Post-Communist Reform

Pain and Progress

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United Nations University Press
TOKYO

The MIT Press
Cambridge, Massachusetts
London, England

United Nations University/World Institute for Development Economics Research (UNU/WIDER)
Helsinki, Finland

This book was set in Palatino by .eps Electronic Publishing Services and was printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

Post-communist reform : pain and progress / Olivier Blanchard . . . [et al.]
p. cm.
Includes bibliographical references and index.
ISBN 0-262-02362-8
1. Russia (Federation)—Economic conditions—1991– 2. Former Soviet republics—Economic conditions. 3. Europe, Eastern—Economic conditions—1989– I. Blanchard, Olivier (Olivier J.)
HC340.12.P67 1993 93-1732
338.947—dc20 CIP

United Nations University Press
The United Nations University
53-70, Jingumae 5-chome
Shibuya-ku, Tokyo 150
Japan

ISBN (United Nations University Press): 92-808-0842-7

Foreword

The World Economy Group is an independent group of leading economists set up by WIDER to report on major economic issues. In 1991, they produced a widely acclaimed report on the general issues of economic transition entitled *Reform in Eastern Europe*. The process of reform was still young. It is now three years old, and much has been learned during those three years. It is time to return and assess the evidence. This is what they offer in this report.

For this purpose, the group has been widened this year to include three additional members who have all been heavily involved in the reform process. Two of them, Maxim Boycko, Director of the Russian Privatization Center, and Andrei Shleifer, Professor of Economics at Harvard University, have been among the architects of the Russian privatization program. The third, Marek Dabrowski, is Chairman of the Polish Council of Ownership Changes and former Deputy Minister of Finance in the first Polish reform government. One of the members of the group, Paul Krugman, could not participate this year.

In their first report, the authors identified three main steps of the reform process, macrostabilization and price liberalization, privatization, and restructuring. They return to those three themes in this report. As could be expected, their report is neither dogmatic nor bland. They take up the issue of whether Russia's reform without stabilization can succeed or is a pact with the devil, bound to end in failure. They argue that the way to make progress in privatization is to realize that privatization is not about distribution or sale of the assets of "the state," but rather of assets with many claimants: workers, managers, local authorities, ministries, all with an incentive to oppose a dilution of their claims. Recognizing that convertibility is unlikely to be quickly implemented in the republics of the ex–Soviet Union, they draw on the experience of the post–World War II European Payments Union to recommend a similar payments system. Examining the progress of restructuring in Poland, they show the damage from the lack of progress on privatization on the evolution of state firms, and they look behind the impressive private sector growth numbers to point out its inability to replace state firms any time soon.

This only gives a glimpse of the many arguments of this report. I warmly recommend a full reading to all those concerned with the difficult problems of economic transition.

Lal Jayawardena
Director of WIDER
Helsinki
January 31, 1993

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1 Overview

Two years ago, this group produced a report on the general issues of economic transition entitled *Reform in Eastern Europe*. Reform was just starting. As we were writing, Polish stabilization was not yet six months old. Privatization programs were still just programs. And restructuring was an issue left for the future. Analysis and advice had to be based on the accumulated wisdom of experience from other countries and other times; how relevant all that was for Eastern Europe was hotly debated.

Two years later, much has happened and much has been learned. The reform process is very much alive. For many Central European countries, stabilization is now a thing of the past, although inflation is still high and the risk of accelerating inflation always present. Privatization plans have been implemented, although progress has been painfully slow. Restructuring is at the top of the agenda, and governments struggle with how best to help growth, how fast to close unprofitable state firms, and so on. And surely one of the most important events of 1992 is the start of

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Written by Olivier Blanchard and Richard Layard.

economic reform in Russia. Under the force of political realities, Russia is following a different route. Stabilization has not been attempted, money creation and inflation are running high. But many prices now clear markets, and privatization is proceeding at a fast pace.

In this new report, we thus return to the three steps of reform we had identified earlier, stabilization and price liberalization, privatization, and restructuring. We assess progress, mistakes, and issues for the future.

Stabilization and Price Liberalization

The prevailing wisdom in 1991, and one embodied in our report of that year, was that both stabilization and price liberalization were preconditions for a successful reform process. The arguments were political, macroeconomic, and microeconomic. The political argument was that the government had to send a clear signal that it was going to balance the budget, and that it was no longer committed to extending unlimited credit to loss-making firms. The macroeconomic argument was that, lacking stabilization, inflation would turn to hyperinflation, with its attendant large dislocations. The microeconomic argument was that, for privatization and restructuring to proceed in the right direction, prices had to be right, and firms could not avoid market discipline.

This was the thinking behind the Central European stabilizations. Russia, however, has not followed this route. Most prices were liberalized in January 1992. But macrostabilization was never implemented, so that during 1992 inflation never fell below 9 percent a month. This raises two issues. Why has there been no stabilization? And can reform succeed nevertheless? These are the issues we explore in chapter 2.

