

## How to Study for Chapter 28    The Collapse Of Communism

Chapter 28 discusses the basic workings of a communist economy. Then, it describes the attempt by Russia to shift to a market economy. This chapter is intended to show the benefits (as well as the problems) of a market economy and the problems of creating a market economy when one had not existed previously.

1. Begin by looking over the Objectives listed below. This will tell you the main points you should be looking for as you read the chapter.
2. New words or definitions and certain key points are highlighted in italics in the text and in red color. Other key points are highlighted in bold type and in blue color.
3. You will be given an In Class Assignment and a Homework assignment to illustrate the main concepts of this chapter.
4. There are a few new words in this chapter. Be sure to spend time on the various definitions. There are no new graphs.
5. The teacher will focus on the main technical parts of this chapter. You are also responsible for the cases and the ways by which each case illustrates a main principle.
6. When you have finished the text, the Test Your Understanding questions, and the assignments, go back to the Objectives. See if you can answer the questions without looking back at the text. Then, take the Practice Quiz for Chapter 30.

## Objectives for Chapter 28    The Collapse of Communism

At the end of Chapter 28, you will be able to answer the following questions:

1. What is meant by **“communism”**?
2. Briefly describe each of the following components of a communist economy: **(1) The Big Push; (2) State-Owned Enterprises; (3) Central Planning; (4) Collective Farming; (5) The Shortage Economy; (6) Trade Autarky**
3. What is the **“soft budget constraint”**?
4. What is **“investment hunger”** and why does it occur?
5. What was **“storming”** and why did it occur?
6. What problems resulted from central planning?
7. What are the four functions of agriculture in economic development?
8. What is a **“State Farm”**? What is a **“Collective Farm”**? What problems result from farming in this manner?
9. What was the **“Monetary Overhang”**? Why did it exist?
10. What was the **“Second Economy”**?
11. Describe the performance of the economy of the former Soviet Union in terms of economic growth.
12. What is the difference between **“extensive growth”** and **“intensive growth”**?
13. What was **“perestroika”** and why did it fail?
14. What is meant by **“privatization”**? How was it accomplished in Russia? What problems developed because of the way by which privatization was undertaken?

15. What problems have there been in the creation of retail and personal services markets in Russia?
16. What are **capital markets**? What problems have there been with the creations of capital markets in Russia?
17. Why have **savings rates** risen so much in Russia?
18. What are **securities markets**? What problems have there been with the creations of capital securities in Russia?
19. Describe the problems of making the ruble convertible. Why has the ruble depreciated so greatly?
20. What have been the policies of Russia in the 1990s regarding international trade?
21. Describe the Russian debt problem.
22. Describe the performance of the Russian economy since the collapse of communism in 1991.
23. Describe the crisis in the Russian economy of 1998 and 1999.



## Chapter 28 The Collapse of Communism

If the globalization of the economy, as discussed in Chapter 27, is one of the major events of the 20<sup>th</sup> century, then the rise and subsequent collapse of communism must certainly be another. As a set of ideas, communism developed mainly in the 19<sup>th</sup> century. But it did not become a major force in the world until the creation of the Soviet Union following the Russian Revolution (1917). During World War II, the Soviet armed forces brought communism to much of Eastern Europe. Political revolutions also brought communism to China, North Korea, Vietnam, and Cuba. The result was the Cold War! In the 1980s, communism began to change considerably. Communist countries took on more and more of the characteristics of market economies. By the early 1990s, communism had collapsed in the former Soviet Union and in Eastern Europe. As of this writing, China, Vietnam, North Korea and Cuba still have communist economies. But they are very different from the period before 1980. As we enter the new millenium, market economies are dominant among the countries of the world. In this chapter, we shall focus on the former Soviet Union. We shall look at the basic components of a communist economy. Then we shall try to assess to what extent and why the communist economic system failed. Finally, we shall examine the transition from a communist economy to a market economy in the largest part of the former Soviet Union – Russia. This final chapter will afford us some perspective in assessing the strengths and weaknesses of market economies.

