Russia's Macroeconomic Stabilization: Paradoxes and Prospects

By Daniel Cloud

I'm a little embarrassed to have to give a talk on the Russian economy in front of so many real economists. As a lay market participant, I naturally have little understanding of economic theory, and no real data to support my conclusions. Still, I'll try my best to give an interesting speech. Maybe you can view this charitably as a kind of a long plaintive question instead of a speech in the normal sense: could what I thought I saw really have been what I saw?

The one advantage I do have is my vantage point-I've been working right down in the thick of Russia's financial markets for the last couple of years while the IMF and the Russian government were trying to stabilize the ruble, and I think I may have spotted some aspects of the whole process from that point of view that they would be unlikely to tell you about themselves.

The question I want to begin by addressing is this; for years the West has been more or less in despair over the prospects for macroeconomic stabilization in Russia. Prominent economists declared the effort a failure. Now, seemingly overnight, it has been achieved. Annualized inflation is running at below 30% (in comparison with more than 2000% in the year 1992) the ruble is freely convertible for all current account transactions, the exchange rate is steady, and GDP is either (depending on whose statistics you believe) growing or about to resume growing. How did this happen? Who was responsible? Why were the doomsayers wrong? This discussion will lead into my final point, about the apparent paradoxes of stabilization, and their possible implications for future Russian asset prices.

Since I assume you're all perfectly familiar with standard ideas about hyperinflation, what causes it and how it should be cured, I'm not going to bore you too much with the aspects of the whole thing that conformed to type-rather, I'm going to concentrate on the peculiar and the poorly-understood, the things the economists running the stabilization program didn't-and still don't-seem to understand.

There were two unusual aspects of the stabilization that seem relevant to me here. Both share the common feature of pointing to the primacy of institutional, political, and historical aspects of the situation in determining the success or failure of the stabilization effort. Since the IMF and other Western economic advisory organizations are not staffed with historians, political scientists, or even many institutionalist economists, these are not the aspects of Russia's stabilization success and their stabilization failure that you will find them emphasizing. But they were very important, and they largely explain why Viktor Chernomyrdin, Russia's Prime Minister, a plodding apparatchik, succeeded in stabilizing the ruble where Yegor Gaidar and Jeffrey Sachs, brilliant young economists, failed.

The first unusual aspect of the situation, a very obvious one but one which seems to have been universally ignored, was the supply-side character of the inflation itself. This is immediately clear even to a tyro like me from the gross macroeconomic facts of the situation-1992 through 95's three-thousand-odd percent cumulative inflation was accompanied by a 30%-plus drop in GDP, indicating (according to my introductory economics textbook) that it was caused by a movement of the aggregate supply curve to the left.

An inflation of the kind Gaidar and Sachs seemed to be trying to cure-a demand-side inflation, in which the aggregate demand curve was moving too far to the right-would have involved some pick-up in goods production, at least in its initial stages. What we instead witnessed in 1992 was a simultaneous collapse of monetary stability and real goods production, a collapse that could only have been caused by a severe supply-side shock like that of higher oil prices to Western economies in the 1970's. And, in fact, such a shock did occur. Let me explain.

The Soviet Union may have been the most elaborately planned economy the world has ever seen. Every nut or bolt, every drop of paint, was theoretically produced in accordance with some master plan for its eventual use, one known only to the planner. Unfortunately, planners are human, markets divine, so that for every plan for the use of the bolt the planner had, the market-both the shadow market that should have existed instead of the plan, and the black market that actually did exist alongside it-had a better one.

Over time, the planners' cumulative vision of how the economy should be organized tended to drift farther and farther away from the form the market would have given it. This created severe incentive problems-if not enough bolts were being produced to fit all the nuts, a black market in bolts would develop, a black market factory managers must participate in if they were to avoid the fatal career consequences of under-fulfilling plan targets.

Once forced into the black market, many economic actors would naturally choose to seek their fortunes there, arbitraging goods out of the plan and selling them at higher black-market prices, and if nothing were done to stop them, the whole system would rapidly grind to a halt. Key links in the chain of planned production would snap as scarce goods were arbitraged away, factories further downstream would grind to a halt as critical components became unavailable or available only at new, higher, market prices, monopoly producers of goods for which there was not enough market demand to cover their costs would cease production (leaving another gap in the available mix of inputs) and in general chaos would ensue as the plan was eaten alive by its antithesis and nemesis, the market.

What kept this from happening until 1992 was the ability of the political system to coerce economic actors into behaving differently than a rational calculation of their purely economic interests would have led them to. Black-marketeers were sent to gulags. In Stalin's time, even showing up late to work was punishable by a prison sentence.

What happened in 1991-92 was quite simple. The Party collapsed, the Soviet Union collapsed, the gulags became a moot issue, and as a direct result the black market took over, destroying the plan, destroying the planned circulation of goods, and throwing the informational problem of the correct relative prices of goods and services right into the spot light.

