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Inflation during Transition: Is Russia's Case Special?

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Since the start of radical reforms in Russia in 1992 there were three major attempts to ensure macroeconomic stabilization. The first one was made in early 1992 by Mr. Gaidar's government and was in fact part of the major shock-therapy reform package similar to the one implemented in Poland in early 1990. The government budget deficit in the first half of 1992 was reduced drastically, the growth of money supply lagged considerably behind price increases, and, as a result, inflation slowed down from 245% in January (immediately after deregulation of prices) to 38% in February and 10% in July-August 1992 (fig. 1).

By that time, however, enterprises were so much short of liquidity that they accumulated huge trade debts and the first non-payment crisis broke out. Faced with a difficult choice of pursuing fiscal and monetary restrictions designed to bring inflation further down or saving the national payment system from collapse, the government and the CBR have chosen the latter. Naturally inflation accelerated — by late 1992 it was running at over 20% a month and remained at this level until late 1993.

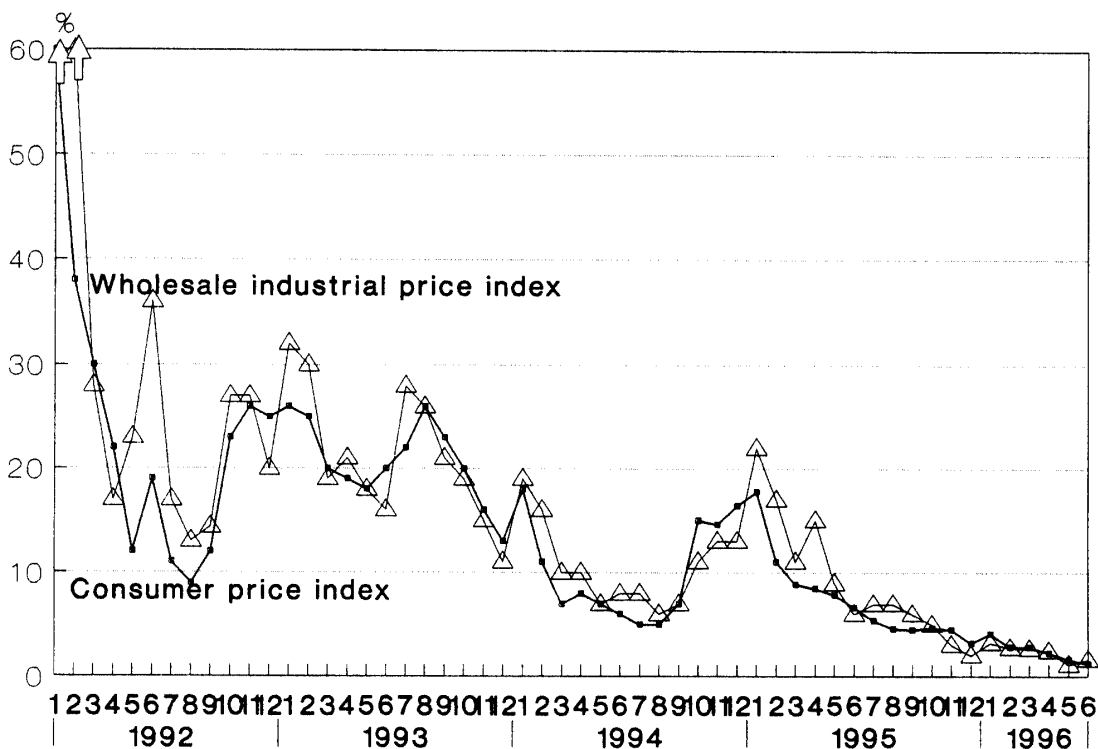


Fig. 1 Monthly inflation rates, %
Source: Goskomstat.

The second attempt to ensure macroeconomic stability was made in late 1993 and lasted until mid 1994. It was initiated by the radical reform-minded ministers in the government (Mr. Fedorov — the Finance Minister and Mr. Gaidar — the Minister of the Economy), but continued even after those reform-minded ministers left the government in January 1994 protesting against inflationary policy and stating that they do not see any chances for macroeconomic stabilization. Nevertheless, the centrist Chernomyrdin government and the Central Bank of Russia (CBR) headed by the gradualist-minded Mr. Geraschenko managed to bring down inflation to 5% a month in July-August 1994 — the best record ever since the beginning of reforms (fig. 1).

Unfortunately the 1992 scenario was then reproduced almost entirely in 1994: enterprises only partially responded to the monetary restrictions by cutting the rates of price increases, whereas the bulk of the adjustment again took the form of the accumulation of trade arrears. Once again the authorities decided to sacrifice macroeconomic stability for the sake of preserving the payment system, which, they thought, was on the verge of a break down: the growth of money supply accelerated, the exchange rate of the ruble collapsed in October 1994 (depreciating by nearly 25% on just one day), and inflation increased to 18% in January 1995 (fig. 1).

Finally, in 1995 the government and the CBR, working in close contact, undertook the third attempt to bring down inflation through combining the restrictive monetary policy with introducing the sort of a crawling peg for the ruble from mid year 1995. While this third attempt is discussed later in the paper and at the time of writing it looks like it has good chances to succeed, the question, why it took so long to bring Russian inflation to a halt, still persists.

Russia's (and CIS) macroeconomic situation was thus very different from both — that of East European countries and Baltic states, pursuing shock-therapy policy, on the one hand, and that of China, pursuing gradual transition strategy, on the other hand. Unlike Russia and CIS countries, other economies in transition generally managed to keep inflation under control.

Poland, the first country that introduced a shock therapy package by deregulating prices, making the national currency convertible, and adopting fiscal and monetary restraints in 1990, the next year, in 1991, managed to bring down inflation to 70% and further down to about 20% in 1995. Other East European countries that introduced shock therapy packages in 1991 reduced inflation to 10 to 30% annually in subsequent years. The Baltic states were the last ones to adopt shock therapy treatment in 1992-93 after becoming independent and introducing their own currencies: in 1994-95 their inflation rates dropped to 25-45% a year (table 1).

