THE SOVIET ECONOMY IN THE WAKE OF THE MOSCOW COUP

Symposium Report

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THE RAND/UCLA CENTER FOR SOVIET STUDIES

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OPENING REMARKS

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Dr. Becker welcomed the symposium participants to the seventh semiannual symposium, the first of this wide-ranging series to consider predominantly economic questions. These questions are of particular significance during this time of economic disintegration in the Soviet Union. Current Soviet economic difficulties also have crucial implications for Western leaders and businesses.

The aftermath of the August 19, 1991 right-wing coup had several consequences which must be considered:

• First, the immediate effect of the coup failure was to revitalize the democratic forces in the Soviet Union and increase the prospects for a radicalization of political and economic reform. In the six weeks following the coup, the initial euphoria of victory has lifted, some backsliding has occurred, and there is a general sense that popular expectations have not been met.

• Second, there has been a rush to independence by the union-republics, at least through verbal declarations. In the case of the Baltics, these actions are a real and final separation from the Union. For republics such as Armenia, Georgia, and Moldova, the declarations represent a step on the path to complete independence. In Central Asia, however, declaring independence seems to be a ploy to preserve the vested interests of the old guard. One result of this apparent disintegration is the further complication of inter-republic economic interchange.

• Third, the economy continues its free-fall with rapidly declining output, falling exports, increasing hard currency debt coupled with disappearing gold reserves, and accelerating inflation. The banking system continues to subsidize unproductive and unprofitable enterprises. Fiscal profligacy at the center and in the republics threatens to cause budget deficits of 15-25% of GNP.

• Fourth, regional protectionism and continued national conflict have increased the incidence of barter trade.

• Finally, Soviet requests for external economic aid have become more insistent, more specific, and more sizable.

Given these conditions, the following questions remain: Where does the Soviet economy go from here? What does it mean for the West, particularly the United States? How will it affect U.S. business?
WESTERN PRIVATE INVESTMENT

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The allure of the Soviet market lies in its size and in the breadth of its needs. At the present time, Western businesses are helping to produce such varied items as breakfast cereals, oil-drilling equipment, motion pictures, pharmaceuticals, and all-terrain vehicles. While some businesses have been able to show a dollar profit from investment in the Soviet Union, the risks involved have claimed many casualties. There are three major difficulties in conducting business with the Soviet Union:

- The USSR lacks a modern infrastructure, which makes business contacts and shipping time-consuming and expensive. Basic physical tools for progress, including telephone systems and FAX machines, are either generally unavailable or of poor quality.

- There is no body of commercial law which may be litigated in the courts. Rather, Western-Soviet business disputes tend to be arbitrated in Stockholm.

- The inconvertibility of the ruble makes it impossible to get hard currency for goods sold in the Soviet Union. There are, however, ways around this constraint through barter or countertrade agreements where the Western partner receives goods which can be sold on hard currency markets.

In terms of future investment, the most promising area appears to be the Far East, because of both its wealth of natural resources and its proximity to the Pacific Rim. The main port, Vladivostok, which will be opened to international traffic next year, is only 10-14 shipping days from the western United States. Plans currently exist to use Vladivostok as a transit point for goods en route to Western Europe, via an improved Trans-Siberian railway.

In the post-coup period the prospects for conducting business improves as instability gives way to a greater sense of stability and hope that the remaining obstructions to business relations will be removed more quickly. However, the timing of investment is critical; Western investors need to build on the new entrepreneurial spirit of the people.
PRIVATIZATION IN RUSSIA

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American business experts are working with Russian leaders to counsel the newly-emerging private bankers, to value the assets of state enterprises with no income history so that stock may be issued, and to identify projects throughout the republic which can be used as models for Western investment.

The drive toward privatization must begin with the creation of a level playing field for all competitors. Fundamental to this is the necessity for all people to understand the principles of a free market. At the present time, terminology is being developed, educational resources about the free market are being prepared and catalogued, and a weekly program is being developed for Russian TV to teach the citizenry how a free market works.

While many of these attempts may come to naught if the disintegration of the economy is not halted, the optimism of the people and the freshness of their attitudes, particularly in Siberia and the Far East, offer hope for the future. This spirit and the increased information flow have certainly decreased the possibility that demagoguery will again be able to halt Russia’s march toward a free market.
THE POLITICS OF PRIVATIZATION

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The fundamental change in the Soviet Union has been a political change: the overthrow of oppression and the establishment of liberty and democracy. Economic reform, particularly privatization, has resulted from this political change. The goals of democratization and privatization, however, are in opposition to each other. Democratization unites people because, by their very nature, democratic rights must be shared by all. On the other hand, privatization divides people because exercising private property rights means that one individual experiences private property at the exclusion of others.