### The Components of a Communist Economy

In Chapter 1, we introduced the terms “**socialism**” and “**communism**”. By our definitions, socialism occurs where the government owns and controls most of the capital goods. A socialist economy becomes “**communist**” when the government is not a democratically-elected one. The former Soviet Union was probably the best example there has been of a prototype communist economy. Indeed, most of the other communist countries patterned their economies on what had been done in the Soviet Union.

To analyze communist economies in detail would take a complete volume. In this chapter, let us focus on a few key components. These are: **(1) The Big Push, (2) State-Owned Enterprises with a Soft Budget Constraint, (3) Central Planning, (4) Collective Farming, (5) A Shortage Economy, and (6) Trade Autarky.** To get a picture of a communist economy, let us examine each of these in turn.

#### **(1) The Big Push**

All of the countries that adopted communist economies did so at a time of considerable economic backwardness. For either military or political reasons, they all believed that they needed to industrialize very quickly. Upon taking power in the Soviet Union in 1929, Stalin prophetically stated that his country would have ten years to overcome 100 years of backwardness if it wished to survive. (His country was invaded by Hitler’s armed forces just twelve years later.) In order to industrialize very quickly, **it was believed that a very high portion of all production had to be capital goods**, with

considerable emphasis on steel and other materials needed for the military. **The focus was to be on large, capital-intensive projects in “heavy industry”**. Normal consumer goods and housing had to be discouraged in order to channel resources into production of capital goods.

The need to channel resources into these priority areas required the government to have considerable control over the economy. This was accomplished through a highly centralized Communist Party. The Communist Party made all major appointments, promotions, and dismissals in the enterprises that came to comprise the Soviet economy. Those who refused to carry out the orders of the Party leadership could quickly see their careers ruined.

## **(2) State Owned Enterprises With a Soft Budget Constraint**

As noted above, in a socialist economy, capital goods are owned by the government. In the former Soviet Union, all enterprises (and all land) were indeed owned by the government. Those who ran the enterprises were bureaucrats. They were most likely to have been members of the Communist Party, as this was the path to any career success. As with all bureaucrats, we have to look at the incentives they face to see how the enterprises would behave. (Review the section on Bureaucracy in Chapter 11.) In the former Soviet Union, there seem to have been two main goals of enterprise managers. **First, there was the goal of meeting the plan targets**. We shall discuss central planning in the next section. As we shall see, there were many plan targets to meet. But the one with the greatest rewards was the target for production. Meeting the production target would bring the managers of the enterprises considerable financial reward (a bonus that could add 25% to 30% to one’s income) as well as prestige. Consistent failure to meet the production targets meant the loss of the bonus, reduced promotion prospects, and possibly the loss of one’s job. This passion to meet the target for production was dysfunction for at least two reasons. **First, the managers of the enterprise desired to meet the target but not to exceed it**. Exceeding the target this year would certainly mean an increase in the plan target next year. The result was that production often went along at a slow pace until the last three days of the month, followed by a frantic pace of production to meet the monthly target. This phenomenon was called **“storming”**. **Second, enterprise managers were very resistant to change and innovation**. If an innovation were a failure, the plan target would not be met. If the innovation were a success, the result would be that the plan target for next year would be raised.

**The second goal of enterprise managers in the former Soviet Union was expansion**. This seems to be a ubiquitous goal of bureaucrats in general. For the manager of the enterprise, power and prestige increased as the size of the enterprise increased. Managers of Soviet enterprises tended to ask for more funds for new capital goods than they actually needed. To increase the chances that their requests would be approved, they would underestimate the costs of the capital goods and the completion time. This phenomenon has been called **“investment hunger”** --- where investment refers to the buying or building of new capital goods. Those higher up in the bureaucracy often approved the increase in capital goods because they saw this as part of the “Big

Push”. This “investment hunger” also was dysfunctional for at least two reasons. **First, the government commonly permitted the buying or building of more capital goods than could possibly be afforded.** When it realized that it was over-extended, the government would then slow the building or buying of all the projects simultaneously. The result of this was that many projects stayed only partially completed for years and years. **Second, enterprises in the former Soviet Union became very large.** In the entire country, there were perhaps 50,000 manufacturing enterprises of any kind. They averaged more than ten times the number of employees as would be found in a typical American company. By becoming so large, they became very hard to manage and costs of production rose – a phenomenon called **diseconomies of scale** (review this concept from Chapter 15). This passion for very large companies has been called **“Gigantomania”**.