In contrast CIS, and some Balkan countries followed less consistent macroeconomic strategies with the result that their inflation rates remained high during transition. It was not until 1995 that Bulgaria and Romania managed to bring down inflation to below 50% a year, whereas the CIS states were only approaching this threshold in 1996.

The purpose of this paper is to discuss the reasons of high inflation in Russia, as well as possible strategies to deal with it. The crucial issue under consideration is whether Russian (CIS) case is unique, i.e. whether there are some objective circumstances that prevented quick macroeconomic stabilization achieved in other countries

Table 1. Inflation in the economies in transition, %

Years	Inflation (CPI), %					
	1990	1991	1992	1993	1994	1995*
<i>Countries pursuing consistent shock-therapy</i>						
Poland	586	70	43	35	31	21
Hungary	29	34	23	22	21	29
Czech Republic	10	46	8	21	10	9
Slovakia	16	62	13	20	12	8
Slovenia	105	247	93	23	18	9
Estonia	17	211	1,069	89	42	25
Latvia	11	124	951	109	26	28
Lithuania	8	225	1,020	410	45	40
<i>Countries pursuing inconsistent shock-therapy</i>						
Romania	4	161	210	256	62	24
Bulgaria	22	334	82	73	122	40
Belarus	5	84	969	1,188	2,530	710
Kazakhstan	4	147	2,568	2,147	2,370	180
Ukraine	4	91	1,445	4,928	350	180
RUSSIA	6	93	1,353	895	215	131
Kyrgyzstan	3	85	855	1,209	670	152
<i>Countries pursuing gradual reforms</i>						
Turkmenistan	5	102	493	1,860	3,520	500
Uzbekistan	7	105	528	761	2,040	316

*Estimate.

Source: For 1990-93 — World Bank (annual inflation), for 1994-95 — PlanEcon, national statistical sources, and press reports (December to December inflation).

or high inflation during transition was the result of pure mismanagement on the part of fiscal and monetary authorities. Recent Russian experience with the exchange rate corridor and its implications for the macroeconomic stabilization and long term growth are also analyzed. Conclusions are drawn at the end of the paper.

Origins of Russian Inflation: Shock Therapists Versus Gradualists

There are two competing explanations for high inflation in Russia¹. One is offered by shock therapists and is based on viewing inflation as a predominantly monetary phenomena, which should be dealt with accordingly, i.e. through cutting the rates of growth of money supply (Illarionov <a>). Former Western advisers to the Russian government — Jeffrey Sachs and Andreas Aslund — have long been suggesting to peg the exchange rate of the ruble to use it as a nominal anchor that would force the CBR to restrict the growth rates of monetary aggregates and would force the

government to cut the deficit (Sachs, Aslund). This monetarist approach is generally supported by IMF, while in Russia it is held by radical democrats, such as Yegor Gaidar and Boris Fedorov (Fedorov).

The advocates of such an approach believe that there is a negative relationship between inflation and economic growth. According to the Moscow-based Institute of the Economic Analysis, macroeconomic stabilization implies that inflation should be brought down to below 40% a year (2.8% a month): this is an empirically determined threshold, if inflation is higher, it leads to the reduction of output and thus deepens the recession (Illarionov).

The other (structuralist) approach is taken by some Western scholars, by most of Russian academic economists and many politicians — from “soft” democratic opposition to communists. They state that Russian inflation is mostly cost-push, not demand pull, that it is not yet in economic textbooks, but soon will be, that it is caused by structural factors of imperfect competition, such as monopoly pricing, barriers to competition and to flow of resources between industries and regions (McKinnon, Sapir, Sato). They feel that the efficacy of the conventional anti-inflationary policy is quite limited because enterprises in economies in transition are not capable of responding in the desired manner to monetary policies, that monetary restrictions may lead only to the reduction of output and new non-payment crisis (accumulation of trade arrears by enterprises), while having only marginal impact on inflation.

The joint report of the Economic Department of the Russian Academy of Sciences and the International Reform Foundation — the so-called report of three academicians — argued that “the failure of attempts to fight inflation should be explained by the inability to understand its origins in the Russian economy (understatement of monopolistic structures, cost-push factors, etc.) and by the choice of non-adequate, purely monetary means to bring it down through demand restrictions” (Shatalin et al.).²

An econometric study of the Institute of Economic Forecasting claimed that cost-push factors may explain in 1993 about 70 to 80 percent of total wholesale price increases, while monetary factors account for only 10 to 15 percent, and inflationary expectations — only for 10 to 20 percent (Belousov et al.).³ Grigory Yavlinsky — the leader of the democratic opposition *Yabloko* group — argued recently that 8-9% monthly inflation (150-180% a year) is predetermined by structural and institutional factors, and that monetary restrictions pushing inflation below this threshold become inefficient in a sense that they lead mostly to the increase in non-payments and to the reductions of output (Yavlinsky).⁴

Overall, it seems like the monetarist arguments are far more persuasive in the debates on the nature of Russian inflation (demand pull or cost push). *First*, the experience of East European countries and Baltic states, most of which managed to reduce inflation to 20-30% a year and now enjoy economic recovery, is quite meaningful: it suggests that Russia and other CIS countries can do this as well. There is nothing special in terms of inflexibility of prices and wages that makes Russia different from East European and Baltic countries. On the contrary, though Russian enterprises are larger on average than in other countries, monopolization of the Russian market may be in fact less pronounced due to its larger size. Anyway,

foreign trade deregulation and convertibility of national currencies proved out to be efficient instruments of fighting monopolistic pressure on prices in all economies in transition. As far as the trade unions are concerned, they are currently pretty weak in Russia as compared to their counterparts in Eastern Europe, and do not seem to be in a position to generate wage driven inflation (the strike rate in Russia is also rather low).

Second, while there is an obvious correlation between the rates of growth of money supply and the rates of inflation (with the lag of 3-4 months), rates of change in output do not seem to be correlated with the fluctuations of money supply (fig. 2). Numerous regressions that were run to check the links between money supply, prices, output, and interest rates have in all cases yielded the same results: prices did, but output did not follow changes in money supply (see, for instance, Koen and Marrese).⁵ In the second half of 1995 Russian inflation was brought down to 4-5% a month and in early 1996-to below 3% a month without any significant decrease of industrial output, to mention the most recent obvious example.

