Key Elements and Priorities of the Reform

Alfred D. Levy (*)

Mr. Holsen has presented an overview of the macroeconomy and the interrelationships among the principal elements of the JSSE analysis and recommendations. In my brief formal presentation, I will try to provide some highlights of our analysis and conclusions in three principal areas of systemic reform that the World Bank team focused on —prices, enterprise ownership and management, and the financial system— and how they fit together.

Price Reform

For well known reasons, prices in the Soviet Union are grossly distorted. In addition to providing an inappropriate basis for the decisions of increasingly independent actors in the system, price distortions had become, by the late 1980s, the principal source of inflationary pressures, disruptions to the supply of goods and services, flight from the ruble, mounting interregional trade barriers, and socially offensive rent-seeking and corruption.

Price reform was, of course, a central element in all of the reform programs being advocated and considered by the authorities in 1990, at the time the JSSE study was undertaken. All of those proposals, however, envisioned gradual reform, with most prices being adjusted administratively over several years, and some prices remaining under state control idenfinitely. The JSSE report, in contrast, recommended the immediate freeing of most prices, with a few exceptions and a safety net, which I will describe below. The unanimity of the four organizations in this regard was remarkable, particularly since many of us had been predisposed toward a gradualist approach before arriving in the USSR, given the disruption to the economy that a massive relative price change could cause, the impact on real personal incomes, and the high degree of monopoly power in Soviet industry.

What we found, in effect, was that inflation and inflationary expectations were already rampant. With prices repressed, however, they were being manifested in hoarding throughout the production and distribution system and in the households' diversion of goods out of official channels and into the rapidly expanding markets (painted in varying shades of gray) where prices were free or camouflaged by barter trade; and refusal to accept rubles as a means of payment. The result was an increasingly precarious supply system, with production falling, state orders being underfilled or ignored, and lengthening queues at the state stores. Demand pressures were being fed by a growing state deficit, being projected at 8% of GDP for 1990, more than the entirety of which was attributable to the budgetary drain of price subsidies. At the

(*) Senior Economic Advisor. The World Bank. Washington.

same time, the rapid growth of wages over the previous couple of years, in the face of a growing shortage of goods on which to spend them, had produced a monetary overhang that was estimated equivalent to about one-fourth of GDP.

In the face of these pressures, the Government simply no longer had the authority to impose an administrative solution to the deteriorating situation. The situation was further exacerbated, of course, by the political struggle between the Union and republican governments, which complicated efforts to achieve any consensus or consistency on reform directions, diverted attention from the economic issues, and contributed to the weakening control over monetary and fiscal aggregates.

In short, the arguments prevalent among Soviet economists and government officials that prices could not be freed until aggregate demand and commodity supplies had beeen stabilized, were no longer sustainable. Price liberalization had itself become a precondition for economic stabilization, as well as for such elements of systemic reform as the allocation of credit for new investment and industrial restructuring, the valuation of assets for privatization, the encouragement of competition, and the imposition of hard budget constraints on enterprises (see below).

Moreover, while the impact of price liberalization on household incomes was potentially serious and could not be ignored, it had to be recognized that the manifestations of suppressed inflation noted above was also having a very negative distributional impact. The politically and financially stronger were usually able to satisfy their demands, through preferential access to the dwindling state supplies or by paying the higher prices of the legal cooperatives or illegal black markets, and to protect their wealth through the holding of hard currencies and commodity stocks. Meanwhile, the less advantaged stood in lines, went without, and saw the real value of their rubles erode.[1]

We did, however, make several exceptions to our general recommendation for price liberalization. The first of these was for housing rents, which were perhaps the most heavily subsidized prices of all in the USSR, not having been changed in much of the country since the late 1920s, and which failed by a wide margin to cover even the maintenance costs on the physical structures. Nevertheless, given the huge impact that the introduction of proper rents would have on household budgets, the necessary slowness of the supply response to higher rents, the political problems posed by millions of families queued up for as long as ten years waiting for the promised cheap apartment, and the absence in the short term of any financing mechanism, we considered that the movement of rents to market levels would have to be phased over a reasonable period of time.[2]

A second exception was suggested for public transportation and other public utilities likely to remain state monopolies.