Theoretically-given perfect information and nice reasonable people and other impossible abstractions-the problem of correcting relative prices for seventy years of Soviet-era drift could have been solved by adjusting some prices up and some prices down. In the real world-with bad weather, everybody drunk and upset, and no-one outside the Kremlin knowing even the faintest bit of twentieth-century economics (no marginal cost concept in wide circulation, for example) it was solved by a simultaneous ferocious upward movement in all nominal prices, with those for scarce goods simply moving up faster.

The sudden death of the plan was a huge shock to the productive capabilities of the Russian economy, probably as much of a shock as the overnight abolition of money would be in America. It is here that we ought to look for the origins of the Russian inflation-and it is from this analysis that the West ought to have formed its prognosis as to the likely future course of the disease. It should have been clear from the beginning that the Russian inflation of 1991-'95 was, like the oil-shock inflation in the West in the 1970's, one of those things that the market would eventually correct of its own accord but that really was not susceptible to a quick, shock fix in the meantime. The Russian inflation was simply not the product of psychology or expectations, and could not be ended by managing expectations-other than the expectation of going to prison for failing to obey the plan.

This brings us to the second unusual aspect of the situation. Where did the coercion go? Did the state cease trying to enforce the plan, or did it lose the ability to enforce the plan? Gaidar and Sachs will claim the former-that they "implemented rapid price reform"-but the fact is that control over prices was ripped from the State's nerveless grasp, and they were simply prudent enough to avoid putting up a fight on this issue. On the issue of whether or not to accommodate the supply-side shock, on the other hand, by printing a lot of new money, they did try to fight, arguing that the inflation should by nipped in the bud with a show of monetary stringency-and they lost, thoroughly and utterly. Gaidar lost his job, and Sachs eventually left the country in a snit because nobody was paying any attention to him.

The fact is that Russia's inflation coincided with-and was immediately caused by-what political scientists call a "power deflation", a phenomenon generally found in revolutions and other sharp shocks to the prevailing political order. A power deflation occurs when the prestige of a regime and the state it controls falls to such a low level that people begin to disregard its authority, either because they no longer perceive it as legitimate or because they no longer fear the consequences of defiance, or most likely both. Like a monetary hyper-inflation, a power deflation has a built-in positive feed-back mechanism-since there are only so many KGB agents and so many prisons, the more people defy or ignore the authority of the state, the safer it is for the marginal person to do so, while the perceived legitimacy of the state and its laws is increasingly damaged by the sight of powerful people using them for a doormat.

Glasnost started a power deflation in the Soviet Union, and the events of 1991-conservative coup attempt, liberal counter-revolution, destruction of the Soviet Union and attempted replacement with the new, unformed, unimpressive Russian state-saw it accelerate. The result was a general breakdown in social-including economic-order. Not only were these (non-economic) events the proximal cause for the collapse of the plan and thus for the price shock that initiated Russia's inflation, they also severely constrained the possible paths out of the inflation -paths already lying well away from where the IMF and Jeffrey Sachs thought they would be, because of the supply-side nature of the inflation itself.

A monetary stabilization requires above all things that stabilizing policies must be perceived as credible, while a power deflation guarantees above all things that no state policy can be perceived as credible. If a state policy does become an irritant to some major interest group during the course of a power deflation, they have every reason to be confident that they can subvert the weakened authority of the discredited, demoralized, disunited, and impecunious state (tax collection, of course, collapses under these circumstances) and have the policy-maker fired or the rules of the game changed in their favor.

Clawing back the state's authority is thus the indispensable prerequisite for a post-revolutionary monetary stabilization. This, however, is a process to which the West, the IMF, Jeffrey Sachs, economists, advisors, consultants, Russian intellectuals, or indeed eggheaded outsiders of any description had little to contribute. The combination of fear and consent that orders all orderly societies can only be recreated by the intuitive genius of the politician, the founding father as it were.

That Jeffrey Sachs should take umbrage at his advice being neither wanted nor heeded during this phase of the crisis only indicates his remarkable naivete about how societies are actually organized, about what is very important and serious, and what is a technical matter of secondary importance. By dint of enormous effort, it seems, an economist can become as stupid as a physicist, as naive about politics and political causes and effects as the geniuses of the Manhattan project. This is quite an achievement for a social scientist.

Just as the supply-side character of the inflation and its links to the State's loss of authority doomed any efforts at a rapid, "shock", demand -side solution, however, they virtually guaranteed that the rouble would be stabilized within a few years of the collapse of the Soviet Union. The inflation, after all, was not the result of some deep-seated and permanent structural problem with the economy or its relation to the state-it was the result of a profoundly dis-equilibrating one-off shock to both these subsections of the larger social world. As equilibrium was restored in both areas-as markets slowly, slowly attracted the working capital to clear, as correct relative prices for various types of goods were gradually established, as Boris Yeltsin reestablished the State's authority with the usual Machiavellian prescription of honeyed words, selective bloodshed, and regular political procedure-the inflation gradually but inevitably went away, as it has now done in almost all of the post-communist economies, whether they've been well or badly managed.