Finally, *third*, there is a theoretical argument that inflation running at over several dozen percent a year can not be caused by the cost-push factors alone, without demand pull support. In a sense, inflation exceeding 30-40% a year may be only monetary in nature. Provided there are no extraordinary circumstances, it is rather difficult to imagine, what kind of structural and institutional rigidities may cause prices to increase several times a year.

The debate on whether the monetary restrictions are excessive or not is understandable in East European countries, where inflation is running at a rate of 10-30% a year and may be close to the lower limit of cost-push inflation fueled by

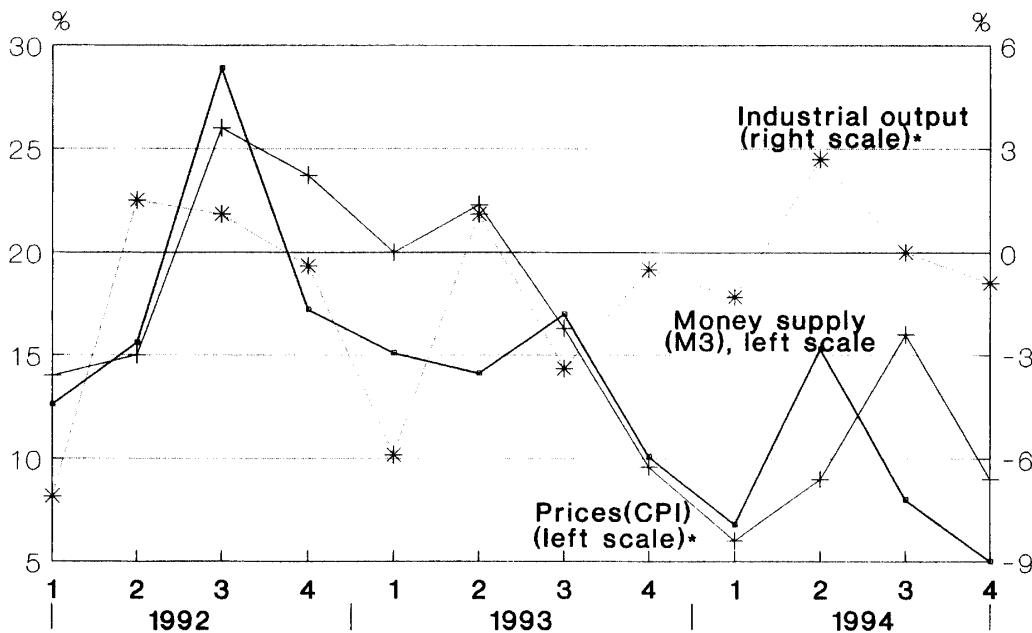


Fig. 2 Average monthly growth rates of money supply, prices, and industrial output, by quarters, %

* /Lagged 4 months.

Source: Computed from Goskomstat data.

imperfect competition in emerging markets. Not so in Russia, where inflation until recently was running at a rate of over a hundred percent a year.

At the same time conventional monetarist approach in fact leaves the question about high Russian inflation without a reasonable answer. High inflation is explained by pure mismanagement and irresponsibility of the government and the central bank (or by the wrong perceptions of the electorate that fails to elect a better government). This is not completely persuasive provided that high inflation continued for years in quite a number of countries. If there is an alternative explanation, it should be related to specifically Russian factors, to differences between Russian (CIS) and East European model of transformation.

Why Russia Failed to Bring Down Inflation

Overall, it looks like there are some macro-and microeconomic obstacles for bringing down high Russian inflation that do not exist in East European countries and China.

The first one is the lack of consensus in the Russian society on the issue of financing the costs of economic reforms. While the Chinese government was able to impose such a consensus “from above” using authoritarian methods, and in East European countries this consensus was built “from below” leading to the emergence of relatively strong democratic governments, in Russia weak democratic government was not able to withstand the pressure of interest groups (complexes, as they are called in Russia — fuel and energy complex, military industrial complex, and agro-industrial complex⁶), of regions, and of political parties; it did not have the power to bring its expenditure in line with the revenues. Simplifying things, there was always a feeling that if the Central Bank will peg the exchange rate, depriving the government of credits to finance its deficit, the day after either the government or the exchange rate will have to fall.

The other macroeconomic reason is the unique magnitude of the second (shadow) economy in Russia and the resulting inability of the government to raise tax revenues. Usually economists believe that there is a choice between high inflation and high taxes (with higher taxes it is possible to reduce the deficit and the financial requirements of the government). In Russia it may not be the case. While Russian tax rates are high as compared to other countries, its tax revenues are very low (fig. 3) because the shadow economy expanded dramatically in recent years. Estimates based on the share of cash in total operations of Russian businesses put the size of the shadow economy as high as 1/3 of total GDP (whereas in the late 1980s only 2% of total cash was held by enterprises, in 1994 it was about 40%, and cash operations are mostly not reported for tax purposes).

As data in table 2 suggest, tax revenues as a proportion of GDP decreased markedly in all East European countries during transition; even so, their level in Russia is currently among the lowest. Chinese government revenues as a percentage of GDP are even lower (and decreased considerably during transition as well), but it looks more like a conscious policy choice rather than a spontaneous process (authoritarian regimes have always better powers to collect tax revenues, if they choose to do so, as did all