Notice that, when we examine the main goals of the managers of enterprises in the former Soviet Union, we did not include profits. Managers of Soviet enterprises did receive a target concerning profits. The profits target was supposed to force enterprises to produce efficiently. But, at all levels of the Soviet bureaucracy, meeting the production target was much more important. If an enterprise met the production target while its costs exceeded its revenues, it would receive assistance from the government. This assistance was commonly a direct subsidy. Companies never had to worry about costs, as they knew that any losses would be covered by the government. This phenomenon has been called the **“soft budget constraint”**. The result, as you might guess, is that Soviet enterprises were very inefficient.

### **(3) Central Planning**

In the former Soviet Union, central planning largely replaced the market. Planners’ preferences replaced consumers’ preferences! Generally, there was a five-year plan to set major goals and priorities and also an annual plan. The annual plan would set the plan targets that were discussed in the previous section. This annual plan began with targets for production for the entire economy. These targets were then broken down by sector, such as agriculture, industry, transportation, and so forth. From there, the plan was continually disaggregated until it reached the enterprise level. But the final plan targets were not simply imposed on the enterprise. There was considerable bargaining between the enterprise director and the planning authorities. The final plan targets determined the quantities of each good that would be produced by the enterprise, the materials that each enterprise would be allowed to have (as well as the company from which the enterprise was to procure these materials), the number of workers that would be allowed as well as the total wages that could be paid, and so forth. For a large enterprise, there could be as many as 200 different plan targets to meet. Meeting the plan targets was mandatory, although, as noted in the last section, managers realized that the production target was by far the most important. It has been estimated that the planning for production and for the allocation of materials was undertaken for 30,000 to perhaps 60,000 products. A plan for one year would commonly be something like 12,000 pages.

For about 4,000 of these products, the former Soviet Union attempted a **Materials Balance**. First, for each product, the planners would estimate the **sources** -- how much would be produced or imported. Then they would estimate the **uses** -- how much would be used in production, consumed, or exported. For each product, the sources and the uses had to balance. Since many of the products were inter-related, achieving a balance of any kind for all products was extremely difficult. (For example, anything that affected the materials balance for iron would also affect the materials balance for steel which would affect the materials balance for machinery and so on.) For this reason, **planning was typically done “on the margin”**. This means that the planners would begin with last year’s plan, whether it was good or not, and then make a few changes for the coming year. Central planning proved to be a virtually impossible task. Can you imagine a group of people planning production of 30,000 to 60,000 products (remember that one company’s production then had to be part of the materials allocation for another company) in a country over almost 300 million people that spoke over 100 languages and that spanned eleven time zones?

Central planning also led to certain dysfunctional behaviors. For example, a manager of an enterprise would, of course, want as easy a production target as possible and as plentiful a supply of materials and labor as possible. In order to achieve that, the enterprise manager would distort information. Commonly, he or she would try to make superiors believe that the enterprise had a capacity to produce a smaller quantity than it really had! Or materials would be reported as “lost or damaged in shipment” and then stored for future use. Enterprises commonly hired people to go around the country and bribe the directors of other enterprises in order to obtain needed materials. This, of course, was illegal. Materials were commonly being used for purposes not specified in the plan. For another example, if the materials allocated to an enterprise were not sufficient to meet the plan target, the enterprise would simply lie about the product it had produced. For example, if there were not enough leather, a shoe company might produce what is really a size 6 shoe and label it as size 8. And for yet a final example, there was the problem of the unit of measurement for the production target. If production were measured in weight, the products would be very heavy. If production were measured in number of units, the products would be very flimsy. One famous cartoon had an enterprise director standing next to an absolutely gigantic nail and telling his colleague how he had met the production quota for that year.

