How Clinton failed Russia.

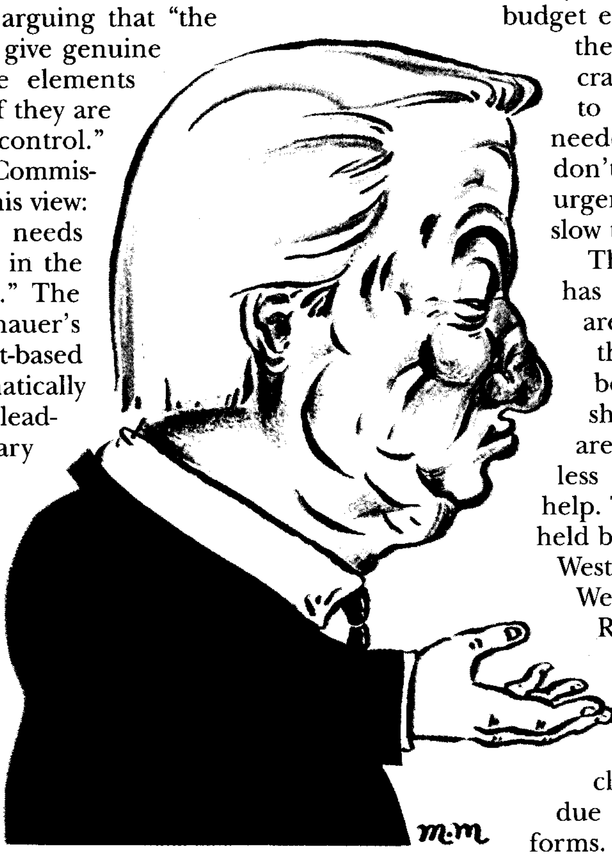
BETRAYAL

By Jeffrey Sachs

In 1948 German Chancellor Konrad Adenauer told U.S. Secretary of State Dean Acheson that the German people were in a state of "mental instability." If the IMF had been present, it would have concluded that any loans to Germany would be unduly risky under the circumstances. Acheson, thank goodness, saw it differently, arguing that "the 1920s teach us that we must give genuine and rapid support to those elements now in control of Germany if they are to be expected to retain control." John McCloy, the U.S. High Commissioner of Germany, echoed this view: "What German democracy needs and has never had is success in the eyes of the German people." The Marshall Plan helped Adenauer's democratic, Western, market-based vision to prevail, most dramatically when Adenauer retained the leadership by a single parliamentary vote in 1949.

U.S. policymakers today are fond of quoting this century's lessons, but not of following them in our policies toward Russia. Neither the Bush administration nor the Clinton administration has been ready to put real financial assistance behind Russia's reforms. The reluctance is even greater among the other G-7 countries. The problem has not been, as the conventional wisdom now has it, that our policy has been Russia first. The problem is that it has hardly been Russia at all.

On a rhetorical level, the West has twice made offers of large-scale assistance, $24 billion in 1992 and $28 billion in 1993. But it is one thing to announce aid, and another to deliver it. Only a tiny fraction of the announced aid has ever arrived, perhaps $4 billion of the $28 billion in 1993. In order to minimize budgetary outlays, the G-7 governments hoped the International Monetary Fund, the World Bank and off-budget export credit agencies could do the job. The international bureaucracies, especially the IMF, proved to be without the leadership needed. The export credit agencies don't really meet Russia's most urgent needs, and have been very slow to deliver assistance.



BORIS YELTSIN BY MATTHEW MARTIN FOR THE NEW REPUBLIC

The absence of Western support has been variously rationalized. We are told Russia's problem is that the reforms themselves have been too radical—too much shock, not enough therapy. We are told Russia's situation is hopeless anyway, with or without our help. The IMF insists that aid has been held back by Russian instability, not by Western inattention. Some insist that Western aid can have little sway on Russia's tumultuous events. Still others say Russia's reforms are already irreversible, so the greatest risks are past.

