

# The Limits of US Influence on Russian Economic Policy

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November 2000  
PONARS Policy Memo 173  
Harvard University

When the Soviet Union broke apart nine years ago, Western observers voiced dire predictions about Russia's fate. Some warned that a quasi-fascist or military dictatorship would seize power; others spoke ominously about the violent disintegration of the country along the lines of Yugoslavia. Many expressed particular misgivings about the dangers posed by Russia's nuclear arsenal, which, they feared, would be vulnerable to diversion and "leakage." So far, none of these predictions has been borne out. Although Russia has experienced severe economic, political, and social problems since 1991, the worst scenarios have not come to pass.

The fact that Russia has avoided outright collapse is a source of encouragement for many Western analysts, but not for all. Some insist that Russia has experienced a "catastrophe," an "unprecedented disaster," and a "great human tragedy" over the past decade. Phrases of this sort, supposedly describing what happened in Russia in the 1990s, have been used over and over in a number of recent critiques of US policy. Most of these critiques are polemical and shrill. In a few cases, the authors raise some valid points, but they fail to provide balanced and sober assessments of developments in Russia and of US policy. Other recent analyses, notably the Cox Committee's September 2000 report on "Russia's Road to Corruption," were written mainly for partisan political ends. Although the committee's report provides important information and raises troubling questions about US policy, the pronounced slant of the document greatly diminishes its value.

The stridency of these critiques is partly offset by a few recent analyses of Western policy that are worth perusing in full. A study released in February 2000 by Sarah Mendelson and John K. Glenn contains valuable insights on the role of non-governmental organizations in Western democracy assistance programs. A lengthy report issued in November 2000 by the US General Accounting Office (GAO) provides a wide-ranging assessment of Western economic programs in Russia. Although some aspects of the GAO study (e.g., its unduly gentle treatment of the international financial institutions) are problematic, the report's authors took pains to be even-handed.

These scattered exceptions aside, the proliferation of one-sided and tendentious critiques of US policy is unfortunate. There is a great deal about US policy that deserves to be condemned, but many of the complaints voiced in recent publications (by Janine Wedel, Stephen Cohen, and others) are spurious and self-serving. A full reply to these publications would require hundreds of pages. The purpose of this brief memo is to lay

out an alternative perspective on US economic policy toward Russia, looking at both the strengths and the shortcomings of US actions. The general emphasis here and many of the specific points differ from the findings of the GAO report.

### **Initial Intentions Versus Execution**

One of the common fallacies in the recent critiques of US policy is the notion that the West played a decisive role in Russia's fate. Although the United States and other Western countries necessarily had an effect on Russian foreign policy in the 1990s, American influence on Russia's internal political and economic complexion was marginal at best. Responsibility for Russia's internal changes--for good or for bad--lay with Russian officials themselves. The tendency on both sides of the American political spectrum to ascribe a highly exaggerated role to the United States is unfortunate. It deflects attention from what actually went on in Russia.

The failure to appreciate how limited the US role in Russia really was has led to a myriad of misconceptions about the nature of US policy. (The term "policy" refers here to technical assistance and advice as well as to financial support.) All evidence suggests that US policy toward Russia--under both George Bush and Bill Clinton--was initially well-intentioned and was not designed as a "crusade" or a malicious plot to "keep Russia down" as some Western and Russian critics have alleged. US officials were well aware that American influence in Russia was likely to be exiguous, but they set out in the hope of at least marginally encouraging the emergence of a free-market economy and liberal democracy. These goals, far from being imposed on Russia, were explicitly endorsed by Russian officials themselves and by the Russian electorate. Over time, the goals became more ethereal as symbolism replaced substance in US-Russian relations, but there is little doubt that the large majority of Russians who elected Boris Yeltsin president in June 1991 were voting for something that approximated democracy and a market economy. It is hard to believe that any US administration would have sought other goals at the outset or would have preferred to stay on the sidelines while Russia tried to remedy the catastrophic economic situation left from the Soviet regime.