A separate, administered-adjustment regime was also proposed for a small number of vital raw material inputs—e.g., energy—whose domestic prices were far below world market prices, and for which an immediate move to world prices could cause serious short-term adjustment problems. Instead of directly administering the prices of such commodities, an export tax was suggested to regulate the wedge between international and domestic prices. Although immediate price liberalization was not being advocated for these commodities, it should be emphasized that there was to be a substantial up-front increase of prices, that the period of subsequent adjustments (reductions of the export tax) and the eventual freeing of prices was to be kept short—two to three years—and that the Government's intentions in this regard were to be preannounced, putting industries on notice of the need to adapt.

The prices of basic foodstuffs were *not* to be protected in our recommendation, but were to be freed along with most other prices. We did recommend, however, that stocks of imported foodstuffs—possibly supplied through Western assistance—be maintained as a precaution against initial overshooting. The ability of the government to release such stocks into the market could serve as a disincentive for farmers, distributors, and households from hoarding in anticipation of further price rises. Safeguards would be needed, of course, to assure that such assistance was not used as a means of subsidization and as a disincentive to domestic production, and some coordination would be required of the amounts and composition of commodities provided by the West for this purpose.[3]

1 With the growing stock of rubles in possession of the households, for which they had nothing to spend, the report made a distinction between real wages (nominal wages deflated by average prices) and «real» real wages (purchasing power represented by goods actually available in exchange for wages). It is possible that, with price liberalization, these two indicators could for some households move in opposite directions.

2 Further analysis and recommendations concerning the housing sector in the Soviet Union can be found in Chapter V.9 of the report.

3 A stabilization fund, financed by untied balance-of-payments assistance, would of course provide greater flexibility.

Finally, while food and other consumer goods prices were to be freed, a safety net was suggested in the form of a basket of rationed goods to be provided in limited volumes (or values) to each household or, if possible, to needy households on a targeted basis, in order to soften the most serious consequences of what would necessarily be a painful period of transition for low-wage Soviet workers.[4]

Enterprise Reform

Reforming Soviet enterprises to operate on commercial principles and in response to market signals will not be simply a matter of privatizing assets and freeing managers from bureaucratic controls, although these are among the necessary measures. As in other socialist economies, state ownership has meant not only administrative control of productive activities but also the use of enterprises to perform many functions normally accorded to the state in western economies. Workers often depend on their enterprises, for example, for housing and for access to education and health care facilities. Many enterprises also provide their workers privileged access to subsidized foodstuffs and other consumer goods, protecting them against the shortages frequently found in the state stores. Enterprise reform will thus require a whole new allocation of responsibilities and redefinition of the flows of resources (taxes, wages, rents and other expenditures) among households, government, and enterprises.

Another factor complicating enterprise reform in the Soviet Union is the extraordinary concentration of industry. In addition to the danger of placing great initial market power in the hands of independent, commercially motivated managers, the freeing of market forces will force the downsizing of major industries, with severe implications for employment and for the economic base of the large cities and regions currently dependent on them. A particular problem is represented by the large military-related industries, which are already facing the necessity of converting a significant proportion of their capacity to civilian production. Not surprisingly, the workers and managers of these large state enterprises and the government ministries associated with them are frequently powerful centers of resistance to reform.

While recognizing that these problems will have to be managed and cannot be solved overnight, the four organizations have recommended that privatization be pursued as rapidly as possible, and that enterprises that cannot be quickly privatized be placed in the interim on a commercial basis. The need for proceeding rapidly is intensified by the process of spontaneous privatization that is already under way throughout the USSR. As described in the report, this process is manifesting itself in many ways: e.g., the hiving off of all or parts of state enterprises and their conversion into cooperatives, the leasing of enterprises or units of them to their workers and managers, the semi-clandestine utilization of enterprise facilities and materials for after-hours production, etc.

These modes of breaking away from the incentive-stifling control of the state bureaucracy have apparently resulted in improvements in productive efficiency at the plant level. Their production still responds to distorted price signals, however. Moreover, common to all of these effectively new forms of property is that, while they convey the benefits of ownership to private individuals and groups, they do not at the same time carry with them the responsibilities and risks of ownership. Consequently, workers and managers are motivated to maximize the immediate exploitation of existing capital assets, by raising wages, salaries, and enterprise social expenditures, but not to preserve or renew assets in the long-term interest of the enterprise. This incentive will only exist when true privatization has occurred, and property rights have been given clear legal definition and protection.