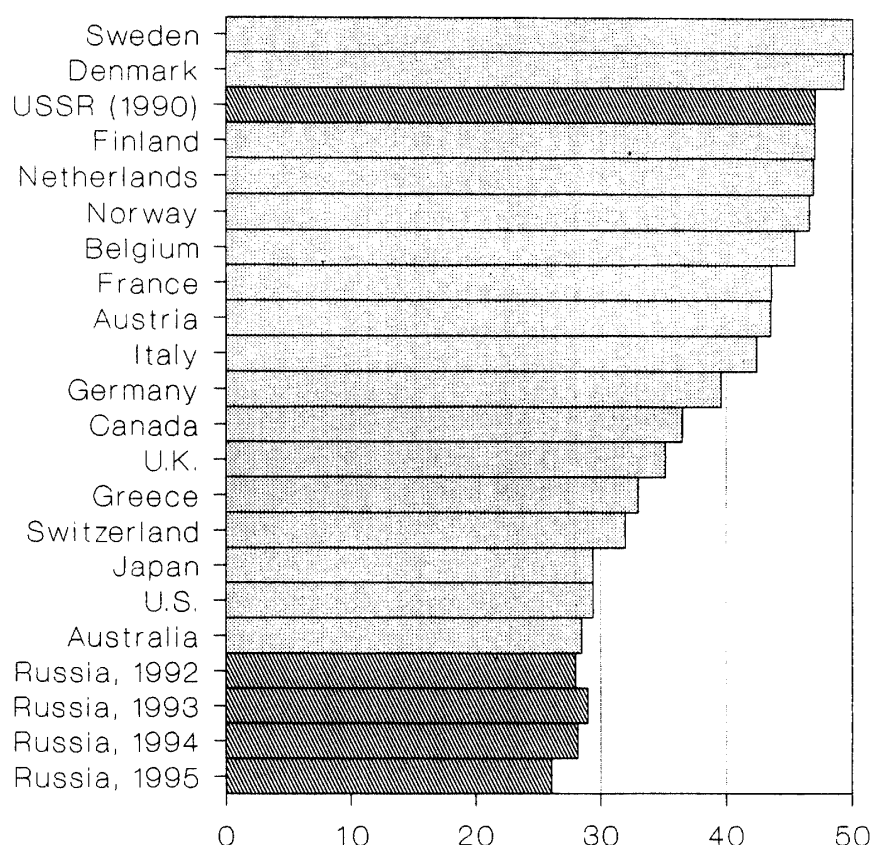


Fig. 3 Government budget revenues, as a % of GDP, 1992* / * /USSR and Russia -without social security contributions (in 1993 and 1994 such contributions amounted to 7.5% of GDP). Source: OECD; Goskomstat.

Table 2. Total revenues of consolidated government budgets as a % of GDP in some economies in transition

Year/Country	1988	1989	1990	1991	1992	1993	1994
Hungary	62.0	59.2	57.6	56.0	57.7	54.0	
Czech Republic						49.8	
Slovak Republic	65.6	69.5	61.2	55.1	56.5	48.0	
Poland	48.0	41.5	43.0	41.5	44.0	45.5	
USSR (1988-90)/ RUSSIA (1992-94)*	43.3	43.5	47.2		28.0	29.0	28.2
Romania	44.9	51.5	40.5	41.0	37.6	30.9	
Bulgaria	57.5	58.0	53.3	42.3	37.0	30.6	
Albania	53.2	48.2	46.8	31.4	25.2	28.5	

*Excluding revenues of the off-budget social insurance funds. If these revenues are included, total government revenues amounted to about 36% in 1993 and 1994. Source: Economic Systems, Vol. 19, No. 2, June 1995, p. 103; Goskomstat.

governments in the CPE's before the transition).

The whole system of public finance has undergone the profound change during

transition. While on the expenditure side there was a dramatic decrease in price subsidies, government financed investment and defence expenditure, on the revenue side there occurred an even more dramatic decrease associated with the complete elimination of turnover taxes and special foreign trade earnings (only partly compensated by newly introduced in 1992 value added and export taxes). As shown in (Tabata), the present economic flow is characterized by the weak role of state in income redistribution and by the concentration of profits, previously appropriated by the state in the form of foreign trade earnings, in specific industries (fuel, other mining industries, and *chelnok*).

Provided that the Russian government is not able — at least in the short run — to cut drastically the financing of health care and education, which are still provided mostly free of charge, and that defense expenditure, despite substantial cuts in recent years, are still very high (about 5% of GDP, according to official estimates — much higher than in East European countries), it may be impossible to fight the deficit in the nearest years.

The microeconomic obstacle for putting inflation under control is associated with the specific reaction of Russian enterprises to demand restrictions. Unlike their East European counterparts that responded to tightening of the monetary policy by holding down prices and cutting employment in an attempt to reduce costs, Russian enterprises were reluctant to slow down price increases and to fire employees. Instead, they accumulated trade arrears stopping payments to their suppliers, payments of wages and salaries to workers, payments of taxes to the government, and payments to reimburse bank credits.

While there was no correlation between changes in money supply and the dynamics of output, the accumulation of the trade arrears, however, definitely depended on monetary policy — two non-payment crises in Russian economy (summer 1992 and summer 1994) were caused by the tightening of money supply and the slowdown of inflation, and there was an increase in non-payments in 1995-96, when restrictionary monetary policy was pursued. In late 1995-early 1996, though, unlike the non-payments crises of summer 1992 and 1994, when trade arrears of enterprises to each other increased greatly, trade arrears were pretty stable, but arrears in paying taxes to the government grew substantially (fig. 4).

Monetarist explanation of this non-payment crisis is straight forward: trade arrears, they say, is not the problem of the government or the CBR; if the latter were more consistent, avoiding giving signs that enterprises may be bailed out, trade arrears would have been sorted out by entrepreneurs themselves through courts, pre-payments schemes for unreliable customers, etc. This was the general approach adopted by Poland, Czechoslovakia, and Baltic states, which so far appears to be successful (Lahiri and Citrin).

