UPDATE

Backgrounder

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FIVE PROBLEMS WITH THE BUSH AID PACKAGE TO RUSSIA

(Updating *Backgrounder* No. 856, "Guidelines for Aid to the Soviet Union," September 23, 1991.)

The aid package to Russia and other former Soviet republics, announced by George Bush on April 1, is a welcome sign that the Administration no longer is straddling the fence on helping democracy in Russia. After months of hesitation, the Bush Administration has committed the United States to a $4.35 billion package to assist Russia's painful but necessary transition to a free market economy and democracy. Russian President Boris Yeltsin has welcomed the aid package primarily because it signals American political support for Yeltsin and his reforms.

While the Bush aid offer may have a positive political impact in Russia and other former Soviet republics, its long-term effectiveness as a tool of free market reform is questionable. It is good that Bush did something, but what he did may fall far short of the economic impact that he desires.

Problem #1: The $11 billion for "general aid" will be wasted.

Bush and German Chancellor Helmut Kohl proposed that the industrial democracies give $11 billion in general aid to Russia and other former Soviet republics. This most likely will be wasted. From September 1990 to January 1992 an estimated $80 billion worth of this type of assistance was delivered or pledged to the Soviet Union and its successor states. The results of this mammoth effort are nowhere to be seen. The $11 billion for "general aid" and "humanitarian assistance," to which the U.S. will contribute $2 billion, will be no more effective than the previous assistance programs. To make matters worse, the measure is late, coming when the winter is over and economic activity in Russia is picking up.

Problem #2: Massive loans and credits will saddle CIS states with more foreign debt.

The Western aid program to Russia includes $4.5 billion in loans from international monetary institutions like the International Monetary Fund (IMF) and the World Bank, of which the U.S. share is $.85 billion. The problem with this is that government-to-government loans usually do more harm than good. The loans will add to the huge $80 billion in foreign debt owed by Russia and the other Commonwealth states. The debt incurred from these loans could hamper economic growth for years. Latin American nations, for example, became completely dependent on World Bank loans, which supplied steadily larger loans each year so these countries could pay back their previous loans.

If cash is going to be given to the central government, outright grants are better than loans. Congress and the Bush Administration are more likely to be cautious in spending money if they know that it will never be repaid. Grants would not load down Russia with massive debts that could cause resentment among its citizens and destroy its international credit. These grants, however, should be channeled through the emerging private sector, which will speed the creeping pace of privatization in Russia. The experience with multilateral aid through international monetary organizations such as the IMF and the World Bank in the Third World has shown that government-to-government aid usually slows long-run economic growth. Many Latin American countries, such as Argentina and Mexico, experienced growth after years of economic stagnation only after the money from the IMF and the World Bank was cut off.

Problem #3: Ruble stabilization assistance could be wasted.

In Bush's package, the U.S. would put $1.5 billion into a $6 billion fund from the West to stabilize the Russian ruble and gradually make the ruble convertible into hard currency. The purpose is to create enough confidence in the ruble so, when allowed, people do not feel the need to exchange rubles for dollars, which would rapidly deplete the central bank's hard currency reserves.

In principle, this is an urgently needed measure. Yet there are two major problems with the Administration's proposal to stabilize the ruble. First, the Bush ruble stabilization plan would leave monetary policy in the hands of the Russian government and the Russian central bank, which consistently have inflated the money supply, thus destroying the value of the ruble. A currency cannot be stabilized, with or without the stabilization fund, until the Russian government stops financing budget deficits by printing money. Only last week, for instance, Moscow relaxed credit restrictions to money-losing state enterprises, confirming that the Russian government is unable to resist political pressures to inflate the money supply. A better investment for Western taxpayers would be to insist that in exchange for a Western-backed fund, monetary policy must be removed from the unreliability of political control.

The second problem is that the ruble does not necessarily need a Western-backed stabilization fund. The ruble could be backed by the vast natural resources in Russia. The Russian government either could sell rights for natural resources, such as gold, diamonds, and oil, to foreigners for "hard" currency or simply use its ample natural resources as a collateral for backing the ruble.

Problem #4: The $1.1 billion in agricultural credit guarantees will harm Russian efforts to privatize state-run collective farms.

Bush promised the former Soviet republics $1.1 billion in loan guarantees for purchases of American grain. Loan guarantees by the U.S. government make the American taxpayer responsible in case of a borrower's default. Since the collapse of the Soviet Union last December, the U.S. has already extended $3.75 billion in loan guarantees to the Commonwealth of Independent States, which, of course, includes Russia.

Continuing to underwrite Russia's purchases of American grain is wrong for two reasons. First, it undermines incentives for the government to privatize agriculture. Bush's message to the hard-liners in the Russian legislature is that there is no urgency in allowing private Russian farmers to feed Russia. They know that, if worse comes to worst, Russia can always buy grain in Iowa with the help of the American taxpayer, rather than privatize Russian agriculture so that Russians can feed themselves.

Second, as in other Third World nations, the avalanche of cheap American grain harms indigenous farmers, who cannot compete with their counterparts in Iowa or Colorado. The result: In addition to enormous domestic political difficulties, the struggling private sector in the Russian countryside will be hurt by powerful economic disincentives created by the U.S. government.

Problem #5: There exist no criteria to measure progress.

Apart from the deficiencies of the specific items, the entire aid package is flawed in one fundamental respect. It does not tie Western assistance to any index of progress, nor does it set any criteria by which Russia's movement toward a free market is to be judged. The Gorbachev years in power are a lesson of how aid without strings is wasted. Between 1985 and 1991, the Soviet Union's debt skyrocketed from an estimated $15 billion to an estimated $80 billion, with $40 billion accumulated in the last two years. A strong commitment to market reforms should be a condition for Western aid to Russia and other CIS states. This is the only way to guarantee that the money will be used for its intended purposes and encourage the only long-run solution to Russia's problems—the continuation of vigorous market reforms.

A good measurement of progress would be the Index of Economic Freedom that passed the Senate last July. Sponsored by Connie Mack, the Florida Republican, the index defines the key elements of a market economy, such as protection of private property rights, free pricing systems, limited government regulation of the economy, private banking and financial institutions, free trade policies, and low taxes. Linking Western aid to the index would create competition among the CIS states and provide a powerful incentive to move quickly in reforming their economic systems.

To be sure, Yeltsin is no Gorbachev. Unlike the former Soviet ruler, the Russian President is serious about free market reform and has taken a number of courageous steps to promote it. Still, like Gorbachev, Yeltsin is under enormous pressure from a largely reactionary Russian parliament to slow the painful reform and to spend Western assistance on cushioning the blow of the reform rather than expediting it.

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It is good that, after the months of procrastination, the Bush Administration has begun to support Boris Yeltsin in deed, not word. The bad news is that the aid package, as currently constituted, is likely to miss the strategic target, which is the acceleration of the free market reform in Russia. There is a better approach. The only way successfully to assist Russia in making the ruble a stable, convertible currency is to insist that, in exchange for Western aid, monetary control is removed from political control. Aid also should be channelled, almost always, directly to the emerging private sector in Russia, rather than to the government. And rather than sending to Russia government bureaucrats with little or no private sector experience to assist with the transition to a market economy, Bush should propose a business corps of American business managers who would spend from one to two years assisting Russian enterprises become dynamic private sector firms.

There is time for the White House and Congress to amend the package, both substantively and operationally, to make it more good news than bad. Russia has had enough bad news to last it for a while.

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