Whether US economic programs proved to be wise or effective--as opposed to well-intentioned--is a very different matter. On some issues US advice was beyond reproach, but on other issues it was misguided. Even when the advice was sound, poor implementation of certain programs often detracted from their effectiveness. Enormous problems also were posed by US and Western financial support for Russia, which had a greater impact than any of the advice did. Most of the lending ultimately worked to Russia's (and the West's) disadvantage.

Four aspects of US policy--on stabilization and price liberalization, large-scale privatization, Russia's relations with the International Monetary Fund (IMF) and other international lenders, and trade policy and food aid--are worth examining at greater length to underscore the positive and negative aspects of US policy.

## Macroeconomic Stabilization and Liberalization

From the outset, the United States urged Russia to pursue macroeconomic stabilization and price and trade liberalization as rapidly as possible. The cumulative experience of the former Communist world in the 1990s shows that this advice was eminently sound. Statistical correlations, controlling for a medley of other variables, confirm that the sooner a former Communist country achieved macroeconomic stabilization (bringing inflation permanently under 40% a year and stabilizing the exchange rate) and the sooner it liberalized prices and commercial transactions, the greater the likelihood that it would be able to resume and sustain economic growth.

The problem with US policy on this issue vis-à-vis Russia was not that the recommendation was unwise, but that it was not implemented stringently enough. The United States failed to respond when Yeltsin decided in early April 1992 to restore costly subsidies to industry and agriculture, a step that signaled the end of the macroeconomic stabilization program. Shortly thereafter, Yeltsin acquiesced in the parliament's appointment of Viktor Gerashchenko as head of the Central Bank. Gerashchenko's free-spending policies and loose control of the money supply locked the Russian economy into an inflationary spiral. These fateful decisions by Yeltsin condemned Russia to suffer from hyperinflationary conditions over the next three-and-a-half years, a situation that impoverished millions of Russians (especially pensioners and others on fixed incomes), undermined political support for the government, discredited the whole notion of market reform (since the rhetoric of reform was still being used), threw the Russian economy into disarray, and helped prevent the emergence of sound financial institutions. US officials were well aware that the Russian government was pursuing disastrous macroeconomic policies, but they chose, more often than not, to turn a blind eye. Under US pressure, billions of dollars of IMF loans to Russia were approved in the early and mid-1990s even though the Russian government did not come close to meeting the IMF's own explicit requirements.

The United States also played along when Russia finally brought down inflation in late 1995 and 1996. It is now clear that the Russian government's belated "success" with stabilization was largely a sham. Fiscal imbalances remained acute, and the whole arrangement was underwritten by the accumulation of a huge and ultimately unsustainable short-term debt, by the sharp appreciation of the ruble in real terms (leaving it highly vulnerable to currency speculators), and by the government's tolerance of wage and payments arrears throughout the economy. The sleight-of-hand that underlay the "stabilization" in Russia was exposed by the August 1998 crisis, but it was fully evident well before that to anyone who was not taken in by the Russian government's own propaganda and by the hype of Western bankers and investors operating in Russia.

Stephen Cohen has voiced the peculiar charge that "economic shock therapy and the abrupt decontrol of prices," which were allegedly imposed on Russia by the United States, generated hyperinflation that caused misery for ordinary Russians. Cohen gets the story precisely backwards. It was the Russian government's failure to heed US advice about the importance of stabilization that led to hyperinflation. If the Russian authorities

had accepted the initial US advice, Russia would be a lot better off today. Yeltsin's decision to disregard US advice and to abandon strict macroeconomic policies brought about the very ills that Cohen decries.

### **Large-Scale Privatization**

By the time the United States began providing economic advice to the Russian government in the early 1990s, the Russian authorities were under growing pressure to privatize thousands of large state-owned enterprises (SOEs). Spontaneous privatization and asset-stripping by enterprise managers had begun in the late 1980s amidst the economic chaos created by Mikhail Gorbachev. Most of the individuals who served in high-level government posts in Russia in the early 1990s have insisted that they had no choice early on but to proceed with a mass large-scale privatization program, a claim endorsed by some Western analysts who were advising the Russian government at the time. These assertions, however, are highly questionable. Spontaneous privatization, asset-stripping, and other problems similar to those in Russia had cropped up elsewhere in the Communist world, notably in Poland, yet the Polish government was not forced to carry out a mass large-scale privatization program in the early 1990s. The decision by the Russian authorities to pursue mass large-scale privatization right away--and to do it by accommodating enterprise managers and workers ("insiders") with an insider-dominated process--was hardly as "unavoidable" as some now allege, any more than it was in Poland.

