September 12, 1991

THE COUP'S CONSEQUENCES FOR ECONOMIC REFORM

Leonid Grigoriev
E.L. Wiegand Fellow

INTRODUCTION

The failure of the August 19 hard-line coup in the Soviet Union has transformed the political situation in that country, sweeping the Communist Party from power and clearing the path for a rapid transition to a market economy and democracy. The coup attempt demonstrated the vulnerability of democracy unsupported by a free market economy.

Prior to the coup, a terrible economic situation was exacerbated by political uncertainty, increasing internal strife between the republics and nationalities, economic and political strikes, and repeated postponement of genuine economic reform. To these factors were added general disorder, a structural crisis, economic recession, and inflation.

The eight plotters of the coup proposed saving the country by turning the clock back and undoing many of the reforms of the past several years. In an irony of history, Soviet President Mikhail Gorbachev had retreated from previous promises of quick reform. His goal was to preserve social stability through a slow, piecemeal approach to evolutionary change. It did not work.

Good News and Bad News. The failure of the coup has brought both good and bad news for Soviet economic reformers. The good news is that the coup has undermined the power of those most stridently opposed to free market reforms: the top bureaucracy of the Communist Party, the KGB, the military, and the enor-

Heritage Foundation E.L. Wiegand Fellow Leonid Grigoriev is one of the architects of the 500-Day Plan for radical economic reform discussed in this study. In Moscow, he is a Department Chief at the Institute of World Economy and International Relations, Profsoyuznaya str., 23, Moscow, 117418, U.S.S.R., FAX 3107027.

mous Soviet military-industrial complex. In addition, Gorbachev's timid and halting approach to economic reform has been discredited in favor of much bolder measures.

The bad news is that the long-term problem of reforming a rapidly disintegrating and backward economy remains. With their political victory, Russian President Boris Yeltsin and his colleagues in the other republics inherit an economic mess. To make matters worse, the crippled Soviet economy likely will be wounded further by the current political upheaval. Even as they embark upon free market reforms, the new authorities throughout the country must keep the present economy working or face the prospect of dangerous social and political instability.

For this reason, it is critical that the republics reach agreement on free trade, currency and banking reforms, price liberalization, and the development of a compatible legal system in which a modern free market economy can flourish. Economic reforms in the republics should be designed to be as similar and thus as compatible as possible to enhance the prospects of overall success.

THE CHALLENGE TO SOVIET REFORMERS

Soviet leaders face a daunting task. Prior to the coup, the leaders in the republics had been too preoccupied with the political struggle to devote sufficient attention to long-term economic reforms. The republics' economic reform record was sparse partly because the Soviet government tied the hands of the republics and frustrated their efforts toward reform. But it is also true that the republics themselves frequently were not free market reform-minded. Short-term political goals and the necessity of securing public support against the central government led republican leaders to back populist measures harmful to economic reform. Such measures included enormous wage increases unsupported by corresponding increases in productivity. The overall budget deficit and excess money supply, meanwhile, contributed to unbalance the consumer market. These led to the expectations of shortages and, predictably, to hoarding.

Before the coup, all economic ills could be blamed on the central Soviet government. Now, however, the blame will shift to the republics as their leaders wrest vast powers for themselves from the central government. No longer can the republics' leaders avoid responsibility for the state of the economy. Almost certainly, their honeymoon with an increasingly impoverished and impatient society will be short.

Unlike Gorbachev, they will not have a half-dozen years to play with economic experiments. Four years of increasingly inept programs were required before Gorbachev and other Soviet leaders could bring themselves to acknowledge in 1989 the reality that true *perestroika* requires radical free market reforms. Even then, they continued to delay their implementation. Gorbachev's refusal in September 1990 to adopt the so-called "500 Days Plan" of radical economic reform wasted an entire year. Now, however, the coordinated approach to economic reform that the 500 Days Plan could have provided almost certainly will be precluded by the republics following different paths.