#### **(4) Collective Farming**

When a country is beginning to develop economically, the agricultural sector has four major functions. (1) It must provide food for the people plus raw materials for industry. (2) Since most of the population is engaged in agriculture, it must provide the labor force that will allow manufacturing industries to grow. (3) It must be the source of most of the savings that will pay for the investment in new capital goods. (4) And finally it must provide export products to earn foreign exchange to buy the imported materials that industries need.

To achieve these results, the former Soviet Union decided to have agriculture collectivized. Collectivization was done in a very bloody and destructive manner in the 1930s. Soviet farms were basically of two types. The first was the *State Farm*. This was a farm but operated like any other enterprise --- a factory in the fields. The second was the *Collective Farm*. Technically, this was a cooperative. It was “owned” by the workers who received a basic wage plus a bonus based on the performance of the collective farm. While the Chair of the collective farm was supposed to be chosen by the workers, in reality, the Chair was chosen by the Communist Party. The collective farms were given plan targets, just as any other enterprise. But anything they produced above the plan targets could be sold on collective farm markets at higher prices. As you might expect from the description of the Soviet enterprise, the farms in the former Soviet Union were very large (“Gigantomania”). Collective farms commonly averaged more than 16,000 acres and State Farms averaged more than 40,000 acres.

Throughout most of the Soviet period, agriculture rarely performed as intended. Over these years, there were many attempts at reform. None of these changed the basic character of Soviet agriculture. Let us examine how Soviet agriculture performed based on the functions specified above. (1) Soviet agricultural production rarely reached the goals of the planners. Indeed, the growth rate of agricultural production was quite low by any standard. In the 1970s, it was estimated that agricultural production per worker was only 6% that of the United States and that production per machine was only 33% that of the United States! (2) The labor force in agriculture did fall, as intended, to provide workers for the growing industries. But it did not fall very much. For example, from 1970 to 1983, the agricultural labor force fell by only 700,000 people out of a total of 26.8 million! The labor force for the growing industries had to come from policies that forced almost all married women to work. (3) The Soviet government tried to extract savings from farm workers through high taxes. This money was to be invested in industry, not agriculture. Because of this policy, agricultural infrastructure was poor. About one-fifth of all grain, fruit, and vegetables would perish due to poor storage facilities. At least 20% of all tractors would be out of service at any given time. And the roads were so poor that a major use for those tractors that did operate was to pull trucks out of the mud. Because of these problems, the Soviet government decided in the 1980s to invest more resources in agriculture. As they did so, they were taking savings away from industrial workers to pay for investments in agriculture, exactly the opposite of what they had intended! Finally, (4) rather than provide export products, Soviet agriculture performed so poorly that large quantities of meat and grain had to be imported. In the mid-1970s, the Soviet Union and the United States agreed to two large sales of wheat to the Soviet Union (known to some in the United States as the “Great Grain Robbery”)!

Probably most embarrassing for the Soviet authorities was the role of *private plots*. State farm members, collective farm members, and city dwellers had access to private plots. These were very small --- less than one acre. They were operated with spade, hoe, and sickle technology and worked by wives or retirees. Yet these private plots were responsible for 60% of all potatoes grown, 40% of all fruits, berries, and nuts, 30% of all meat, milk, and vegetables, and 25% of all agricultural production!

### (5) A Shortage Economy

In the former Soviet Union, prices were not determined by demand and supply. Indeed, in most cases, prices were set below equilibrium prices and were rarely changed. The result was **shortages** for most consumer goods. For most of these goods, the shortages were resolved by **distribution on a first-come, first served basis**. Long lines were pervasive throughout the former Soviet Union. It was common for people who had worked a full day to spend two more hours in line everyday shopping. If one had a recipe that required three or more ingredients, one could be assured that at least one of these ingredients would not be available at all! The average waiting time for housing was ten to fifteen years. The average waiting time for an automobile or a telephone was over three years! The pervasiveness of shortages led to forced savings --- called a **“monetary overhang”**. This means that people had income but could not find anything to spend it on. So, unwillingly, they saved it.

Distribution on a first-come, first-served basis was not the only means to resolve the shortage problem. In some cases, there was “seller choice”. Those most favored were members of the Communist Party. And it was not uncommon for workers in stores to hide some goods and then sell them to friends and family.