The Russian government's decision to embark on mass large-scale privatization in 1992 was strongly endorsed by US officials, who consistently advised the Russian authorities to enact such a scheme. It is important to emphasize, however, that the US advice was not what drove the voucher privatization. Russian leaders themselves had already decided to pursue the program, and the only thing the US government did was to reinforce that inclination. The United States did have some influence on the details of the program by providing funding and technical expertise, but the basic decision to proceed with mass large-scale privatization was taken in Moscow.

It is not clear whether anything the United States might have done would have deterred the Russian authorities from pursuing a mass large-scale privatization program at such an early stage, but there is at least some reason to believe that the withholding of funds combined with vigorous warnings against the program would have produced a different outcome. Regardless of whether that is the case, it is clear that the United States never considered such a stance. On the contrary, US officials ended up making mass large-scale privatization the centerpiece of their whole economic policy. The Bush and Clinton administrations gave such high priority to Russia's large-scale privatization program that they were willing to overlook or put up with a host of irresponsible policies on other matters. So long as large-scale privatization was moving ahead, that was deemed sufficient evidence of "free-market reform."

In that sense, US priorities became skewed. The Russian government needed to accomplish three crucial tasks in the early 1990s: 1) rapid macroeconomic stabilization, 2) the establishment of hard budget constraints for large enterprises, and 3) the removal of countless barriers to the emergence of a thriving small business sector, which would quickly offset and provide an alternative to large-scale industry. Nothing of the sort actually occurred. The Russian government maintained direct subsidies to large enterprises long after they were privatized, and even when the government finally curbed its explicit subsidies, it continued propping up the enterprises indirectly by tolerating the buildup of wage and payments arrears. Meanwhile, prospective entrepreneurs in Russia were stymied by government interference and cumbersome licensing requirements. As a result, the three things Russia needed most in the 1990s--sound fiscal policies, far-reaching corporate restructuring, and the rapid growth of small business--fell by the wayside, as mass large-scale privatization overshadowed everything else.

Even if the Russian government had been more fiscally responsible and had done more to remove barriers to small business, the prompt implementation of mass large-scale privatization would still have been unwise. A substantial number of the thousands of large SOEs were inherently unviable in a free-market economy. The ostensible transfer of ownership of these enterprises was self-defeating in the absence of an effective bankruptcy regime and sound financial institutions. In the vacuum that existed in Russia, soft budget constraints remained the norm both for large firms and for banks, and ambiguities about property rights were pervasive. Russia's microeconomic weaknesses thwarted efforts in the mid- to late 1990s to achieve sustained economic growth.

The dismal results of Russia's mass large-scale privatization program were hardly unique. The pitfalls of such programs have been just as evident in other former Communist countries that adopted them early on. The Czech Republic began with a highly favorable macroeconomic situation and a surge in small business formation, but serious problems emerged after the Czech government promptly implemented an elaborate scheme for the mass privatization of large industry. (This is the case even though the privatization of large SOEs in the Czech Republic, unlike in Russia, was not insider-dominated.) As a result, the Czech economy lapsed into a prolonged recession in 1997-99. By contrast, countries like Hungary and Poland, which eschewed early programs of mass large-scale privatization and instead pursued bold macroeconomic reforms and removed barriers to the growth of small business, have been by far the most economically successful. The notion that corporate restructuring would be impossible in the absence of private ownership has been undermined by the experience of both Poland and Hungary, where extensive restructuring has occurred in many large SOEs. The trick was to impose hard budget constraints and to foster a small business sector that could absorb workers leaving (or laid off from) large enterprises.