Economic Tower of Babel. Since the economic reforms of countries such as Hungary and Poland are more advanced and better known than those in the Soviet Union, it is instructive to compare some of the principal differences between these countries. Unlike Hungary and Poland, economic reform in the Soviet Union has not been introduced by professional economists. The suddenness with which the communist system in the Soviet Union collapsed has allowed the democratic forces little time to discuss and debate the merits of different approaches to economic reform and develop technical expertise. Consequently, every politician has his own vision of the economic system to be constructed, a virtual Tower of Babel of economic reform.

Most important, the necessary tightening of the current inflationary monetary policy has been made much more difficult by the dismantling of central authority. From the standpoint of monetary reform, it would have been much better if the disintegration of the Soviet Union had followed, rather than preceded free market reforms.

Today three competing economic reform programs are being discussed in Moscow. The program advocated by Grigory Yavlinsky, one of four members of the Committee for the Management of the National Economy, recommends the preservation of a strong and coherent economic union including an integrated banking system, a single currency at least for one to two years, and a common international economic policy. Other programs would leave economic reforms in the hands of the republics, thereby slowing the pace of reform.

IMPLICATIONS OF THE COUP

The effects of the August 19 coup on economic reform are mixed. The first effect is psychological relief. Since the December 1990 resignation of Foreign Minister Eduard Shevardnadze and the replacement that month of Vadim Bakatin as Minister of the Interior by the reactionary Boris Pugo, the population has been waiting for a showdown between hard-liners appointed by Gorbachev and democratic reformers. During this time, the economy steadily deteriorated, making life for the ordinary citizen even more difficult. This atmosphere of political and economic insecurity impeded economic reform. For example, the growth of the private sector, especially the establishment of new businesses, was hampered severely by a fear of reprisals against entrepreneurs if the communist hard-liners took over power. Now the shoe has dropped. The hardliners have made their anticipated move and have failed.

A second benefit of the coup is that the reactionary communist forces have been clearly identified. Until August 19, most of the political leaders of the Soviet Union glibly invoked the rhetoric of free market reform, while in fact advocating profoundly different approaches. Western observers, in particular, often were mystified why this apparent consensus on economic reform produced so little in the way of genuine market reform. Now, however, the anti-reformist forces behind the coup have surfaced and been capsized by a wave of popular opposition.

West Misled. Over the past year, the true reformers in the Soviet Union warned their Western friends and colleagues to listen with reservations to the Soviet establishment regarding the course of events. But many in the West, especially those in government, were too easily misled by a willingness to believe their Soviet counterparts. Many Western journalists too, curiously, were misled easily. Consequently, these Western governments treated Soviet Prime Minister Valentin Pavlov's government as their preferred partner. Only the coup made this approach politically untenable. Now all of Gorbachev's former cabinet has been dismissed, including all those upon whom Western governments were relying to promote economic reform.

In contrast, the true reformers steadfastly have distanced themselves from the central government since that government rejected the 500 Days Plan in September 1990. These reformers are now free, politically and intellectually, to help in economic reform. The coming to power of leaders such as Russia's Yeltsin creates very promising political conditions for radical market reform, but its successful implementation will require the fullest cooperation between economists and political leaders.

The failure of the coup has created an excellent opportunity to destroy the power of the *nomenklatura*, the Communist Party bureaucracy which controlled the economy and was capable of frustrating all reforms in recent years. By refusing to share power with the emerging democratic forces throughout the Soviet Union and by clamping down on private economic activity, the *nomenklatura* in the central government was able to force Gorbachev to slow his reforms.

The local *nomenklatura*'s resistance to reform arose from a desire to protect its members' rank and social standing (including privileges) in society. Its special place in the system was derived from its control over the local economy. Now, if the *nomenklatura*'s power is broken as a result of the coup, businessmen and entrepreneurs will have considerably more opportunity to operate. Nevertheless, there remains the danger that the population may come to regard the entrepreneurs in the same negative light as they now do the *nomenklatura*.

Risk Reduced. A third benefit of the failure of the coup is the long-term effect on the economy and on economic reform. To begin with, the social and political risk of entrepreneurial activity has been reduced substantially. The same is true for foreign investments. No longer is there the threat that property and capital will be seized upon the whim of a bureaucrat nor the danger of criminal prosecution for engaging in private economic activity. In addition, foreign assistance now is much more likely. But at the same time, the erosion of the central government's authority has diminished its ability to implement a comprehensive reform for the entire country from the top—in the East European style.