As was explained when we discussed price ceilings, the shortage economy would lead to **black markets**. In the former Soviet Union, this was called the **Second Economy**. Large amounts of clothing and housing services (such as repairs) were sold in the black market at high prices. Blue jeans, in particular, could command a very high price. As mentioned above, enterprise managers hired individuals to go around the country buying materials on a black market. Truck drivers would divert cargo and then sell it on a black market. Foreign goods would be smuggled into the country. People would steal materials from their places of employment and use them to construct summer homes and other amenities. (Stealing from the government was not looked down on in the former Soviet Union.) Bribery of government officials was a fact of everyday life.

There were also shortages in the labor market. Workers were free to move between jobs. Workers were generally hard to find while jobs were easy to find. A common result was shirking by workers. Workers would show up for work, leave in the morning, go shopping or drinking, and then return to work in the afternoon to punch out. These workers would not be fired because there was no one to replace them.

### (6) Trade Autarky

The last aspect of the economy of the former Soviet Union was a complete aversion to international trade. This was called **“autarky”** and resulted from the government seeing other countries as “the enemy”. Imports were limited to those necessary goods that could not be produced at home. Exports, mainly from agriculture, were to earn the money to pay for these imports. All international trade was handled by specific agencies; with a few exceptions, enterprises could not trade directly with companies in other countries. The Russian Ruble was not convertible into foreign monies. Transactions involving foreign exchange were tightly controlled by the government. The price charged for a good within the Soviet Union and the price charge in international trade

had virtually no relation to each other.

### **Economic Performance of the Former Soviet Union**

The description of the economy of the former Soviet Union is a description of an economy modeled on the military. Those at the top gave the orders and others obeyed. The use of markets was more limited than in most other countries. The economic performance of this type of economic system was unsatisfactory. Let us examine this performance.

We can measure performance by many means. But since the goal of the planners was **economic growth**, let us focus on this measure. According to official Soviet statistics, from 1950 to 1984, production in the former Soviet Union grew at an annual rate of 7.6%. American estimates had this much lower -- 4.4%. This would mean that, each year, the former Soviet Union would produce 4.4% more goods and services than the year before. During the same period, the American economy grew at an annual rate of 3.4%. Especially during the 1950s, when Americans thought that the former Soviet economy was growing at an annual rate of 6%, there was great fear that the Soviet Union would catch up with, or even overtake, the United States.

Two important points should be noted as we look at these economic growth statistics. First, according to American estimates made at the time, **the growth of the economy of the former Soviet Union slowed consistently over this time**. From 6% in the 1950s, the Soviet economy grew 5.1% in the 1960s, 3.7% in the 1970s, and only 2% from 1980 – 1984. The second point is that, after communism ended and Soviet records were made available to Americans, we learned that **American estimates of Soviet growth were too high**. The economy of the former Soviet Union was actually performing more poorly than we had thought. By the mid-1980s, the economy may not have been growing at all. Economic growth can be of two types. One is called **“extensive growth”**. This growth occurs because of increases in the quantities of the various factors of production (more labor, more capital, and so forth). The other is called **“intensive growth”**. This growth occurs because of the ability to make better use of those factors of production that exist (more productive workers, better technologies, and so forth). The relatively high growth rates of the 1950s and 1960s reflected extensive growth. By 1970, the ability to grow by increasing the quantities of the factors of production was beginning to run out. The quantities of both labor and capital began growing slower than previously. **The low growth rates after 1970 indicate that the Soviet economy was not doing a good job at increasing the productivity of its workers nor of improving its technologies**. The best measure we have of this is quantity produced per unit of input, where “input” includes both labor and capital. In the 1950s, this measure rose 1.7% per year in the former Soviet Union. From 1960 to 1981, it rose at an annual rate of only 0.8%. And from 1983 to 1987, it actually fell at an annual rate of 0.7%. **The former Soviet Union was not only behind the countries of the West, it was losing ground**. By the middle of the 1980s, the leaders of the former Soviet Union had come to believe that their country had little chance of achieving a desirable rate of economic growth without making fundamental changes in the economic system.