There is also an argument that if bankruptcies were common in Russia, non-payment crisis would have never become as severe as it did. However, in East European countries bankruptcies were by no means common during the transition period, but the non-payment crisis was never as acute as in Russia. The ratio of interenterprise arrears to broad money supply (over 50% during the peaks of non-payment crises in mid 1992 and mid 1994) was over 2 times higher than in Czech

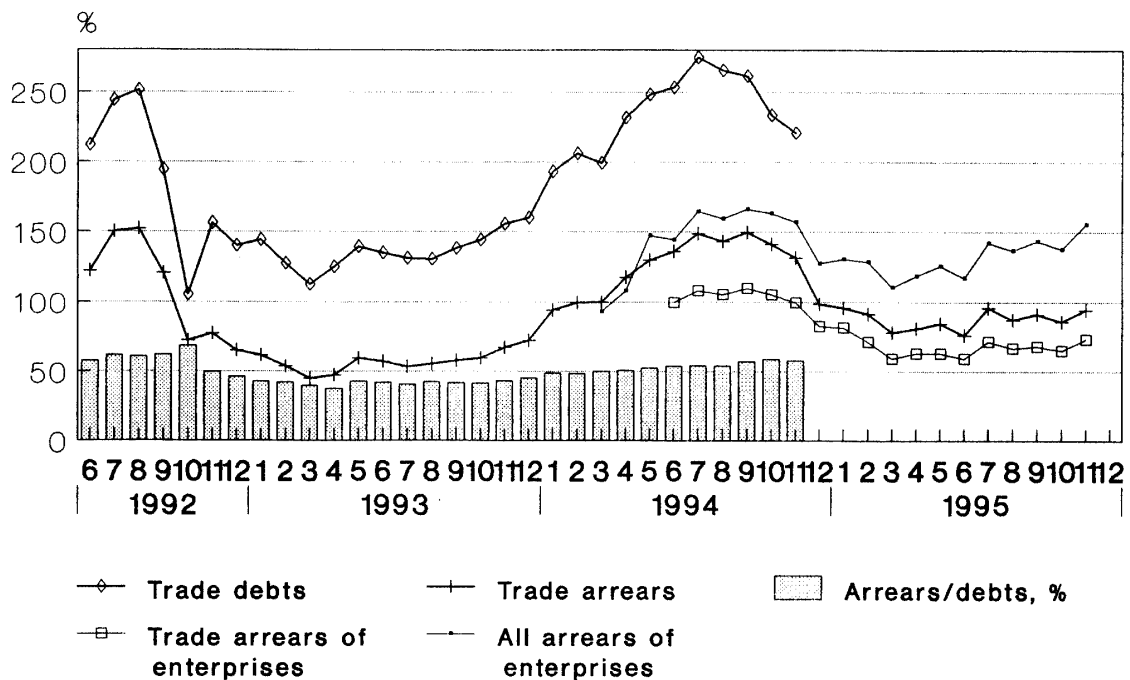


Fig. 4 Trade debts and trade arrears to industrial enterprises, as a % of monthly industrial output

Source: Calculated from Goskomstat data.

Republic in 1991; Poland’s ratio in 1990–91 was about the same as in Russia, but it did not increase as rapidly as it did in Russia after deregulation of prices.⁷

It is more likely that the trade arrears are associated with bribery and specific Russian entrepreneurial culture: managers often “close their eyes” on bad debts of their partners due to bribes or special favors that were received in the past or may be received in future.

Whatever the reasons for the non-payments are, they do not allow the government and the CBR to press enterprises heavily through the demand restrictions. There is always a danger that the payment system will collapse and the economy will degrade to a primitive barter exchange, which would be even worse than high inflation.

The practical implication of this analysis of obstacles to fight Russian inflation is perhaps the understanding that there may be no quick fix for the problem and that the gradual strategy (step by step consistent reduction of the money supply growth rates in several years) rather than short-term campaigns designed to bring inflation to an end in several months may be, if not the best, than the only feasible solution.

After two unsuccessful attempts to introduce a conventional shock therapy stabilization package (first half of 1992 and first half of 1994) it seems like the government and the CBR adopted a more promising step by step approach in late 1994. From that time on both — the government budget deficit and the rates of monetary expansion — were reduced rather steadily, which resulted in the constant decrease of monthly inflation rate from 18% in January to 3% in December 1995 (fig. 1). From July 1, 1995 the government and the CBR even introduced sort of the crawling peg — a corridor for the exchange rate of 4300–4900 rubles per \$1 for the second half of 1995, which was then changed to 4550–5150R per \$1 for the first half of 1996, and replaced

by a sliding scale for the second half of 1996 (from 5000 to 5600R in mid year to 5500 to 6100R by the end of the year).

Exchange Rate Policy

1995 and 1996 ruble stability looks pretty impressive, if one recalls that the ruble devaluated greatly in recent years — it was traded at about 200R per \$1 in January 1992, when Mr. Gaidar started radical market-type reforms. It is even more impressive, if one takes in to account that consumer prices grew by over 2 times from December 1994 to December 1995.

Whether the stability of the ruble will continue depends mostly on inflation. By the beginning of 1996 Russian domestic prices have increased to a level of about 70% of the U.S. prices, whereas a year before they were just about 40% of that in the U.S. (fig. 5). To put in differently, the purchasing power parity (PPP) exchange rate of the ruble last year was rapidly approaching the actual exchange rate because the latter was rather stable, while Russian prices grew much more rapidly than the U.S. prices.

It is highly doubtful that the CBR can prevent the depreciation of the ruble, if Russian prices will reach the U.S. (world) level. In all economies in transition (in fact, in most less developed economies) the national currency is usually undervalued as compared to PPP (table 3) due to several reasons.⁸

First, prices of non-tradables (housing, transportation, etc.) are usually lower in those countries — partly because they are often controlled by the state, partly because world demand for those goods is concentrated in developed countries, which are better places for business and living. As a result, even if domestic prices for tradables are in line with the world prices, the national currency is underpriced as compared to PPP, which is calculated including non-tradables.

Second, most less developed countries, including economies in transition, are usually heavily indebted and need to earn hard currency through foreign trade in order to service their debts. Thus, there is a downward pressure on the exchange rate which has to be low to stimulate exports and limit imports, so that there is a trade surplus that may be used to finance debt service payments.

And finally, *third*, there is capital flight from most of these countries (especially important in the case of Russia), which should also be financed through positive trade balance, which pushes the actual exchange rate even lower.

All in all, even if one takes into account only tradable goods, the exchange rate in emerging market economies, Russia included, in the long and medium term should be undervalued to allow the country to earn a trade surplus needed to finance debt service payments and capital flight.