The first question is easier to answer than the second. Going beyond the conflicts between the Central Bank and the government, the basic answer is that stabilization was not implemented because there was insufficient support for the unemployment that would have resulted. In April 1992, the People's Congress told the government that the top priority was to "stabilize production." Concretely, this meant propping up employment in state firms through credit and thus money creation. Whether or not this message reflected the priorities of people at large, the message was clear that, for the time being, no government could stabilize and survive. The reformers in the government thus had a choice. Their main purpose was to turn Russia into a capitalist economy. To do this, they needed to retain power, and to retain power, they had to accept a massive growth of credit to state firms. By this strategy, they secured a major triumph on another front. In June, the Supreme Soviet approved a plan for the fastest privatization in history, and at the time of this writing, the plan is being implemented.

The second question is much harder to answer. Was prevailing wisdom right, and is the trade of no-stabilization for privatization a pact with the devil? One can see many ways the current course can go wrong, and, at the time of this writing, events provide little reassurance. Maintaining employment in existing firms does not allow for the release of people and factors needed elsewhere. But one can think of worse and more immediate consequences. First, there is no such thing as steady high inflation. Indeed, generous credit and low unemployment are both fueling accelerating wage demands and, at the time of writing, high inflation appears to have become hyperinflation. Hyperinflations never last very long. Second, the political signals given by the lack of control of credit may well lead to more demands by firms and other organized groups, and threaten the other achievements of reform so far. It is only one step from the use of credit to keep state firms alive to the reestablishment of price restrictions and controls to protect specific firms and groups in the population, a step that would eliminate much of the progress on price liberalization accomplished in 1992. If privatization means less de facto access to credit and subsidies, state firms may be reluctant to go private and privatization may slow down. The price signals under which privatization is taking place are fuzzy at best; the efficiency and wealth distribution implications may soon prove costly. These are the issues to watch for in the near future.

Privatization

Faced with the task of privatizing state firms, the first approach of Eastern European reform governments was to look at the methods that had been used in the West. It became quickly clear that this was not the right way: the task was too large, the information and bureaucratic requirements too burdensome. The second approach consisted of a set of plans aimed at finding the right tradeoff among speed, efficiency, and equity. There were many such, often ingenious plans; *Reform in Eastern Europe* sketched our own, based on reliance on the creation of transitional holding companies.

Two years later, reality has set in. Ambitious and clever plans have been disfigured by political compromises, bogged down in political fights, tied down by bureaucratic bottlenecks and foot dragging, sabotaged by those who would lose most from their implementation. The overall pace of privatization has been very slow. The basic lesson is clear: privatization is not about the distribution of assets belonging to "the state," which can dispose of them as it wishes, but about the distribution of assets with many de facto claimants: workers, managers, local authorities, central ministries, and so on. Unless these claimants are appeased, bribed, or disenfranchised, privatization cannot proceed. The main challenge of privatization is thus how to deal with and reconcile those claims. This is the issue we explore in chapter 3.

Nowhere are these conflicting claims more evident than in Russia. And the Russian privatization program starts squarely from the recognition of those claims, and of the relative power of the claimants. Who are these claimants? Pre-reform, they were ministries and managers. Ministries could affect delivery of scarce inputs, but only managers had the know-how required to make firms function. The collapse of central planning and the advent of reform have drastically changed the distribution of claims. Workers now have influence over employment, wages, and sometimes the choice of managers. They strongly feel that they have a large claim, sometimes even an exclusive claim to their firms. Managers on the other hand have remained very powerful, as their knowledge of the networks of suppliers and buyers is essential to running the firms. Both de jure and de facto, local governments have become more powerful and, with the strong support of their constituency, have also claimed a stake in firms under their jurisdiction. The major losers have been ministries, which are far from the firms and have lost their grip on the control of supplies.

Absent a privatization program, this new distribution of overlapping and conflicting claims is likely to lead to a continuation of the status quo. And because many of the stakeholders have enough effective control to veto any change, no restructuring can take place. This shows why privatization is essential. But it also shows why a program that establishes claims, and thus probably reduces some of them so that the sum of claims does not exceed one, may still be acceptable to all initial stakeholders: it is better to hold a smaller claim on a going concern than a larger claim on a paralyzed firm.

Based on this assessment, the Russian privatization program has been organized along the following lines. Workers and managers will get a lot. They have the choice at this point between three plans; in all three, they will receive at least a third of the shares, either free or at knockdown prices. Local authorities will get their share, but should get it mostly in the form of privatization proceeds, rather than control. That half of the labor force that works outside the enterprises to be privatized, and currently holds no claim, will also get something. This is being done through vouchers. Some 80–90 percent of the shares (other than those provided on preferential terms to workers and managers) will be auctioned for vouchers, the rest auctioned for cash. The distribution of vouchers was largely completed by the end of 1992; this precommits the government to find enterprises to sell. The ministries, which would very much want to form holding companies and to create a system of cross holdings, are, for the moment, getting little.