But the most preposterous claim is that Russia's instability is due to overzealous economic reforms. The Soviet Union was in economic decline for years before the arrival of Gorbachev, and was in steep decline for the six years of Gorbachev's rule. In 1991, before the arrival of the reformers, it was widely predicted that Soviet cities would succumb to hunger, if not starvation, by the winter. Oil production was falling sharply (from 560 million tons in 1989 to 461 million tons in 1991); the budget deficit reached 20 percent of GNP; the Soviet foreign debts were in default; farmers were hoarding grain; inflation was surging; the black market exchange rate was more

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than thirty times the official price.

All this occurred before the West had ever heard the name Yegor Gaidar, Russia's economic reform leader in 1992. From the start, the Russian reformers constituted a small group facing a hostile, corrupt bureaucracy, a hard-line Supreme Soviet and a Cabinet in which conservatives always held a numerical majority. The reformers had the advantage of Boris Yeltsin's backing, executive power, society's desperation, the collapse of the old structures and the power of their ideas, bolstered by the contemporaneous experience in Eastern Europe.

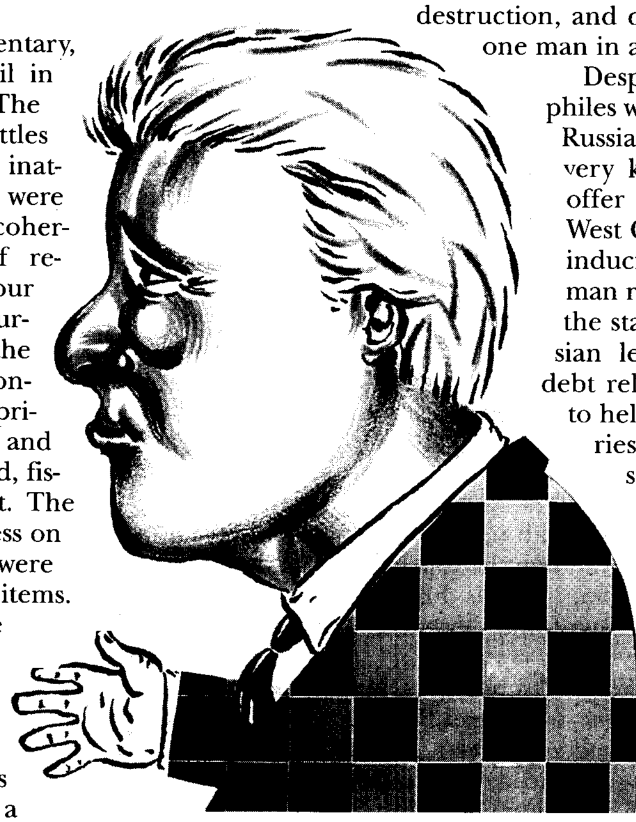
The reformers also counted on the backing of large-scale Western aid, which never arrived. From a tactical point of view, the Western goal should have been the one articulated by Acheson, to help "the elements now in control ... to retain control." By helping their policies succeed, we could help them broaden their public support and give credence to the basic liberal concepts. We failed at each key turn, and have stood by as the reformers have seen their power slip away in the tumult.

Contrary to recent commentary, "shock therapy" did not fail in Russia. It was never tried. The combination of political battles inside Russia and Western inattention meant the reformers were never able to implement a coherent, sustained program of reforms. Their agenda had four items: stabilization of the currency, liberalization of the economy by ending price controls and central planning, privatization of state enterprises and the construction of a targeted, fiscally sound social safety net. The reformers made great progress on the middle items, but were blocked on the first and last items. Not coincidentally, those are the areas where Western aid could have made the most difference.

For several years, since well before 1992, Russia has been printing money at a remarkable rate so that the government can pay its bills. The money supply is now growing at 10 percent to 15 percent each month, leading to a monthly inflation rate of about the same level. Many kinds of spending should be slashed. Russian society is paying a fearful price in high inflation in order to keep providing subsidies to profligate state industry and state farms. But other kinds of spending, such as in the social sphere, should be increased.