Besides the problems of Soviet industrial structure outlined above, a program for privatization must face the related issues of how state assets are to be distributed and paid for, given the huge gap between total asset value and accumulated household savings; and how, in the case of the large enterprises, owners will be able to exert their authority and discipline over managers. There are clearly trade-offs to be faced between the speeed of privatization and the level of payment to be made to the state; between the efficiency benefits of relying on a market process of asset distribution and equity in the sharing of wealth previously conceived to belong to the society as a whole; and between spreading assets widely among the population and preserving owners' ability to set managerial objectives and enforce performance.

These trade-offs are most easily confronted in the case of small enterprises, including retail shops and other service activities and small manufacturing plants and easily dividible units of large enterprises.

4 International wage comparisons are complicated by the extent to which Soviet workers have traditionally received a large fraction of their compensation, effectively, in kind—subsidized food, housing, health care, etc. As these increasingly become market-allocated, money wages can be expected to adjust to reflect labor costs and productivities more fully.

The JSSE report recommends that these be sold quickly by public auction, and that, where necessary, payment be allowed over a reasonable time period. Particularly urgent, in our view, is the privatization of the distribution system, without which market-based business relationships, competition among producers, and freedom of entry to new enterprises will not be possible. Trucks, warehouses, and retail stores in particular, could be quickly sold to private operators, and proper legal and regulatory measures introduced to ensure competition among them. The sale of small shops has already begun, to a still minor degree, in several cities, including Moscow and Leningrad. New owners are strictly limited in what they can do with their properties, however, and may only sell them back to the city governments.

As regards the larger enterprises, the report broadly endorses the idea contained in Soviet reform proposals of conversion to joint stock companies and creation of state property funds as the initial holders of these shares and as exercisers of ownership rights over the enterprises. The report discusses several alternative mechanisms by which the shares could be sold off to private investors over time. Meanwhile, the enterprises themselves would be put on a commercial basis and subjected to a hard budget constraint. Enterprises not able to survive in the increasingly competitive environment would be allowed to disappear. Funds would be made available for restructuring the assets and operations of enterprises capable, with this assistance, of becoming profitable, but rigorous criteria would have to be applied to assure that such support did not become another form of perpetual subsidy.

Financial Sector Reform

As described in the report, the Soviet banking system is evolving rapidly on two fronts: the breakup of the specialized state banks and the proliferation of new commercial and cooperative banking institutions. At the time of the JSSE mission in October 1990, the latter numbered about 435; there are now said to be some 1,500 of them. Both of these trends are, in principle, positive from the point of view of achieving a dynamic and competitive, market-oriented financial system. A number of features of the current evolution give cause for concern, however, and point to a need for caution regarding the speed at which the sector is privatized.

An overriding concern stems from the still-confused division of authority and state of relations between the Union and the republics and the failure so far to clarify, despite new banking laws passed December 1990, responsibility for controlling money and credit. Until these basic issues are resolved, monetary expansion will continue to be determined passively by the financing needs of the Union and republican budgets.

Related to the question of effective monetary control is that of an independent authority to regulate and supervise the growing commercial banking sector (including now the branches of the formerly unified state specialized banks). Many of the new banking institutions have been established by enterprises and governmental agencies at all levels with the expressed mandate of serving the financing needs of their founders and shareholders. Some are little more than substitutes for atrophying branch ministries, assuming the latters' function of cross-subsidizing and cartelizing the enterprises within their respective groups. Anticompetitive elements are also being introduced in the form of associations and interlocking ownerships interests, including those of the dissolving state specialized banks. Conflicts of interest abound as well as the risks of high degrees of portfolio concentration. As these institutions grow and account for an increasing proportion of the assets of the banking system, such risks can eventually become a threat to the solvency of and confidence in the system itself.

Of more immediate and urgent concern, from the systemic point of view, are the portfolio quality and solvency of the state specialized banks, which still account for more than 90% of the assets of the Soviet banking system. With neither banks nor their borrowers facing hard budget constraints in the past, there was no concept of credit risk and no need for provisions or reserves or for assessing and monitoring portfolio quality. This is still an area of almost total absence of information. Nevertheless, long used as channels of support to loss-making state enterprises and for the financing of state-directed investments and social expenditures, the quality of specialized bank portfolios must be considered doubtful. This concern is heightened by the likely impact of the economic reforms themselves on the profitability of many of the largest and most credit-intensive enterprises.