Numerous analysts warned in the early 1990s that mass large-scale privatization was likely to exacerbate the very problems it was ostensibly designed to solve, but this view never carried weight within the US government. To the extent that US support for the early mass privatization of large SOEs reinforced the Russian government's own determination to press ahead, US interests were not well served. To be sure, it is doubtful

that the United States could have derailed the program even if it had wanted to. Moreover, it is likely that US involvement in the voucher privatization made the process somewhat more transparent than it otherwise would have been. Nonetheless, the United States would have been a lot better off if it had given more thought to the drawbacks of abruptly transferring ownership of thousands of highly inefficient Russian SOEs to "insiders" who were intent on keeping their enterprises open and on minimizing the extent of restructuring. Moreover, even if ownership had not been transferred to "insiders" and instead had been purchased by investment funds, serious problems would still have arisen, as the experience in the Czech Republic shows. Czech investment fund managers have been far more interested in collecting their fees and in arranging opaque side-deals than in carrying out far-reaching corporate restructuring or in selling controlling stakes to strategic foreign investors. It is a shame that the whole concept of early mass large-scale privatization did not receive a more thorough and skeptical hearing within the US government.

### **Relations with the IMF**

The United States has always been the largest financial backer and most important member of the IMF. Consequently, US officials in the 1990s had a disproportionate say in the IMF's decisions on whether to lend money to Russia. No funds at all were provided during the brief window of opportunity in late 1991 and early 1992 when a radical economic reform program was still under way in Russia. By the time the IMF approved its first, very modest loan to Russia in August 1992, the window of opportunity had already largely closed. Over the next seven years, the IMF lent a total of \$22.2 billion to Russia and thereby, with each new loan agreement, conferred its "seal of approval" on the changes under way in the Russian economy.

Although the IMF initially established sound priorities for Russia, the Fund was guilty of some egregious misjudgments. In 1992, IMF officials urged the Russian government to preserve a common ruble zone with the other former Soviet republics, a step that soon led to uncontrolled monetary emissions and a huge outflow of funds from Russia, causing even greater macroeconomic turmoil. Not until the summer of 1993 was the common ruble zone finally abolished. The IMF also went astray later on when it repeatedly downplayed the severity of Russia's growing short-term debt. To make matters worse, in 1998 the IMF joined the US Treasury Department in exhorting the Russian government to defend the ruble against feverish speculation. Although many outside analysts warned that the sharp real appreciation of the ruble from 1995 to 1998 had made the currency highly vulnerable, US officials and the IMF continued to urge the Russian authorities to hang tough. By the time a de facto devaluation was announced in August 1998, Russia had been forced to raise its domestic interest rates to debilitating levels and had squandered most of its dwindling foreign currency reserves in a vain attempt to stave off the speculators.

Despite the IMF's numerous gaffes, the main problem was not the Fund itself, but the pressure that the Fund encountered from the US government. The IMF repeatedly agreed

to provide loans to Russia even when the Russian government failed to meet the Fund's own criteria. The US government pressured the IMF to transfer money regardless of whether the explicit conditions had been met. This pattern began in the Bush administration, and it became much more pronounced under Clinton, primarily because of two factors: a preoccupation with Russia's nuclear weapons, and a commitment to see Yeltsin reelected in 1996. US officials claimed that a failure to turn over money to the Russian government--even if much of it was misused or wasted--would risk social and political instability, which in turn would endanger control of Russia's nuclear arsenal. Similarly, the Clinton administration was willing to push for huge new loans to Russia in 1995 and 1996--at the height of the corrupt "loans for shares" privatization--to support Yeltsin's re-election bid. Although the money did boost Yeltsin's campaign, it was also widely construed in Russia as a tacit reward for the "loans for shares." Moreover, even after Yeltsin was safely reelected, US officials failed to press for a tightening of the IMF's lending programs. Because of continued fears that political instability would endanger Russia's nuclear arsenal, the IMF was not permitted to treat Russia with the same degree of stringency applied to all other countries.