One very big question is how the public will react to radical reforms, especially during the transition period. After six years of false promises and increasing economic misery, it is by no means certain that the population can be persuaded to work harder. Public trust in any kind of government reform program clearly is very low.

Difficult Message. Although the failure of the coup gives new hope to many people, much of the population remains passive and large segments fear losing even their present standard of living. No political leader has yet had the courage to tell the people that the transition to a market economy will entail hard work and that only a tiny minority will become rich soon.

This news may not be welcomed by the large majority of poor people in the Soviet Union. Much of the population dreams of a quick transition to Western living standards. Soviet publications have contributed to this illusion by their emphasis on the rosier aspects of market economies, such as high technology, much as they formerly created a negative image through stories of Western unemployment and inequality of income.

The main goals of the transition—creating an efficient market economy and the foundation for a stable democracy—will inevitably lead to some inequality. It will take some time before an emerging middle class will be able to stabilize social and political life. Therefore, it is necessary to explain to the population why inequality is unavoidable, and for what purpose they now must work and sacrifice. It is especially important — but difficult — to convince them of the need to be patient once again.

THE GOALS OF ECONOMIC REFORM

Given that the country does not have a stable government, that it faces the actual political secession of several republics, and that the republics may each choose a different road to market reform, what should be the goals of the transition? The economic and social costs of the transition to a market economy should be minimized. This is essential not only for humanitarian reasons, but to avoid a popular backlash that could derail the entire reform process.

Some important areas of reform are:

♦♦ **Legal System.**

The legal system for a market economy does not now exist, and its development will take time, especially in the current unsettled political climate. The disintegration of existing government structures is creating considerable legal uncertainty. So, too, is the rapid change of existing laws and regulations. It is necessary to decide first of all which law is valid: union or republican. And property rights are still not defined, especially concerning land and real estate. Such laws as bankruptcy codes, contract regulations, and privatization law should be reassessed and quickly approved.

◆◆ Internal Trade.

Trade within the Soviet Union overnight has become in effect foreign trade between republics. This trade can be damaged by the republics and regional authorities adopting protectionist measures, such as regulations restricting the export of consumer goods to other regions. Some authorities also have extended these restrictions to construction materials and other goods.

The old system of internal trade by governmental command has steadily been replaced by barter. The Soviet government viewed trade by bartering as illegal and inimical to the Soviet economy, but was unable to prevent it. Attempts by the central government to stop barter trading created obstacles to the flow of goods, services, and money. And this slowed even more an already poorly functioning economy.

This attempt to hinder barter trade is certain to continue, particularly as part of a misguided effort by the republics and regional authorities to protect local living standards. The central government has lost any ability to prevent it. If the republican governments persist in trying to stop it, the result is certain to be a no-win situation in which industrial production and living standards continue to fall.

An additional contribution to this growing disorder is the widespread breaking of contracts. At present, there is no legal recourse if a contract is broken. Nor is there discipline imposed by the market in the form of bankruptcy costs and courts.

◆◆ Prices.

The loss of central control over economic enterprises means that price liberalization is inevitable. Much of the Soviet economy is riddled with monopolies, especially in technology. More than half of them involve machinery: a single enterprise may produce 60 percent to 100 percent of the Soviet Union's output of certain categories of machinery. The republics in which such enterprises are located may reduce production of machinery components needed elsewhere in the Soviet Union. Meanwhile, a monopoly could raise the prices of these products for export to other regions and thus cause hyperinflation and price wars. There could well be a "price shock" as Soviet internal prices rapidly increase to world market levels, especially in energy and raw materials.

Such an adjustment is inevitable in the long run, but the present situation will accelerate it. Several products quickly will become sources of trouble, especially oil, cotton, sugar, grain, and other specialized agricultural goods. Their production and distribution is largely controlled by the republics. In these conditions, it will be very difficult to monitor consumer prices and to establish a "safety net" for the poorest segment of the population.

◆◆ Currency and Banking.