## Reform of the Soviet Economy

The last half of the 1980s was a period of *perestroika*, meaning restructuring. This was the plan of the Soviet leader, Gorbachev, to reform the economy without changing its basic communist character. Perestroika had several aspects. But the major aspect that concerns us involved changes in the enterprise. Under perestroika, enterprises were to be free to enter into deals with other enterprises as they wished. The proportion of goods produced that the enterprise had to sell to the government was to decline. Enterprises were to become self-financing. This meant that capital goods purchases and bonus payments to workers were to come from profits that were earned. (The soft-budget constraint was to be replaced by a hard budget constraint!) Enterprise directors were to be elected by the workers. Also under perestroika, people were to be allowed to engage legally in many of those activities that had been part of the underground economy. Finally, under perestroika, the government was to stress modernization by replacing old capital goods with new ones embodying more modern technologies.

It is important to note what perestroika did not do. (1) It did not allow for a change in property arrangements. Enterprises were still owned and controlled by the government. State farms and collective farms in agriculture were retained. (2) It did not create prices that were determined by demand and supply. (3) It reduced, but did not eliminate, central planning. (4) It did not open the country to international trade, although it did allow enterprises, for the first time, to enter into foreign trade agreements on their own. In all, it only made marginal changes in the economy. And it was implemented slowly over time. The slow implementation meant that enterprises were in continual confusion! Enterprises could now make deals with each other. But there was no legal system to enforce the deals. And there were no wholesale markets to reduce the transactions costs of making the deals. Some prices were freely negotiated and some were set by the government. Some production had to be sold to the government while other production did not. The rules were constantly changing. Because perestroika was resisted by those in high government positions, no one could be sure that the reforms would last. This confusion caused production to actually fall in 1989 and 1990. Between 1985 and 1989, the budget deficit more than doubled! This means that the government was spending much more than it was taking in as tax revenues. Rubles were being created at very rapid rates to pay for these budget deficits. This increase in money available, at a time production was falling, created very great shortages. In addition, the debt of the Soviet Union to Western countries had more than doubled since 1984. In response to the crisis, many of the changes of perestroika were reversed. It was an admission of failure.

In 1990, there was a major commission report which shifted the focus of discussion completely. While perestroika had focused on making some reforms in the communist economic system, the new discussion was about shifting from a communist, command economy to a capitalist, market economy. In 1991, communism collapsed completely. The former Soviet Union broke into different countries. The Cold War was over. But the discussions of 1990 carried over as Russia attempted the transition to a capitalist, market economy.

### **\*Test Your Understanding\***

Assume that a communist economy is considering shifting to a market economy.

1. What would be the **advantages** of shifting to a market economy?
2. **Explain what would have to be done to shift to a market economy.** What new institutions would have to be created? Why? What would the people have to learn to do that we, in America, take for granted?
3. What **problems** do you think the country would experience in shifting to a market economy? Why?
4. What **disadvantages** can you see for a market economy, as compared to a communist economy?

### **The Transition from Communism to a Market Economy**

In shifting from a communist economy to a market economy, Russia was attempting something that would be very difficult. There were no guidelines! Should the transition be swift or gradual? Which steps need to precede first and which should happen later? While there was agreement that the government-owned enterprises should be privatized, just how should this be accomplished? And what kind of a safety net, if any, should exist for those who would be hurt by the great changes?

Because the Soviet Union had collapsed in August of 1991, the new Russia was faced with the problem of creating its own political institutions. This had to happen first as none of the old political institutions remained. **A new constitution was approved by referendum in December of 1993.** Among other things, it set out the basic rules for private property ownership, established the rules for formation of partnerships, corporations, and cooperatives, and established protection for contracts and for intellectual property. Remember from Chapter 10 that “providing the rules” is one of the most important functions for government in a market economy. The new constitution also created a legislature and a very strong President.