Even if restructured with clean balance sheets, the specialized banks, by virtue of their peculiar past functions, would be poorly suited to enter into genuine commercial banking. In addition to sectoral specialization, there has been an almost total division of functional responsibility between the State Savings Bank and the lending banks. The Savings Bank has been the chief mobilizer of financial resources in the economy, having, until recently, a virtual monopoly as depository for the savings of households but doing practically no lending. Instead, its resources are redeposited in the central bank (Gosbank),[5] where they are used to finance the state deficit or are relent to the other specialized banks. The latter, in turn, have been almost pure lenders, the remainder of their liabilities consisting of mandatory deposits of state enterprises. With the one exception of the Bank for Foreign Economic Affairs, the managers and staff of the specialized state banks are almost totally without the kinds of skills and experience required to operate a market-based commercial bank.

For these reasons, the four organizations were much more cautious in their recommendations for commercialization and privatization of the banking system and the liberalization of financial markets than was the case for the real sectors. Instead, heavy emphasis is given to the urgency of establishing an effective system of banking regulation and supervision, instituting a massive program of training for staff and managers, as well as for regulators and supervisors, and beginning the process of restructuring (or liquidating) the existing banking institutions, cleaning the books of bad debt and building a sound capital base.[6] The legal and regulatory framework for a sound banking system is a little understood area for most Soviet policy-makers, and its mention is interpreted by many as an attempt to reimpose central administrative controls. Recent Soviet legislation has sought to move in this direction, but implementation requires resolution of the political problems alluded to above. Once this is achieved, this will be an area where western technical assistance and investment can make a major contribution to the transition to a market economy.

Turning very briefly to the report's treatment of securities markets, we have recognized their importance as alternative mechanisms for mobilizing resources for both corporate and governmental finance, for providing competition to and a source of liquidity to the banking system, a tool of monetary control, and for the privatization of state enterprises. The contemplation of such markets has created a lot of excitement in some quarters of the Soviet Union—the city of Moscow already has three stock markets, at least on paper—and has attracted many visiting delegations ready to give advice and to sell used computers and other services. We have urged the Soviet authorities, however, to give first priority to the rationalization of the banking system, which necessarily will account for the bulk of financial activity in the foreseeable future, and to give greater attention initially to the development of the short-term end of the financial market. Securities trading will likely begin on an informal basis rather quickly, but the establishment of formal stock and corporate debt markets should await the introduction of a proper legal and regulatory framework.

Concluding Remarks

In this presentation, I have attempted to cover a broad and complex set of topics in a short space of time, and obviously many important reform issues have been glossed over or ignored altogether. We could not, in any event, set out a blueprint for the Soviet Union's transition to the market system, and indeed such a blueprint would no longer be relevant, if ever it was. The fact of the matter is that economic reform is already well under way in the Soviet Union, spurred by the cracks in the planning system created by the 1987 reform laws, rising inflationary pressures, and the progressive loss of central government authority. Markets are functioning and growing rapidly. Privatization is rampant and spreading.

The process is unfolding, however, in a way that is inefficient and inequitable, providing rent-seeking and asset-appropriating opportunities for the few in an environment of accelerating inflation and growing shortages. Some of the problems are consequences of political upheaval—falling tax collections, internal trade barriers, conflicting laws, etc.—and little progress can be expected until the new political relationships are sorted out. Many problems are also created by remaining remnants of the old planning systems—price controls, barriers to entry, control of distribution channels, etc. Perhaps the most difficult single hurdle in the reform process is for the Soviet authorities (at republican and local as well as at the union level) to make the intellectual leap to seeing the market not solely as an unrestrained liberalization of individual energies but also as a disciplining force on those energies that channels them in a socially productive direction. Until prices are freed, privatization is pursued in the context of full property rights, and competition is encouraged, the Soviet economy will continue to operate in the growing freedom of markets but without the protection and benefits of market discipline.

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5 Indeed, for most of its history the Savings Bank has been simply a department of the Gosbank.

6 Since the assets of the state lending institutions (ex., the Savings Bank) are virtually all obligations of the state sector, and their liabilities are chiefly to the Gosbank, outright liquidation (and starting fresh with new institutions) would seem to be the most efficient course. This may effectively be happening to some extent as seen, for example, in the «spontaneous privatization» of some branches of the Zhilsotsbank. It may not, however, be politically feasible on a large scale.