The Clinton administration's willingness to condone IMF loans to Russia despite Russia's failure to meet the requirements proved to be a grave mistake. The loans served as a lubricant for the Russian government to avoid or defer genuine reform. In 1993 and 1994, money from the IMF allowed the Russian government to pursue and stick with fiscally irresponsible policies. Later on, IMF funding helped Russian officials get away with the "loans for shares" scheme. If the IMF money had not been available in 1995-96, the Russian government might have been forced to earn money by soliciting competitive bids from prospective buyers of lucrative companies. In 1997 and 1998 the IMF's loans propelled the Russian government's quixotic defense of the ruble. The entire tranche of \$4.8 billion supplied by the IMF to Russia in July 1998 was siphoned off in this futile cause.

Stephen Cohen has argued that the IMF inflicted great harm on Russia by imposing "tight-fisted monetarism," "severe budget austerity" and "leap-to-capitalism shock therapy." Again, Cohen has the situation backwards. He is right that the IMF's impact in Russia was negative, but he is wrong about the reasons. The problem with the IMF was not that it was too stringent, but that it was--under US pressure--too indulgent, especially in the early and mid-1990s. According to the GAO report, some Western officials now claim that "the policy advice and high-level dialogue provided by the IMF has [sic] been of value to Russia's transition in several important respects," but even if this claim is accurate, it is hardly enough to outweigh the damage done by the IMF's loose lending practices.

## **US Trade Policy and Food Aid**

Throughout the 1990s, the US government extended generous subsidies to US companies doing business in Russia and provided billions of dollars of free or highly subsidized food to the Russian government. These policies were beneficial to a handful of large US

corporations, but they were much less favorable for Russia and for US taxpayers. The Clinton administration's trade subsidies and its food aid program set a bad example for Russia of how the state can intervene in support of private financial interests. The food aid program inhibited the growth of private farming in Russia and boosted the fortunes of Russia's state-controlled grain monopolies. To the extent that US export policies helped inspire or legitimize greater state control of the Russian economy, they were detrimental to the proclaimed US goal of encouraging a free-market economy.

The notion that investment flows should be determined by market forces was never at the heart of the Clinton administration's policy toward Russia. Instead, the administration provided generous subsidies to large, well-connected US businesses and investors through the Export-Import Bank, the Trade Development Administration, the Overseas Private Investment Corporation, and a host of other government agencies. Combined with US policies on related matters--the purported enlargement of the G-7 into a G-8 (including Russia), the repeated provision of IMF loans, and the constant linking of economic policies with rationales about Russia's nuclear weapons--the administration's trade and investment subsidies contributed to a serious moral hazard, giving Western (and Russian) investors the erroneous impression that Russia was "too big to fail" and that bailouts would continue ad infinitum.

US food aid has been equally deleterious. The aid has been a great boon for the largest US grain producers and shipping companies, but it has been unnecessary in Russia and has almost never reached those it was intended to help. Corruption, rent-seeking, and waste in Russia have dogged the program from the very start. More often than not, US food supplies have undercut private farmers in Russia, helped keep Russian grain prices so low that they deter aspiring private growers, and propped up Russia's largest, most inefficient distributors. The food aid also creates a moral hazard of its own. To the extent that the Russian government and legislature believe that Western countries will step in to provide food assistance to Russia--whether needed or not--they have had an incentive not to press ahead with desperately needed agricultural reforms.

Just as important as the concrete effects of US subsidy policies has been the symbolism. At a time when the United States has been urging Russia to adopt free markets, it is incongruous for the US government to be subsidizing and mitigating the risks of private American companies and banks that want to operate in Russia. Such practices tarnish the free-market principles that the United States claims to be promoting.

## **Conclusion**

Now that the prospects for bold economic reform in Russia are greater than at any time since 1992, it is appropriate to reassess US-Russian economic ties. Many of the recent critiques are wide of the mark. Although US economic policy has frequently gone astray, the main problem is that the United States has been too lenient, not too strict. The crisis of August 1998 has restored a good measure of sobriety to US policy, but the earlier mistakes could still recur. For the next US administration, therefore, the best approach



will be to treat the Russian economy with the same degree of stringency expected of the South Korean or Mexican economy. Above all, the United States must be realistic about the limits of its influence on internal reform in Russia.

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