Privatization is proceeding along these lines. Many firms have been bought by insiders, at very low prices. These privatized firms are creating a strong constituency for reform. Many local auctions have been highly successful, yielding high prices and a strong temptation for local authorities to sell more firms, trading control for cash. Many things can obviously go wrong. Resources allocated to the privatization process are much too small. Those firms that are doing poorly but have access to credit do not want to be privatized. Ministries are not happy with current developments. But, at this point, privatization is proceeding quickly.

Trade and Payments Arrangements

1991 saw the collapse of trade among CMEA countries, 1992 the collapse of trade among the republics of the ex–Soviet Union. Central planning had led to an extraordinary degree of specialization of the republics. The most extreme example was perhaps Belarus, where trade with other republics was equal to more than 70 percent of the republic's net material product (NMP). This specialization makes the collapse of trade all the more worrisome.

Why has trade collapsed? Partly because of the reluctance of Russia and Russian firms to sell underpriced goods, such as oil, to other republics. Mostly because of the reluctance of the republics to accept rubles in exchange for goods. This has led firms to ask for payment in hard currency. But hard currency is in limited supply in most republics. And it has led to barter trade. But barter is an extraordinarily primitive way of conducting trade. For all these reasons, trade has declined, leading in turn to a decrease in output and further declines in trade.

The economists' answer to the problem is convertibility. Let all the republics have their own currency, and make their currency convertible, either at a fixed or, more likely, because of the lack of reserves, at a flexible rate. Movements in the exchange rate will solve the hard currency shortage, will solve any bilateral imbalance problem, and trade will increase. But many republics are not willing to consider full convertibility just yet. They are reluctant to accept the likely real depreciation that would come with convertibility, and they want to retain more control of foreign transactions than they would under convertibility. It is with that political constraint in mind that we explore, in chapter 4, the advantages of a payment mechanism.

Here is one very useful historical precedent, from Western Europe after World War II. Western Europe had emerged from the war with massive trade restrictions, and bilateral trade was the rule. A payments system was put in place, the European Payments Union, and was run by the Bank for International Settlements. It had two major functions.

The first was multilateral clearing of claims, with, each month, a statement of net credit or net debit for each country. This allowed countries with overall balanced trade to carry out transactions without the need to hold hard currency, and thus less of a need to generate hard currency earnings through transactions with the rest of the world.

The second was to relax the constraint that trade within the EPU be balanced each month. Each country was allocated a quota on its cumulative imbalances. When the country went beyond its quota, it had to settle an increasing portion in gold or dollars. Creditors in turn had to accept a portion of their net cumulative balance in credit, and the rest in gold or hard currency.

The system was supported politically by the US, which helped to capitalize it. It worked from 1950 to 1958, by which time most members had moved to full current account convertibility. The system was a success. We argue that a similar system could be set up at this point among the republics. It would not solve all problems. Exchange rates would still have to be set at levels consistent with balanced trade. And countries that ran large imbalances would still have to take the measures needed to prevent further imbalances. But it would eliminate the need for barter trade, save on the need for hard currency holdings, and allow interrepublic trade to recover. Central European countries, even those that have already established convertibility, would also gain from participating, as this would allow for trade between them and the republics without need for hard currency. And, like the US after the war, the West could both help set up and fund the system, giving it some leverage later in ensuring proper behavior of the participating republics.

Restructuring

Reform in Poland is now three years old. Stabilization has been achieved, at least for the time being. The central issues are now those of restructuring, of how to close those state firms that need to be closed, of how to successfully transform those that should survive, and of how to foster and protect the growth of the new private sector. These are the issues we deal with in chapter 5.

Three preconditions are essential to the success of restructuring.

The first is price liberalization, so that prices provide the right incentives to firms and to consumers. This was largely achieved early on in the reform process.

The second is the hardening of the "soft budget constraint," so that market signals are not offset by subsidies or confiscatory taxation. In sharp contrast to Russia, credibility on this front was also achieved early on. This credibility has been tested a few times, especially in the first half of 1992, when it appeared that the newly formed government might be more sympathetic to the plight of struggling state firms. But it has survived, and firms are now accepting the realities of hard budget constraints.

The third is privatization, so that firms have the right incentives to respond to market signals. There, as we discussed earlier, progress has been very slow. The reasons are many. Initial plans, and even those that followed, were too complex. Many of the power plays now taking place in Russia were carried out either within the Polish government or in Parliament, leading to long debates and longer delays. The bureaucracies in charge have had strong incentives to err on the side of prudence, thus of inaction. As a result, the large majority of state firms is still in ownership limbo. If everything goes right, the most ambitious plan to date, "mass privatization," will clear Parliament during the first quarter of 1993.

In the absence of privatization, the magnitude of the restructuring task, together with uncertainty about their stake