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REPEATING THE PAST: HOW THE IMF COULD HARM RUSSIAN ECONOMIC REFORM

(Updating *Backgrounder* No. 856, "Guidelines for Aid to the Soviet Union," September 23, 1991, and *Backgrounder Update* No. 178, "Five Problems with the Bush Aid Package to Russia," April 8, 1992.)

Congress currently is considering the Bush Administration's multi-billion dollar Freedom Support Act of 1992, a complex package of credits, loan guarantees, and grants to aid the countries of the former Soviet Union. American assistance would include $12 billion in loan guarantees for the International Monetary Fund (IMF) and up to $3 billion as the United States share of a $6 billion international fund to stabilize the Russian ruble. Much of this aid will be funneled through the IMF and the World Bank, as a part of a $24 billion international aid package announced by the major industrialized countries on April 1.

Growing, prosperous economies in these countries are indeed in America's best economic and security interest. But well-intentioned policy makers should ask what is the best way to ensure this outcome. The IMF and World Bank have very poor records in promoting economic growth in less developed countries. Large handouts from these organizations to Latin American countries in the 1980s delayed necessary economic reforms and stifled economic growth. And in the current IMF dealings with Russia, the same pattern of failed aid policies seems to be emerging.

To avoid the mistakes of the past, American policy makers must do more than hand out money and hope for the best results. The Bush Administration should insist that the IMF and World Bank focus their efforts in the former Soviet Union on privatization and other policy reforms that promote rapid job creation and economic growth. And to ensure this, Congress and the Administration would do well to establish an index of economic freedom to guarantee that American aid is used only to support real market reforms.

The U.S. and its economically powerful allies already have contributed $44 billion to Russia and the other republics of the former Soviet Union, with few visible positive results. And a current dispute between the IMF and Russia suggests that future aid also will be of little use and raises serious concerns over the West's strategy for helping former communist countries.

The Currency Controversy

Economic growth depends, among other things, on a stable, non-inflated currency. If a government expands the money supply irresponsibly by flooding the market with paper money or simply by extending easy credits, the value of the currency will fall rapidly and it will be useless as a medium of exchange or store of value.

The Russian government, unfortunately, is pursuing just such a policy. Last year a ruble could be purchased for between seven and ten cents. Today a ruble is worth less than a penny. Since the beginning of this year Russian printing presses have worked around the clock to supply the government with currency. Most of this newly printed paper is given to money-losing state enterprises to pay salaries and other bills. In addition, the government has yet to tighten the easy credit given to the state sector. These high-inflation policies are likely to accelerate. In response to strike threats and pressure from state enterprises, Russian Deputy Prime Minister

Yegor Gaidar, who tried to control inflation, essentially admitted defeat in a May 31 television address. There he promised to increase the number of rubles in circulation by 500 percent by August.

Stabilization Fund. IMF negotiators correctly see this situation as untenable and insist that Russia slow its inflation rate. In exchange the IMF offers $6 billion, with up to $3 billion coming from the U.S., for a stabilization fund to stop the fall in the value of the ruble. The Russian government could draw from this fund to purchase rubles at a fixed rate as a way to support the currency's value. Proponents of this approach suggest that the very existence of the fund could instill confidence in the ruble without the money actually being touched.

Yet this IMF strategy is seriously flawed. A stabilization fund still leaves the government in Moscow in control of the money supply and free to print rubles or extend cheap credit. And there would be strong pressure to do so. Government bureaucrats and the workers in inefficient state-owned enterprises will not want their government subsidies ended. And if the West, through the stabilization fund, in effect will pay the bills in the future for such an inflationary policy, the Russian government will find it difficult to avoid the temptation to inflate.

A better approach, if foreign aid must be used, would be for the Russian government to establish an independent currency board which could only issue rubles, at a fixed exchange rate, in the amount of the hard currency that it has in its accounts. There would be no central bank supporting the currency board system. Therefore the board would have no powers to manipulate the money supply in response to political pressures. Hong Kong and Singapore, which possess very stable currencies, use just this approach. The currency board effectively would remove the money supply from the hands of politicians and provide Russia with a stable currency in the matter of months.