Here is where Western help could make the biggest difference. By providing funds for the necessary parts of the budget, the West would directly reduce Russia's inflation rate, since the government wouldn't have to print money to cover those needs. The aid would also give the reformers the leverage in Russia's internal political debate to shift spending away from useless industrial subsidies to areas of real need, such as temporary welfare spending. The Marshall Plan provided precisely this kind of budgetary support, making it possible for democratic governments in postwar Europe to end high inflation, meet social needs and implement longer-term reforms.

Ending inflation would not by itself solve Russia's vast economic problems. A deep crisis will continue for years, as Russia cuts back its vast military-industrial complex. But ending inflation would reduce the pervasive sense of panic in Russia, and thereby help to stabilize the society. As Keynes put it in 1919 of a similar situation in Central Europe: "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."



BILL CLINTON BY MATTHEW MARTIN FOR THE NEW REPUBLIC

Despite what world-weary Russophiles will tell you, the Soviet and then Russian leadership has always been very keen for such assistance. The offer of a few billion dollars from West Germany played a clear role in inducing Gorbachev to agree to German reunification within NATO. From the start of reforms in 1992 the Russian leadership has actively sought debt relief and new budgetary funds, to help keep the army fed, the factories operating and the dispossessed off the streets. The leadership knows well how the financial collapse and bread riots in 1917 contributed to insurrection and civil war.

Yet the West has been nearly oblivious to the reformers' needs for budgetary support, and the kind of leverage such support would have given them. In late 1991 when Gaidar first came to office, the G-7 governments disgracefully pressed the Russian government to continue servicing the Soviet foreign debt, at a time when the G-7 should have been working hard to provide the new government with fiscal breathing space. It took sixteen months to reach an accord on debt rescheduling that should have been established within weeks.

The IMF actually told the G-7 in January 1992 that Russia had no substantial financial needs for the year. It changed that view, under Russian protest, in March 1992, but still did nothing to help mobilize budgetary support for Russia. When the G-7 announced a $24 billion aid package in April 1992, the G-7 and IMF failed to follow through in the actual design and implementation of an aid program. In fact, most of the promised $24 billion was fluff—not real aid, but short-term trade credits on commercial terms that Russia would have to pay back in the near future.

The Russian reformers were buffeted by the emptiness of the Western aid offer. The announcement of the $24 billion was at first a huge boost. It gave the reformers stature with Yeltsin, the Parliament and the public. But when it turned out to be a mostly empty gesture, the tables were turned. The reformers were seen as stooges of the West, who had sold out Russia for empty promises.

An astute IMF would have understood the imminent risks in the spring, and would have found ways to speed the disbursements of aid. In practice, the IMF withheld its own support, on the grounds that things were already too risky. In a surrealistic episode, they agreed to a first loan of $1 billion during the summer, on the condition that the money not actually be used, but rather be held in reserves.

Without foreign financial backing, Gaidar began to search for domestic political support through compromises with "centrist" forces that were pushing for huge subsidies. Many Western pundits also called for "compromise," without understanding that Gaidar was effectively trading away the chance to end high inflation in 1992. The decisive blow came when Gaidar acquiesced to centrist demands that Viktor Gerashchenko, Gorbachev's Soviet Central Bank chief, take over control of the Russian Central Bank.

Gaidar's compromises helped sink stabilization. The steady reduction of inflation between February and August 1992 ceased with the renewal of money-printing, and returned to around 30 percent and rising. When Gaidar had a showdown with the hard-line People's Congress at the end of the year, he had little to show the public for his leadership. He was dumped, and replaced by Viktor Chernomyrdin, a Gorbachev-era apparatchik.