Therefore, in undertaking the privatization of the Soviet economy, the popular consensus accompanying democratization is lost. All people would like better economic conditions, but under any system of distribution of property rights, some people will be relatively more advantaged. The disadvantaged portion of the society may then join with the remaining bureaucracy to delay or block attempts to implement the reform. For example, Gorbachev's much-noted shift to the right in the fall of 1990 was occasioned by the August 1990 introduction of the "500 Day Plan," an ambitious program of privatization and economic reform, and the resulting turmoil. Given the difficulty of unifying popular support and delays in plans for resolution of economic problems, any program of privatization will be a lengthy process.

The process of "de-statization" -- the privatization of the huge state enterprises -- is beset by two crucial questions: How much are their assets worth? To whom will the shares be sold? As noted above, Western business experts are working with Soviet officials in an attempt to value the assets of the state enterprises. To answer the second question, two plans have been suggested, each with its own difficulties. In the first plan, each citizen of the USSR would receive an equal share in the value of the state enterprises. Many citizens, however, would be tempted to sell their shares in exchange for much-needed hard currency, much of which is in the hands of organized crime. In the second plan, the workers in an enterprise would have a priority right to buy the shares. This plan, however, would effectively exclude the pensioners from owning shares, a contentious point.

In world history, we have had undemocratic societies with private property and undemocratic societies without private property. We have also had democratic societies with private property. But there has never before been a democratic society without private property -- which is what has developed in the Soviet Union. Attempting to grant individuals rights to private property against a backdrop of democratic coalitions and protests could prove to be a difficult and lengthy endeavor.
THE PRIVATIZATION EXPERIENCE IN EASTERN EUROPE

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Professor Berend outlined five major lessons from the East-Central European experience with privatization and applied these lessons to the Soviet case.

First, it is necessary to differentiate between two spheres of privatization. The first sphere includes the privatization of grass-roots, mostly small-scale businesses. In most cases, this amounts to deregulating the businesses which already exist. This sphere of privatization unleashes the new entrepreneurs and has typically been highly successful. For example, in 1990, 12,000 new private firms were established in Hungary alone. The second sphere encompasses the large state-owned enterprises. Privatization of this huge sector is tremendously difficult and will take anywhere from ten to twenty years to complete. Even given this time span, only a few of these enterprises are able to be successfully privatized. As discussed above, this process will be no easier in the Soviet Union.

Second, policymakers must decide between privatization and re-privatization -- selling the enterprises to new stockholders or returning the enterprises to their previous owners. Both Czechoslovakia and the former German Democratic Republic have re-privatized. Hungary re-privatized land and farms, but not industries, although some compensation was offered to previous owners. Re-privatization, however, has caused substantial problems in many cases because two or three parties attempted to claim legal ownership. In practice, this choice does not present a problem for the Soviet Union since it has a much longer history of socialism than Eastern Europe. Most of the state enterprises were built by the socialist state, eliminating claims of previous ownership.

Third, there are numerous obstacles to successful privatization. In most East European nations, domestic private funds are scarce, and while many East European nations hoped for large foreign investments, newly privatized industries have been of little interest to Western investors. At the present time half of all Western investment in Eastern Europe is in Hungary, where it represents only 3% of total investment. Numerous reasons exist for the Western reluctance to invest in Eastern Europe. Among these are bureaucratic barriers and lags, a poor infrastructure, political instability in the region, and a xenophobic tradition. Finally, there is the ethical dilemma of who has money to invest. As discussed above, most cash is in the possession of criminals who, therefore, have an advantage in purchasing previously state-owned assets. A difficulty also exists in that the people with the most business experience, those most qualified to lead newly-privatized firms, are the former economic and managerial elite. This has caused an ethical dilemma regarding permitting this people to retain their positions of leadership. The Soviet Union will also face these obstacles in its attempts to privatize.

Fourth, policymakers must decide whether to privatize through a state-run, centrally-directed process or spontaneously. Poland and Czechoslovakia privatized from the center, while Hungary stressed spontaneity. In Czechoslovakia and Poland, the decision was to
distribute 40% of all shares to the citizenry. This egalitarian ideal, while popular, will not help to accumulate capital nor will it solve the economic problems at hand. Such an option will, however, probably be quite popular in the Soviet Union.