The Failure To Privatize

An even more serious problem with the IMF's policy toward Russia is that it ignores the urgent need to privatize government-owned assets. While there has been much talk of privatization in Russia, no major government divestment of assets has actually occurred. Worse still, the pressure to print more rubles and extend further credits comes principally from just the cash-strapped state-owned enterprises that should be sold off or closed. Economic reform in Russia should aim first at transferring productive assets, from factories to farms to small retail outlets, to private owners who will profit only if these enterprises provide consumers with the goods and services that they actually wish to purchase, and at affordable prices. As long as land, machines, materials, buildings, and labor remain in state hands, they are wasted producing goods inefficiently, in quantities that do not meet market demands, and at prices that few can afford.

This IMF blind spot toward privatization seems to be a continuation of its approach to the Latin America debt crisis in the 1980s. Irresponsible economic policies made the governments of Argentina, Brazil, and Mexico unable to meet their foreign debt obligations. In response, the IMF and World Bank passed out billions of dollars in assistance. In return for loans, these countries promised to reform their economies.

Subsidies Continued. In fact, international funds often made matters worse. The IMF and World Bank did not insist that debtor governments eliminate huge subsidies to inefficient, money-losing state-owned enterprises. Thus international funds allowed these governments to continue paying subsidies that they would have been forced to cut if they had to rely solely on their own assets.

While receiving international funds, for example, Argentina was losing nearly $1 billion per year on its state-owned railroad. In 1987, the government of Brazil put aside $6.5 billion to cover the debts of state enterprises, even as it shopped for more money from international organizations. In Mexico, the state-owned oil company, PEMEX, the state airline, Aeromexico, and the state food distribution network, Conosupo, were among the many money-losing enterprises requiring billions a year in government handouts. But since the IMF and World Bank were happy to lend these countries billions of dollars, while ignoring the need to privatize, these countries had little incentive to close or sell off these enterprises. Only when it was clear that new large handouts would not be forthcoming were reformers in these countries able successfully to promote privatization and other market reforms.

The Plague of High Taxes

In Russia, the IMF seems to be repeating its pattern of focusing first on balance of payments problems rather than on promoting growth-oriented free market policies. This is most evident in the area of taxation. Key to the creation of new enterprises and new jobs is the ability of entrepreneurs to accumulate the capital necessary to rent business space, hire workers, purchase tools, machines and materials, and transport products to market.

Yet Russia imposes a 32 percent tax on business profits, a 38 percent payroll tax on workers, and a 28 percent value-added tax on manufactured products. The tax on annual income of over $4,000 is 60 percent. An entrepreneur could find himself paying a cumulative 80 percent tax on his profits. Such rates of taxation guarantee that the economy will not grow. It is not surprising that Russian tax collections are 60 percent below projections. With high taxes, there is less produced and thus less taxes to collect.

By tying loans first to macroeconomic policies, for example, balanced budgets, the IMF often has forced governments to raise taxes or keep taxes high. Just last year the IMF forced the government of Argentine President Carlos Menem to hike his country's value-added tax. If the IMF wished to promote rapid economic growth, it would work with the Russians on ways to reduce taxes.

The danger of a repeat of the foreign aid mistakes of the 1980s is compounded by the fact that the same American policy makers who oversaw the aid policy at that time still direct policy in the 1990s. Secretary of State James Baker, as Treasury Secretary from 1985 to 1988, devised those policies. His successor and the current Treasury Secretary, Nicholas Brady, continued them.

The Russians themselves seem to recognize the potential danger of accepting uncritically aid from the West and the strings that inevitably are attached. On June 12 Russian President Boris Yeltsin stated that, "We know cases in the world when some countries have followed the advice of the IMF and suffered a fiasco."

Promoting Economic Freedom

The bill before Congress to assist the countries of the former Soviet Union does contain free market rhetoric. But there is no indication that the IMF, World Bank or Bush Administration officials will do anything different than in the past. The best way to hold the Administration, the international financial organizations, and thus the former republics of the Soviet Union to sound economic policy would be to add an index of economic freedom to any foreign aid bill. Such an index was included in the foreign aid bill last year, which was passed by the full Senate. Unfortunately, House action did not follow. This index would set out certain indicators to guide aid decisions and to gauge progress. It would focus on privatization, protection of private property rights, wages and prices set by the market, private banking, free trade, and deregulation. America would insist that its aid money be used only to promote these goals.

Russia and the other countries of the former Soviet Union will have a difficult time overcoming the ravages of decades of communism. The U.S. and its Western allies owe it to the brave people of these countries who have now won their political freedom to give them the advice and assistance that will enable them to win their economic liberty as well.

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