The situation might then have proved hopeless, but for the clear and present danger of hyperinflation. Yeltsin pushed hard for key reformers to be kept within the Cabinet. Under worsening financial conditions, Chernomyrdin agreed. The reformist finance minister Boris Federov fought for cuts in subsidies and for government controls on the wayward Central Bank. Chernomyrdin played the "centrist" hand, granting some victories to Federov and some to Gerashchenko. Federov staved off hyperinflation, and actually reduced the rate from 27 percent per month in January to around 12 percent in December. But with the money supply soaring, the reformers were still attacked at home and abroad for inflicting "shock therapy" on the population!

Even after Gaidar's departure, the West had tremendous potential influence to support Russian reforms, if it had cared to use it. The Russian leaders remained very interested in debt relief, budgetary support and long-term financing for industrial restructuring, particularly for the energy sector and for military-to-civilian conversion. The G-7 tabled another aid offer in April 1993, of $28 billion for the year, but as in 1992, there were few specific mechanisms established to deliver the funds, at least during 1993.

The real chance for a breakthrough to stabilization in 1993 came after Yeltsin's victory in the April referendum. With strong Western aid, the reformers could have made a political breakthrough. The IMF took exactly the opposite approach, laying out an excruciatingly slow program of aid ($1.5 billion in the spring, $1.5 billion in the fall and further funds at a later, unspecified date). With the ground cut from beneath him, Federov was stymied and Western leverage on behalf of reforms all but disappeared. By the summer, Central Bank Chairman Gerashchenko felt empowered to embark on a new, Communist-style adventure of currency confiscation, and Chernomyrdin backed him up, over the bitter objections of Federov. The last chance for the West in 1993 came in October, just after Yeltsin's coup. The moment was critical for three reasons. First, Federov had an enormous opportunity for action and was moving rapidly to clean up the abuses of the budget and Central Bank. Second, the public was highly disoriented, and needed a concrete sign of continuing reforms. Third, elections were on the horizon in just eight weeks.

The IMF came back to Moscow in October with a degree of obtuseness unmatched in its sorry history in Russia. It rejected any immediate support on the grounds that the Russians had violated the monetary targets in August, under completely different political conditions. It took pride in saying, explicitly, that the forthcoming election should be of no relevance to the institution's lending timetable. It announced that it would not give any support in the fall, and would disburse funds in the first quarter of 1994.

So the reformers went into the elections in December with rapidly growing public misunderstanding. They had avoided hyperinflation; yet they were blamed for the inflation nonetheless. They had fought corruption by ending many bureaucratic interventions in the economy, but they were blamed for corruption nonetheless. They had tried, over hard-line opposition, to shift government spending from wasteful subsidies to targeted social relief, but they were blamed for the absence of an adequate social safety net. They had succeeded in privatizing 80,000 enterprises, but were blamed for continued insecurity of property rights.

After the elections, Prime Minister Chernomyrdin, who had remained aloof from the vote, issued an attack on the reform team. He blamed the reformers for the election debacle despite the fact that he himself had commanded the government for the entire year, and had undermined the reformers on countless occasions. If Chernomyrdin put in the knife, the U.S. administration turned the blade, when Strobe Talbott quipped that Russia needed "less shock, more therapy." This apparent rejection of the reform strategy came just as Yeltsin was considering the formation of the next government.

One common line of attack on the reformers is that they should have adopted the Chinese approach, rather than "shock therapy." After all, China is booming. Why not Russia? Unfortunately, there is little in China's experience that is directly applicable. Deng Xiaoping's China in 1978 was a peasant society in which more than 70 percent of the population consisted of subsistence farmers. Seven hundred million peasants were willing to bear incredible hardships for pennies a day, and enough found their way to the booming export manufactures of the coastal regions. Russia and Eastern Europe are utterly different: urban, industrialized, with unaffordable social guarantees. In Russia and Eastern Europe it is not enough to grant the peasants economic freedom; the state enterprise and subsidy system must be cut down to size, to avoid hyperinflation and make room for private business.