Finally, the aim and extent of privatization must be determined. Do the leaders wish to achieve full privatization or will they allow some state sector enterprises that would work alongside the private sector as in France, Austria, and Italy? Eastern Europe did not consider maintaining a state sector because of the experience of the communist era, but this second option could play an important role in the Soviet Union.
THE ECONOMIC OUTLOOK AND THE PROBLEM OF FOREIGN AID

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Western nations previously waged economic warfare against the Soviet Union. Now, however, their discussions center around the goals of and conditions for the extension of economic aid. The goals and utility of this aid, however, are intertwined with radical reform of the Soviet system, a fact which must be taken into consideration by Western leaders.

The Soviet Union’s most crucial need is for short-term humanitarian aid. The Soviet economy is collapsing; agricultural output is falling; the distribution system has fallen apart; and fuel supplies are inadequate. Therefore, imports of food, fuel, and medical supplies are necessary to get the people through the winter and early spring without mass suffering. Politically, providing for the basic needs of the people may help to prevent the unleashing of a conservative backlash linked to extreme hardship.

While humanitarian aid is necessary, Western leaders should keep in mind that the degree of agricultural output shortfall is uncertain. Peasants have an incentive to understate their production in order to sell any excess on the free market for considerably higher prices. Thus, any food shortage which might occur is not necessarily the result of nature, but has likely arisen because of the breakdown of an inadequately administered system of prices, incentives, and distribution. Relaxation of price controls would probably lead to an enormous increase in the amount of food available at state stores, albeit at much higher prices. The need for food aid, therefore, represents the costs of having delayed the liberalization of the controlled price system.

Large-scale financial aid to the Soviet Union, on the other hand, has three main purposes:

• to stabilize the ruble and enable its convertibility into an international currency;
• to help liquidate monetary overhang, reduce the budget deficits, and control inflation by importing consumer goods; and
• to finance the re-structuring of the Soviet capital plant.

These purposes, however, cannot be achieved without prior substantial economic reform. As long as monetary and fiscal profligacy continue in the republics and the center, the ruble cannot be stabilized, regardless of the amount of external aid. A massive influx of consumer goods, funded by the West, would reduce the budget deficits and absorb monetary overhang temporarily, but would fail to solve the underlying problems. In addition, importing consumer goods would permit the government to delay difficult changes, such as budgetary reallocation and spending cuts. Finally, the re-structuring of
the capital plant must be preceded by a considerable measure of privatization and the institution of free prices or the investment will be misdirected.

The current environment in the Soviet Union is not conducive to the effective utilization of Western aid. Soviet credit-worthiness is at an all-time low as Soviet hard currency debt has grown to $70 billion and foreign exchange reserves have dwindled away. In addition, the presence of numerous quasi-independent republics suggests a potential scenario of multiple currencies being manipulated against each other in competitive beggar-thy-neighbor devaluations and the imposition of barriers to inter-republic exchange of goods, labor, and capital.

Given this environment, the West must tie aid to real economic reform. In the long term, three sets of actions by the republics are necessary before Western aid can be meaningfully utilized.

- radical systemic reform;
- monetary and fiscal stabilization; and,
- inter-republic economic coordination.

Given the difficulty of instituting these changes, Western non-humanitarian aid is principally an issue of the mid- to long-term.

The Soviet Union, however, faces two sets of costs in this long-term transition: the costs of delaying liberalization and reform and the unavoidable pain of that reform no matter when it occurs or how courageously it is undertaken. This second set of costs likewise has two components:

- The effects of price liberalization and subsidy cuts in an atmosphere of incomplete de-monopolization and inadequate competition. (This includes accelerated inflation, an increase in industrial bankruptcies, and significant increases in unemployment. In this case, Western aid can provide support for domestic safety nets and may also support import programs to stimulate domestic competition.)

- The costs involved in re-tooling the Soviet economy for operation in the world market. The value of Soviet productive capital stock is roughly estimated at $500 billion. But this capital must be repaired, re-equipped, modernized, and, in many cases, scrapped as unsalvageable. The costs of this re-tooling will be increased further by Soviet entrepreneurial inexperience and the inadequate infrastructure. Long-term Western aid, especially technical assistance and direct investment through joint ventures, can ease the burdens and accelerate the progress of this transition. The potential requirements, however, are much more than the West can sustain, leaving the Soviet people to bear most of the burden.

Significant Western investment will probably occur and, under the right conditions, may prove worthwhile. This aid, representing great efforts and outlays of cash, will facilitate the historic transformation of the Soviet Union into a free, democratic society.