It is also important to create stimulus for export-oriented industries, which in those countries (definitely — in case of Russia) become locomotives of economic growth. If the exchange rate policy is not favorable for those industries, the whole growth strategy may be put into question. Russian export oriented industries (fuel energy, steel, non-ferrous metals and diamonds account for over 3/4 of total Russian exports) managed to increase their sales abroad in 1993-95, but are still unable to increase investment. That is to say, Russian economic recovery, which was expected

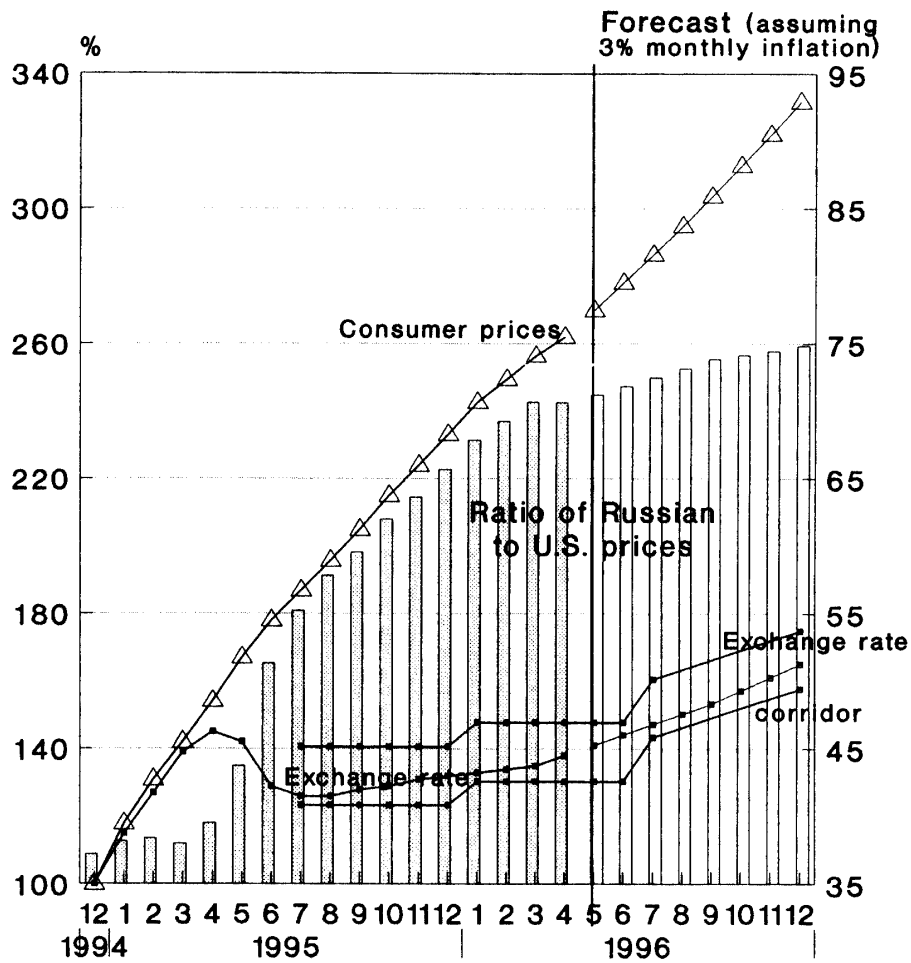


Fig. 5 Consumer prices, exchange rate of the dollar (Dec. 1994= 100%, left scale), and the ratio of Russian to U.S. prices (% , bars, right scale)

Source: Goskomstat.

Table 3. Ratio of the actual exchange rate to the PPP rate of the dollar for selected economies in transition (range of monthly averages)

Country/Year	1990	1991	1992	1993	1994	1995*
Slovenia	0.9-1.4	1.0-1.7	1.4-1.6	1.4-1.6	1.3-1.6	1.1-1.3
Hungary	1.9-2.4	1.9-2.0	1.7-1.8	1.6-1.8	1.6-1.8	1.5-1.6
Poland	2.1-3.9	1.6-1.9	1.8-2.0	1.8-2.0	1.7-1.9	1.5-1.7
Czech Republic	2.5-3.8	3.5-3.1	2.7-3.1	2.5-2.6	2.2-2.5	1.9-2.2
Slovak Republic	2.9-3.9	3.0-3.6	2.9-3.0	2.6-2.8	2.4-2.7	2.2-2.3
Romania	1.8-2.6	1.6-5.0	2.8-4.2	2.2-3.1	2.1-2.6	2.1-2.2
Bulgaria	3.3-5.1	2.9-10.9	3.0-4.7	2.3-2.8	2.3-3.1	2.2-2.0
RUSSIA	—	33.0-131.0	10.2-45.7	4.0-12.0	3.5-4.1	2.3-3.5

*1st half of the year.

Source: PlanEcon.

to materialize in 1996, is still based on a shaky foundation.

If Russian prices continue to grow at a monthly rate of 3%, by the end of 1996, provided the exchange rate would remain within the earrier, they would closely approach the level of world prices. This may limit Russian exports, boost imports, put an end to the considerable trade surplus that Russia enjoys at a moment, and draw the ruble down.

Will the CBR and the government manage to hold down inflation? True, last year there was a remarkable progress in bringing down inflation: it was reduced to 4-5% a month in the second half of the year, while by summer 1996 it fell to below 2% — a best record ever since the beginning of reforms in January 1992). Also true, by now there is a well functioning market for short-term government securities, which allows to finance the deficit in a non-inflationary way. Besides, in 1995 the government managed to collect over \$1 billion through mortgaging the shares of major state-owned companies to commercial banks and it may well be that this source of revenues would be available in 1996.

Nevertheless, the obstacles for fighting inflation are by no means insignificant. The government revenue base is still weak (about 30% of GDP); there is not much room for manoeuvre in cutting the government expenditure — after the cuts that have been already made in the course of recent 3 years; the non-payments situation, as it usually happened in times of monetary restrictions and declining inflation, deteriorated again considerably in the first half of 1995. Finally, though the budget for 1996 have been already approved by the old parliament before December 1995 parliamentary elections, the new parliament, dominated by communists and nationalists (40% and 12% of the seats in the Duma respectively) is definitely more spending oriented and may pass pieces of legislation that will make it difficult for the government to cut the deficit.

It may be argued that, even if inflation would be relatively high, there are also some possibilities to prevent the scissors between prices and the exchange rate from closing in the short term.

