomics about the "impossible trinity". This is not a theological doctrine: rather it is a theorem in international monetary economics, that a country cannot simultaneously have a pegged exchange rate, free capital movements and a monetary policy devoted to domestic policy goals. The argument is that if the exchange rate is pegged, monetary policy has to be devoted to maintaining the peg,

and cannot be used to attain domestic policy goals except to the extent they result from the exchange rate peg. Reflecting on the experience of the last decade, including that of Argentina, I believe that the "impossible trinity" is slightly misstated. It should be stated in the form, a country cannot have an independent *macroeconomic* policy together with a pegged exchange rate and free capital flows. That is because monetary policy may not be powerful enough by itself to maintain the exchange rate when it comes under pressure. Then the authorities will have to use both fiscal and monetary policies to defend the exchange rate in the presence of free capital movements.

Sixth lesson: flat taxes have worked better than had been expected.

The sixth lesson, about fiscal policy, originates in Russia. A flat tax at a low rate works much better then the consensus in western economics had believed it would. This is a lesson of potentially enormous interest and importance. It has been learned by several of Russia's neighbors, as the low flat tax rate movement is spreading from Russia to the other countries in the CIS and some in Eastern Europe as well.

Seventh lesson: private ownership.

Almost always, private ownership is more efficient than public ownership. To be sure, there are publicly owned companies that work well, such as Electricite de France. And to be sure, privatizing before an appropriate legal and regulatory framework is in place can be dangerous. But on average, and in the majority of cases, private ownership has turned out to be more efficient than public.

And the eighth lesson: financial sector reform.

Efficient financial markets really help. I believed this before I joined the financial sector, and you are probably not surprised to know that I believe that now too. But I do think the evidence and experience support this view as well.

So much for the major lessons. Now let me mention two critical economy puzzles.

First puzzle: program ownership.

We are used to saying in the international institutions, both in the World Bank and the IMF, that economic programs do not succeed unless they are "owned by the country". That means that the government should want to undertake the program and its reforms, and that there should be public backing for them.

A well-designed program is more likely to succeed if it has strong political support, within the government and from the public. But often a program starts with only partial backing. If it succeeds, it will gather the support of the government and the public. Sometimes, only some members of the government favor the program at the beginning, and it may not command widespread public support. Then, the international institutions will have to decide whether to support the program despite the lack of full ownership by the country.

They should back the program if they conclude that it will succeed, for if it succeeds, it is likely to become owned. To require of every program that it will command full ownership when it begins is to set too demanding a standard, one that makes reforms far less likely.

Second puzzle: When do countries reform?

It is often said that major reforms take place only in a crisis. That is a compelling hypothesis. But countries that appear to be in a crisis, often do not reform. The problem seems to be that the country does not yet feel the crisis deeply enough, even though it looks very serious to outsiders. Or to put it differently, it is hard to know what it takes to make a country accept that it is in a crisis so deep that it has no chance but to reform. In August 1998, Russia knew that it was in a deep crisis, and weak as the political system was at the time, the government was able to change policies and chart a new course that has served the country well.

Desperate as the Russian crisis was in 1998, it was probably less deep than the Argentine crisis in 2001 and later. Yet Argentina did not undertake a comprehensive set of reforms in the wake of its crisis. Clearly the difference owes much to the Russian president having remained in office with the power to change the government, whereas Argentina changed presidents several times within a few months of the crisis.

So part of the answer to the question of when a country reforms depends on the strength of the political system. But we still need to analyze further the question of what it is that determines when a country becomes willing and able to undertake comprehensive reforms.

Russian reform.

There is a famous saying of Adam Smith that “there is much ruin in a nation”. He said this when told that the loss of the American colonies would ruin the United Kingdom. He was right, and Britain managed to avoid ruin.

There is also a lot of reform in a nation. Economies will never reach nirvana, in which perfection has been attained and no structural policy changes are needed, for circumstances, the economic environment, and ideas, are always changing. So the reform process in Russia will not end. But even beyond that philosophical point, it is also true that the current reform process, the reforms that are needed to advance the transition process, is far from complete. There is an unfinished program of reform of which the Russian government is fully aware, and which was laid out in great detail by Deputy Prime Minister Zhukov.

Rather than discuss that reform program at length, I want only to make three comments.

One is that the program that was developed by Minister Gref and his colleagues in the first Putin administration, and its extensions by the government now, commands wide support from those who study the Russian economy and who wish Russia well. It should proceed.

Second, I take comfort from Deputy Prime Minister Zhukov's statement that Russia is well equipped to withstand a decline in oil prices should it come, because the government has been budgeting for a low price of oil, and has not spent the excess revenues that resulted from high oil prices. However government spending has been trending upwards, and that trend needs to be carefully watched.

Thirdly, I would like to say, as a very friendly outsider, that it is essential to draw a line under the Yukos crisis, and to begin a process of restoring investor confidence and improving the climate for long term investment. No matter what may be said by anyone, this crisis is having a profound impact on foreign investor confidence in Russia and in Russian corporate governance. This needs to be taken into account as the reform process continues.

Let me conclude by saying what a pleasure it is to be in this conference hall again, to be in Moscow again, and to be in Russia in this, the sixth year of rapid growth, with the prospect of rapid growth continuing. I would like to wish you and all the citizens of Russia continuing success as you move ahead in implementing economic reforms.

And finally, thank you again for granting me the distinction of becoming an Honorary Professor of the Academy.