The final, successful monetary stabilization-the Chubais-Paramonova stabilization, as perhaps it should be called, starting in November 1994 and lasting until the present day-came almost as an anticlimax. After a period of reserve building, the ruble was put in a band against the dollar in the summer of 1995, and inflation is now running below 30% per annum, as against more than 2000% in 1992. Most of the credit belongs to the Russians-especially the much-slandered politicians. Some goes to the IMF. Other western economic advisors may have done more harm than good in the short term, with their willful disregard of the institutional, historical, and political underpinnings of the problem. Of course, they did get the debate going, so I suppose that's something.

The last thing I want to talk about here is the way forward. What happens after a stabilization? Why are they of interest to financial speculators like myself?

The interesting thing about monetary stabilizations is that, as recent Latin American experience shows, they are often followed by bull markets. Being a young man at loose ends in the early 1990's, and having noticed this fact, I set about looking for promising pre-stabilization situations (otherwise known as hyperinflations) to speculate on.

The Eastern European, plan-shock and power-deflation variant of hyperinflation seemed more promising to me than the Third World, chronically-weak-state version, because it was a intrinsically limited response to a one-off event, rather than an ongoing, decades-old structural problem.

The first post-plan stabilization I found to speculate on was Poland. That worked well, prices in the Polish stock market went up ten times between 1992 and 1994, but I still didn't really come away with an adequate theoretical understanding of why stabilizations were often followed by such exaggerated bull markets. Now, though, having had a chance to study the Russian case very closely, I believe I may have stumbled on an explanation for the link. It relies on what I call the paradox of quantity. This is all probably very old news to any real economist, but the idea is still exciting to me, and I haven't found it in a book anywhere yet, so I'll just go ahead and explain what I mean, and if I bore you can play cards among yourselves or read the newspaper.

The paradox of quantity is as follows: people say that inflation is the result of too much money chasing too few goods. But if you look at any hyperinflation, it is immediately apparent that this explanation can not be the whole story-because during a hyperinflation, there is actually very little money around. This is because, soon after the inflation starts, demand for money as a store of value-as opposed to transactions demand -falls almost to zero. Since nobody wants to hold money, any money issued goes straight to financing transactions and thence (absent lasting Keynesian stimulus effects, unlikely in a hyperinflation) right to the aggregate price level. The amount of real money in the economy is unchanged, and it is very low. Official Russian M2 velocity is now in the seven or eight region, which for such a developed and presumably fully monetized economy is quite high, particularly when you consider that for tax and other reasons GDP is under-reported by a very wide margin-and the velocity number has been higher in the recent past.

After a stabilization, on the other hand, demand for money as a store of value increases rapidly-as far as I can tell, this is how you know that monetary stabilization is really happening-and velocity should fall to a more normal level. The question is, how do you get from the high velocity level to the low velocity level? Does GDP shrink sharply? No..... There must be enormous growth in money and quasi-money of various kinds, to accommodate the newly-kindled savings demand. This, then, is the paradox of quantity-the journey from hyperinflation, where too much money is chasing too few goods, to final macroeconomic stability, where enough money is chasing enough goods, involves the creation of enormous amounts of new money.

The difference between the initial, or inflationary, and final, or stabilizing monetary expansions is that the hyperinflation was caused by a corrupt (or fatally weak) state creating excess money in order to transfer wealth from savers to itself, whereas the stabilization involves the creation of money to satisfy savers' demand to move wealth from non -monetary (or non-domestic) forms to domestic-currency-denominated forms. But the magnitude of the money creation involved is still staggering.

In Russia, for example, if we put M2 velocity somewhere around eight, and assume that it will eventually end up in the two-to-four range, real money will have to grow by between 100 and 300 percent in the next couple of years. This idea is borne out by other indicators. Outstanding bank loans, for example, are less than 10% of GDP in Russia today-somehow, over the next few years, they will have to get up to the much higher percentages that characterize more normal economies. Once again, large-scale money creation is implied. And since all of this money will be demanded by savers rather than imposed on the economy by the state, the growth will be non-inflationary.

It shouldn't be hard to see why a non-inflationary doubling or quadrupling of the money supply would be good for asset markets. Think of it as an asset-allocation problem-today I have a ruble of cash and a ruble-worth of stock, tomorrow I have four rubles of cash, so how many rubles worth of stock do I want to own? Of course since asset prices (unlike goods prices) are made on the margin, the effect is in reality more complicated (and I think much bigger) than this example suggests.

Well, I've explained to you the real story behind ruble stabilization-the problem was supply-side, the solution was political, and anybody who knew both these things and knew something about politics knew that victory was inevitable, West or no West.

I've also explained to you why bond and stock prices in Russia have both doubled this year, and why a bull market in ruble denominated assets is now a feature of the scene, one that is likely to continue to exist at least over the next year or two, until velocity gets down to more normal levels.

Finally, I have explained in general why monetary stabilizations are often followed by bull markets. I could go on to explain to you why they are sometimes not followed by bull markets, but I think I had better quit while I'm ahead. This is an awful lot of economics for an economic illiterate like myself to have presented to such an august audience, and I'm sure that many of you have already lost patience with my painful ignorance.