Both the theory and practice of market reform demonstrate that a relatively strong, stable currency is a prerequisite for market signals to operate. Without these, a true market cannot emerge to replace the quickly vanishing command system of Soviet central planning. In the past, the Soviet Central Bank served as a branch of the Ministry of Finance. Currently, the banking authorities in the various republics have acquired considerable independence from the Central Bank but remain subordinate to their own Ministries of Finance.

This can create a monetarist nightmare: a dozen uncoordinated republican central banks could emerge that are responsive only to their governments' needs. Yet these banks, at least for the immediate future, will continue to use the same common currency—the ruble, printed only in Russia.

Many of the republics already have introduced their own quasi-currencies—such as coupons for consumer goods. Soon some of them will introduce their own currencies. The republics are doing this primarily for political reasons, many of them valid, and only secondarily for economic reasons. But while it may be inevitable that the republics create their own currencies, the economic consequences of this could be harmful. The republics are in practice liable to wind up with a three-tiered currency system: hard currency for international transactions; rubles and hard currencies for inter-republic business; and local republican currencies for use within the republics. The system will lead to a good deal of confusion, as most goods purchased even in Russia come from other republics. And the process of privatization and decentralization of decision-making will mean that most enterprises will have to continue to buy industrial and consumer goods outside of their republics.

It is unlikely that contracts for the export and import of such goods will be denominated in the local currencies, which will not be immediately convertible. Instead, dollars or rubles are likely to serve as the means of exchange. It is likely that there will be a steady demand for rubles by most of the republics in order to pay for raw materials bought from Russia, Uzbekistan and other resource-rich republics. The supply of rubles will depend on exports and the prices of consumer goods which will be vulnerable to competition from Eastern Europe and the Third World. It would not be easy for the republican central banks to keep the rate of exchange for the local currency high with respect to the dollar or even to the ruble. Trying to do so, for example, would exacerbate the trade deficit.

"Dollarization" of trade between the republics is likely, as was the case with the Soviet-East European trading organization, The Council for Mutual Economic Assistance (Comecon). Meanwhile the use of local currencies for economic transactions within the republics and the ruble or dollar for intra-republican transactions may be very painful for everyone.

♦♦ **Budget, Fiscal, and Monetary Policy.**

The budgets of half of the republics were subsidized by the central government. This year, some of the republics stopped payments to the central government and tried to balance their own budgets at the expense of the central budget.

This policy will not be sustainable over the long run, however; secession will lead to greater expenditures by the republics on bureaucracy, diplomatic relations, law enforcement, and defense, which previously were handled by the central government. Social welfare programs also will become the responsibility of the republican governments. These governments will be faced with intense populist pressure to spend more money for social security and economic development. A coordinated fiscal and monetary policy will be a number one priority to prevent trade between different regions of republics from breaking down because of the lack of a stable currency.

A related problem concerns the transfers of government funds between republics. The central government previously transferred funds from the relatively prosperous republics of the Baltic states, Russia, and Ukraine to the poorer areas of Central Asia. But at that time, the prices for raw materials were relatively low. In order to offset the reduction of subsidies, there is likely to be a quick rise of prices for cotton and other export goods from Central Asia. The loss of subsidies and resulting hikes in prices may lead to dangerous social instability in the Central Asian republics. The threat is particularly worrisome given the potential long-term Muslim fundamentalist threat to secular governments in Central Asia.

♦♦ Structural Crisis and Investments.

The economic crisis will be especially hard in the Urals and Siberia in Russia's northern regions. There the combination of industry, poor agriculture, and a lack of a developed service or consumer sector may produce severe economic conditions.

As the central government's investments in these and other regions continue to decline, it will be the task of the Russian government to deal with the structural consequences of lower investment, such as temporarily higher unemployment and decreased production. Foreign investment and assistance could help to offset the decline of government investment in these regions. The fall from power of the hard-line local authorities creates an opportunity for the introduction of a market economy in these immense and resource-rich regions. A special investment fund for foreign investors could be the source of direct or portfolio investment in enterprises that have been transformed into joint-stock companies. Such a fund could also directly assist the process of privatization.

♦♦ Privatization.

