Executive Memorandum
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MOSCOW NEEDS A FREE MARKET, NOT FOREIGN AID

Mikhail Gorbachev is promising free market economic reforms if the West gives financial aid to the Soviet Union. Two weeks ago he implied that $100 billion would be an appropriate amount for the West to invest in a reformed Soviet economy. Gorbachev also endorsed a mission by Soviet economist Grigory A. Yavlinsky to the United States to explore how the West could become directly involved in economic reform. Washington should welcome Gorbachev's apparent new enthusiasm for a market economy. But Washington, as a friend of the emerging new society in the U.S.S.R., should counsel Gorbachev that he is making a serious mistake if he assumes that further economic reform depends on foreign aid. Instead, a friendly Washington should advise that economic reform requires dismantling the communist political system, which is at the root of the Soviet economic crisis. To avoid making the Soviet economic crisis even worse than it is, the Bush administration should resist Soviet demands for massive aid, telling Gorbachev that the best way for the Soviet economy to recover is to create a free market as quickly as possible.

Gorbachev's "aid for reform" approach has four flaws:

FLAW No. 1: It wrongly assumes that foreign aid will spur economic reform. Western aid will hamper, not promote, free market reform in the Soviet Union. Western money will be wasted unless the Soviet economy is already well on its way to becoming a free market, as many countries' economies already are in Eastern Europe. In the current situation, aid given to the U.S.S.R. would block free market reforms not only by defusing political pressures for radical economic change, but by propping up the economic and political system at the root of the economic crisis.

The central government would use the foreign aid primarily to cover up the failures of the state sector of the economy. The gross national product of the state-owned sector of the Soviet economy dropped $2.6 billion in 1990, while the private sector or "cooperatives" grew by $1.1 billion. Sending more dollars into this failing state economy would be like pouring money down a drain. Western hard currency would be used to purchase and funnel foreign consumer goods into the state-run economy, thus dampening domestic production of such goods. This also would weaken the incentives to privatize state-owned enterprises. Existing private firms, meanwhile, would be at a disadvantage in competing with the state-run enterprises receiving the foreign-aid subsidies.

The "aid for reform" approach makes little political sense as well. The West may hope to buy free market reforms in the Soviet Union with foreign aid. But Gorbachev has reneged on promises of reform before. Last year he withdrew his support for the "500 Day" economic reform plan written by Yavlinsky and economist Stanislav Shatalin. He also blocked attempts by the republics to institute many free market reforms. And only weeks after the U.S. promised him $1 billion in agricultural credits last year, his government cracked down on the Lithuanian republic and introduced a series of harsh, anti-free market economic measures.

The only way out of the deepening economic crisis in the Soviet Union is for the private sector to grow and create wealth. This cannot happen if foreign governments use aid to shore up the dying Soviet state-run economy. Far more important to resolving the economic crisis than an infusion of Western aid would be establishing and protecting private property rights, allowing the market to set wages and prices, and privatizing state-owned enterprises.

FLAW No. 2: The "aid for reform" strategy mistakenly implies that a shortage of cash is causing the economic crisis. The cause of the Soviet economic crisis is not a shortage of government funds, but the collapse of the command economic system. As the repression under Gorbachev relaxed, so too did the state's control of the economy. The command economy was inefficient in the best of times, but with the deterioration of state control it went into a tailspin. The result was factories sitting idle because of supply shortages, a broken down food distribution system and plummeting industrial production.

Moscow may indeed be short of funds to buy consumer goods abroad, but making up the shortage with Western loans will not resolve the crisis created by the dysfunctioning economic system. The Soviet Union is like a car with a broken motor and an empty gas tank. The West could fill this tank completely with the fuel of foreign aid, but it would do nothing to make the motor work.

FLAW No. 3: Gorbachev's strategy ignores the need for democratic reforms. Czechoslovakia, Hungary, Poland and other East European states began drastic free market reforms only after democratic governments were elected. The old communist regimes had to be swept aside before the serious work of dismantling the command economy could begin. Western aid for Eastern Europe waited until after the democratic revolutions of 1989 had succeeded. By contrast, Gorbachev wants this Western aid up front, before the Soviet political system is democratized. So far, in fact, he has not even promised to change the political system that itself is the major obstacle to free market reforms. Free and fair elections at the national and local levels would break the stranglehold of the communist party officials over the state and economy. This would reduce significantly the ability of the bureaucrats and party functionaries to sabotage the economic reforms. These bureaucrats risk losing their jobs if a free market is created in the Soviet Union.

FLAW #4: "aid for reform" would create a dependency on the International Monetary Fund and other international banks. Some economists close to Gorbachev, such as Yavlinsky, seem to believe that the IMF and World Bank should become involved in reforming the Soviet economy. Presumably they assume that these international lending institutions would be more likely to lend the Soviet Union money if they were involved in drawing up the economic reform blueprints. Moscow must realize that it does not need assistance from the IMF or World Bank. These institutions have compiled a dismal record of failure in their projects to help countries grow economically. Some 48 countries have been taking IMF money and advice for between ten and nineteen years, and most of them are no better off economically than when they started. IMF loans to Argentina, Bolivia, Costa Rica, the Dominican Republic, Haiti, Peru and Uruguay have transformed these countries into permanent debtors. Meanwhile, their economic problems remain unsolved. The World Bank has poured a staggering amount of resources into Africa. All the while, the African economy has deteriorated. Gorbachev and Yavlinsky must ask themselves if they want the World Bank and the IMF to transform the U.S.S.R. into an African-style economic basket case.

The Soviet Union does not need the typical IMF and World Bank prescriptions of balanced budgets or huge infrastructure projects. The Soviet Union's economy requires massive privatization, property rights protection, deregulation of the economy and free trade. The IMF and the World Bank are not the places to turn for advice on these structural free market reforms.

Because of these four flaws, the Bush Administration should counter pleas from Gorbachev for a massive bailout of his political system with an offer to help the peoples of the Soviet Union build a free enterprise society. Bush should explain to Gorbachev that without economic reforms leading to a market economy, Western aid would perpetuate, not end, the economic crisis in the Soviet Union.

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