First, major Russian exporters (gas and oil) may be not that sensitive to the exchange rate because they pay an export tax, which may be decreased/abolished in order to boost exports in times when exchange rate is unfavorable. However, this is exactly what the government have been doing recently: it scrapped all export duties for most oil products and all processed forest products from December 1, 1995, halved most other tariffs from April 1, 1996; and eliminated them completely from July 1, 1996. Hence, there is not much room left for manoeuvre. For exporters in manufacturing things are even worse: there are no export tariffs for those goods, yet their exports because of the highly priced ruble is already unprofitable.

Second, prices for Russian gas and oil which were sold at a discount to CIS countries may be increased. But these prices are already approaching world levels (about 70% in 1995); besides, exports to near abroad, after it decreased dramatically in 1992-95, is now not that significant (\$13 billion or about 17% of the total exports in 1995).

Third, the CBR may use its foreign exchange reserves to support the ruble. By the end of 1995 these reserves stood at \$15 billion dollars, whereas the highest weekly

trading volume ever registered at MICEX — the major Russian foreign exchange — was \$1.2 billion (August 1994), and in December 1995 weekly trading volumes were normally under \$0.2 billion. That is to say, theoretically the CBR even under high demand for hard currency may probably keep the ruble from falling for over 2 months. It is unlikely, however, that the CBR will be willing to do this: if high demand for hard currency will force the CBR to loose several billion dollars in one or two weeks, the boundaries of the exchange rate corridor would be probably changed to allow a devaluation of the ruble.

In 1995 Russia was different from Mexico in that there was no significant private foreign investment that could leave the country overnight and create a tremendous downward pressure on a national currency. However, foreign investment into ruble denominated government treasury bills were recently allowed by authorities and quickly increased to some \$2 billion legally and an estimated \$3 billion illegally (through Russian intermediaries) by mid 1996. Foreign investment into those securities are definitely desirable to lower abnormally high domestic interest rates that hinder investment, but they create additional source of uncertainty with respect to the ability of the CBR to maintain the exchange rate of the ruble.

To sum up, it seems like the possibilities for maintaining the gap between price increases and the exchange rate that existed in 1995 were mostly depleted in 1996. Besides, it is doubtful that the strong ruble policy is an appropriate device to fight inflation. The desirability of the strong ruble policy is highly questionable because it puts pressure on the export sector and increases foreign debt forcing Russia to maintain high interest rates to slow down the capital flight at a time when exactly the opposite is needed.

Economists and policy makers tend to disagree on what kind of exchange rate policy is best for economies in transition. While some stress the importance of maintaining the stable nominal exchange rate by fixing it and using as a nominal anchor to fight inflation, others claim that real exchange rates are supposed to be kept stable (which implies constant devaluations if inflation is higher than elsewhere)— so as to ensure that the actual rate is substantially below PPP rate in order to stimulate export and growth (Hosino et al.). Czech Republic, Estonia, Latvia, Mongolia tried to keep stable the nominal exchange rate despite the continuation of rather high inflation, thus allowing the real exchange rate to appreciate. In contrast, in Poland, Romania, Slovakia, Slovenia, Croatia, Ukraine and Belarus the real exchange rate was more or less stable in 1991-94 while the nominal exchange rate depreciated considerably. Each approach has its own advantages: while the first one may prove to be useful for fighting high inflation quickly (wherever it is possible) at the initial stages of macroeconomic stabilization, the second one may be better suited for overcoming transformational recession and promoting economic recovery by facilitating the transfer of resources from domestic demand to exports, which is the pressing need in all economies in transition (Sato).

There is a difference between stable and strong currency: whereas the former is highly desirable for all countries, the latter may prove to be an unaffordable luxury for economies in transition, like Russia, trying to overcome the transformational recession. It may well be therefore that the CBR and the government were right to

established a sort of a crawling peg for the ruble, but were wrong in choosing to peg it at a pretty high level.

By pegging the ruble at a lower rate and continuing to build up foreign exchange reserves, the CBR could have killed more than two birds with one stone: Russian exports and trade surplus would increase, domestic interest rates would fall, there would be additional stimulus for the dedollarization of the Russian economy and for the inflow of foreign direct investment. Weaker ruble, to put differently, may be a device that would allow to maintain higher savings rate without high interest rates, to create additional stimulus for productions, investment and exports, while limiting consumption and imports.

Though personal savings rate was high in Russia in recent years, the ruble savings rate (i.e. the proportion of personal disposable income — PDI — invested into ruble cash, ruble bank accounts and other ruble denominated financial assets) declined from about 20% in 1992 to 9% in 1995, while investment in hard currency (capital flight) as a percentage of PDI increased from 1 to 10% (fig. 6). In late 1995 Russian citizens and businesses, according to EBRD estimates, were holding some \$43 billion in foreign currency, mostly U.S. dollars (\$10 billion — in domestic bank accounts, \$15 billion in cash and another \$18 billions in accounts outside Russia)⁹, which was equivalent to over 10% of Russian \$350 billion 1995 GDP at actual exchange rate. Despite the stability of the ruble in 1995 and much higher ruble interest rates (as compared to dollar interest rates), there was no noticeable decrease in purchases of hard currency (fig. 6). While low ruble policy may not immediately cause the reduction of purchases of hard currency, it may at least make it easier for CBR to limit the growth of ruble money supply through making the capital flight more expensive (as more rubles will be needed to buy hard currency).

There is a perception that the undervalued exchange rate may fuel inflation. The conventional shock-therapy approach to macroeconomic stabilization even recommends to use the pegged exchange rate as a nominal anchor while pursuing an anti-inflationary policy. There is certainly a reason in such an argument: high ruble by increasing import competition helps to hold down inflation — in fact this was the case in Russia in the second half of 1995. However, with an appropriate monetary policy (at least partial sterilization of increases in the money supply caused by foreign exchange reserves build up) the inflationary pressure may be dealt with, as proven by the example of many emerging market economies. Exchange rate is far too important to use it only for fighting inflation. Even more so, that Russia currently seems to be pretty close to achieving macroeconomic stability and looks forward to economic growth.