Privatization is the keystone of major market reform. The republics and regions are likely to pursue similar programs of privatization in housing, retail, trade, and services. Agriculture is more problematic. Vast differences in climate, technology, products, and traditions mean that the process of agricultural land privatization is likely to differ widely in each republic. Complicated too will be the privatization of large industrial enterprises. The structural crisis and the rapid changes in prices alone will make the valuation of fixed assets and prices of enterprises very difficult.

One of the major problems to be addressed is the need to combine speed with efficiency in privatization. There is no quick and simple solution for this immense task. The problems of privatization in Russia are complicated and there are numerous obstacles to privatization. These include a lack of capital markets and banking institutions, non-existent property rights, and the *nomenklatura*'s so-called privatization program, which is already underway.

Among a number of proposals to surmount these obstacles is to use a voucher system. Preliminarily approved on July 3 by the Russian parliament, such a scheme would exchange up to 100 million coupons for the securities of about 30,000 enterprises. This approach appears at first glance to have a lot of advantages. For example, giving the enterprises away rather than selling them is more equitable and creates millions of instant shareholders. It also supposedly could speed the development of capital markets and eliminate the problem of evaluating these enterprises, many of which have little value.

Nevertheless, problems exist with the voucher system. For example, it has never been done before, is very complex, and it entails huge administrative and informational costs. The voucher model could be considered, as in Czechoslovakia, for privatizing a few hundred enterprises. It is probably not the best approach for privatizing the majority of state-owned companies in Russia.

Long Process. Privatization will require extensive efforts to make it work properly. The combination of selling securities at a discount to workers and a partial free distribution of shares will take years anyway. The equipment and production process of the plant, which will be worthless in many factories, would be handed over to the factory managers. From this moment on, the government discontinues investing in any machinery for any state enterprises. Each enterprise would have to pay for new investments.

The recent political events have clarified one outstanding question relating to property in the Soviet Union: Who owns it? It appears that the republics will take control of the central government's enterprises on their territory. Tensions between the republics may arise from not only border or national problems, but from disputes such as access to water in Central Asia.

Over the very long term, carving up the Soviet Union's wealth republic by republic is likely to prove especially advantageous to Russia. Even by itself, it will be the largest country on the planet. It presently accounts for three-quarters of the Soviet Union's territory, two-thirds of the nominal value of fixed assets, 51 percent of the population, and the greater part of the human capital, including most of the best universities and scientific institutes. In a country the size of the Soviet Union, the speed by which its various regions will manage the transition to a market economy inevitably will differ greatly. But the process will be much easier and more rapid if Russia leads rather than follows. The recent triumph of democracy in Russia has brought within reach what seemed impossible only a short time ago: the creation of a true market economy and democracy on Russian soil.

CONCLUSION

The failed coup of August 19 has opened vast new possibilities for the peoples of the Soviet Union. But in so doing, it has also made more urgent the need for more radical free market reforms. No longer can the new democratic leaders postpone greater economic reform because they fear hardline opposition. In seizing political power, the reformers have assumed responsibility for saving their peoples from a rapidly approaching economic disaster. They need to exercise this power by moving as quickly as possible toward free market reform.

They may be prevented from doing so through fear and confusion. Change has come so quickly with so little time for preparation that the democratic leaders face enormous tasks for which they are unprepared. But deal with them they must, and without delay. While doing so, they must also be careful not to make a bad situation worse by adopting mistaken policies.

Lengthy Agenda. The agenda for immediate action on economic reform is quite lengthy. Among the most important items are: swiftly creating the legal system necessary for the functioning of a market economy, resisting the temptation to erect barriers to trade with other republics, creating a stable monetary system that avoids both hyperinflation and economic isolation; reducing the rapidly ballooning deficits of the republican governments; ensuring that the grossly inefficient and distorted Soviet economy continues to operate as a new market system is created; and moving quickly to privatize state-owned enterprises in all sectors of the economy.

Only through quick and comprehensive action can the new political leaders hope to avert the worst of the economic scenarios now unfolding. The peoples of the Soviet Union have suffered enough from ill-conceived economic experiments. The victory of democracy entitles them to the economic liberties from which they have so long been deprived.