The last ten years have made clear that gradual reform is a myth in Eurasia. Gorbachev tried it for six years, and left the country bankrupt. The situation is even more desperate in neighboring Ukraine, where hard-line Communists never ceded power to reformers. Subsidies were not cut; enterprises were not privatized. Today, Ukraine has inflation of nearly 100 percent per month and wages of five dollars per month at the black market exchange rate. Poland, the Czech Republic and the Baltic States, in contrast, have seen rapid gains. After four years of "shock therapy," Poland is stable, democratic and the fastest growing economy in all of Europe, with a stock market that rose by more than 700 percent this year. The same *Business Week* this month that editorializes against "shock therapy" in Russia describes Poland as Europe's next economic "tiger."

Almost all Western observers get it half right and half wrong in thinking about Russia. When Vice President Al Gore made a dramatic statement in Moscow last month that the IMF had let Russia down by insisting on excessively tough reforms, he was right that Western support has been insufficient, but mistaken in blaming overly zealous reforms. When Treasury Secretary Lloyd Bentsen countered that the IMF was not to blame, since the reforms had not gone far enough, this again was half right and half wrong. Russia needs more reforms, but it also needs much more effective international help than the IMF has offered or coordinated.

Some say that no matter how much aid is given, Russia's problems are simply insoluble. It's true we can't shape the future of Russia's economy. But we can have a decisive effect on monetary stability, as we did in postwar Germany. Here's how. The Russian budget deficit is now around 8 percent of GNP, nearly all of which is covered by printing money. The money-printing is fueling a monthly inflation of between 10 percent and 15 percent. The main trick for 1994 is to shift the method of budget financing, from money-printing to noninflationary methods, such as selling treasury bills and borrowing from abroad. The aim is to reduce money printing to 2 percent of GNP. This would dramatically slow money supply growth, so that inflation would drop to around 2 percent to 3 percent per month by the end of this year.

How can this be done? Foreign assistance should cover around 4 percent of GNP in budgetary spending, or about $14 billion directly for the Russian budget. Domestic Russian bonds can cover another 2 percent. Money-printing would be around 2 percent of GNP. Why not simply ask the Russians to cut more spending or raise more taxes? There's the rub. While Russia should certainly cut subsidies, it must also sharply *increase* social spending, by around 4 percent of GNP. But how can it do this if the budget deficit is already so large? Russia must shift spending domestically from subsidies (down 4 percent of GNP) to social policy (up 4 percent of GNP), while receiving the foreign assistance to help cover the deficit. Russia is simply unable to cut spending by enough to close the deficit and meet the extreme social needs at the same time.

Obviously, a substantial restructuring of the budget and its financing would require strong Russian and Western political leadership, massive coordination and technical sophistication. There was never any chance it could be put together by IMF missions talking with middle-level Russian officials. It could only be done at the top levels of the Russian government and the G-7. Unfortunately, in two years of Russian reform, the G-7 leadership has never engaged in this kind of detailed coordination. Senior U.S. officials have spent a few days in Moscow, not the weeks needed to set the job on course. And so Clinton arrived in Moscow this week too late to prevent the present dire circumstances, with too little apparently on his agenda. There is still time to turn things around, but not by an administration too wary of foreign involvement.

Above all, Clinton should not console himself with the thought that nothing too serious can happen in Russia. Many Western policymakers have confidently predicted that if the reformers leave now, they will be back in a year, after the Communists once again prove themselves unable to govern. This might happen, but chances are it will not. History has probably given the Clinton administration one chance for bringing Russia back from the brink; and it reveals an alarmingly simple pattern. The moderate Girondists did not follow Robespierre back into power. With rampant inflation, social disarray and falling living standards, revolutionary France opted for Napoleon instead. In revolutionary Russia, Aleksandr Kerensky did not return to power after Lenin's policies and civil war had led to hyperinflation. The disarray of the early 1920s opened the way for Stalin's rise to power. Nor was Bruning's government given another chance in Germany once Hitler came to power in 1933. •