Conclusions

1. Recent Russian inflation is mostly of demand pull, not cost push origin. The arguments that structural and institutional barriers in the economies in transition with imperfect markets may cause cost-push inflation of over 100% a year do not hold neither theoretically, nor empirically.

2. Despite the predominantly monetary origin of the Russian inflation, there are,

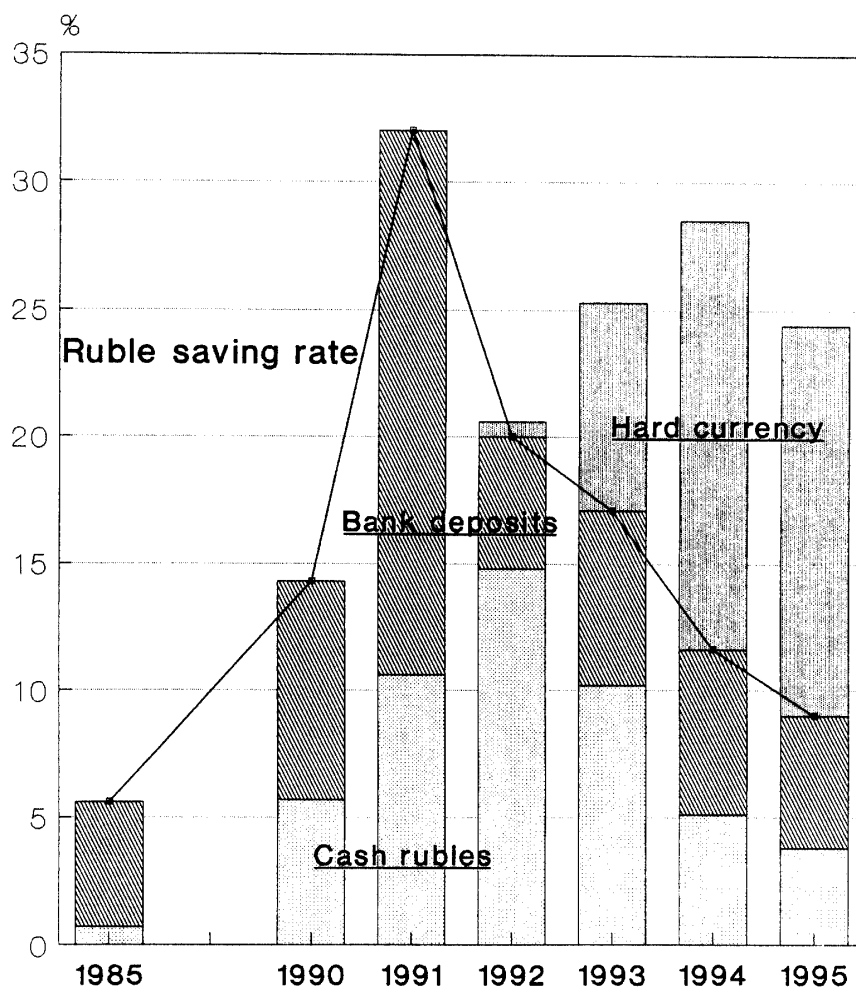


Fig. 6 Personal savings, as a % of personal disposable income
Source: Goskomstat.

nevertheless, some objective factors that explain why it was more difficult to bring down inflation in Russia and other CIS countries than in East European and Baltic states. Russian economy seems to be different at least in several respects: it is more difficult to work out a consensus on how to cut the budget deficit (partly because of stronger position of communists and nationalists, partly due to disagreement between powerful industrial lobbies); it is also more difficult to ensure a solid inflow of revenues to the government budget (because of the larger size of shadow economy); and, finally, it is more difficult to overcome the “non-conventional” reaction of enterprises to demand restrictions (increase in arrears instead of holding down prices and wages).

Hence, the best policy to fight inflation seems to be not the conventional stabilization package (relying on the pegged exchange rate as the nominal anchor and designed to cut inflation drastically in several months), but rather consistent, though gradual, efforts to bring down the budget deficit and slow down the rates of growth of money supply.

Taking into account objective difficulties in bringing down inflation, recent Russian experience with macroeconomic stabilization should be viewed as moderately

successful.

3. Sort of the crawling peg established for the ruble from mid 1995 proved to be an important device in fighting inflation in the second half of 1995. However, Russian domestic prices were rapidly approaching world levels and there is now a danger that strong ruble will undermine exports and economic recovery. The better option for the economies in transition struggling to overcome transformational recession may be to peg the exchange rate at a lower level in order to stimulate exports and investment, while fighting inflation through restrictive monetary policy (sterilization of increases in money supply caused by the growth of foreign exchange reserves), not through highly priced national currency.

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Notes

- 1 For more details see (Popov <a>).
- 2 Another academic economist suggests that "for each percent of inflation fall the national economy pays 3 to 5 percent of production slumps" and that by raising inflation to 15% monthly it would be possible to reach the production level of 70% of 1991, i.e. to increase output as compared to current levels (Lvov).
- 3 By mid 1995 the role of monetary factors, according to these estimates, declined to zero, the role of cost factors fell to about 30-40%, whereas the role of factors associated with inertia (expectations) increased to over 50%.
- 4 In the *Yabloko* Economic Program the "rigid" threshold inflation level is defined as 8-10% a month and the "real" threshold level — as 15-20% a month (Economic Program. Materials for the II Congress. *Yabloko*, Sept. 1995, pp. 87-89).
- 5 Studies mentioned earlier (Belousov et al.) claiming that cost push factors predominate in Russian inflation are based on regressions linking price increases to the increases in costs: even if these regressions yield good results, they may not be interpreted as proof that inflation is cost driven. It may be appropriate to distinguish between active (demand pull) and passive (cost push) factors of inflation (Tabata <a>).
- 6 See (Popov <a>&) for details.
- 7 See (Lahiri and Citrin) for the comparison of interenterprise arrears in economies in transition. Comparing arrears as a % of GDP may be misleading in periods of high inflation, since arrears is a stock indicator, whereas GDP is a flow indicator.
- 8 See (Popov <c>) for a more detailed discussion.
- 9 *Business MN*, 1995, No. 43.