As noted above, there was agreement that the government-owned enterprises should be **privatized**. Beginning in 1992, some 15,000 enterprises were placed on a privatization list. Those considered to have military importance were excluded. Those enterprises that were placed on the privatization list were required to become joint-stock companies, such as those described in Chapter 13. In most of these cases, the employees and the managers were given the right to acquire ownership shares, often at preferential prices. But at least some of the shares had to be offered to the general public. Vouchers were issued to every person in Russia (all 148 million men, women, and children). Those people who received the vouchers could use them to buy shares in the enterprises, could put them into a voucher investment fund (similar to a mutual fund in the United States), or could sell them to others in a market that was developed for that purpose. This first stage of this process, called voucher privatization, was completed by June of 1994. More than 100,000 enterprises were privatized in this stage. After June of 1994, the remaining shares were sold at auction. Another 20,000 enterprises were privatized in this manner

between July of 1994 and February of 1996. **By 1995, about 65% of the total capital in Russia was privately owned. Half of all workers were working in non-governmental enterprises.** Over 50 million Russians were shareholders. **And almost half of all income earned in Russia was earned from ownership of companies, rather than wages.** As more and more people came to earn income from ownership of property, **the distribution of income in Russia became more unequal** (and now is similar to the distribution of income for the United States described in Chapter 27).

As we noted in Chapter 13, there is often a difference between ownership of a corporation and control over that corporation. Because the Russian privatization gave preference to insiders (employees or managers) and because insiders were able to use some illegal methods to protect themselves against stock purchases by outsiders, these insiders gained control of about three-fourths of the privatized enterprises. The former enterprise managers and their close associates now control most of the newly privatized enterprises.

Obviously, a major aspect of the shift to a market economy is the **creation of markets**. Over the course of the 1990s, new markets have been developed. Some markets, especially retail markets and markets for personal services, develop on their own. Since there was already a Second Economy, it was not too difficult for retail markets or markets for personal services to develop. But there have been two main concerns in the development of these types of markets. **First, there is the problem of monopoly.** In the former Soviet Union, many industries had been monopolies by design. But in the market economy of the new Russia, monopoly is quite undesirable. In 1995, Russia passed an anti-monopoly law that is similar to the anti-trust laws of the United States, as discussed in Chapter 24. It also created a commission to enforce this law. In the few years since 1995, the law did only a little to reduce the problem of monopoly. What competition there is in retail markets has resulted from greater access to imported products. **Second, there has been the problem of corruption.** There have been so many examples of this that the new Russian economy has been called **“Mafia Capitalism” or “Crony Capitalism”**. Government officials have used their control over the issuing of licenses to obtain bribes. People trying to enter an industry have faced threats of violence. Criminal groups have sought financial information about their business competitors from banks; if the banks did not provide such information, bankers have been assassinated. The new government has to collect most of its tax money from sales taxes because cheating on income taxes is so rampant. Corruption in Russia has been aided by the decision to maintain price ceilings on certain products (ostensibly as a way to help low-income people). As we saw in Chapter 8, price ceilings create opportunities for some people to profit by selling on a black market. It has been said of Russia that “the first rule of the game is that there are no rules”.

Other types of markets are more difficult to organize. They require a complex set of rules and perhaps supervision. We shall discuss three of these here: capital markets, securities markets, and foreign exchange markets.

*Capital markets are the means by which the savings of the population are channeled to the businesses for the purpose of buying new capital goods.* In the United States, this important function is performed by banks and other financial institutions. But such institutions did not exist in the former Soviet Union. Russia has attempted to develop new capital markets, but it has not succeeded very well. **First, the Russian people are not placing their savings in the private banks.** There are now over 2500 banks in Russia, some 2000 of which were created after 1990. Yet, the people simply distrust these banks and with good reason. Many have been poorly run and had inadequate funding. Many speculated in foreign currencies and went broke. (And it didn't help that, in a period of high inflation, the new banks paid an interest rate that was less than the inflation rate.) This distrust of the banks came at a time when the **savings of Russian households rose considerably.** In the mid-1980s, Russian households saved only about 5% of their incomes, on average. By the mid-1990s, this had risen to almost 30%, a very high savings rate by international standards. Economists are not certain as to why this large increase in savings occurred. It could be a result of increasing uncertainty, it could be a result of the great reduction in programs for retirement, disability, or health care, it could be a result of the new ability to buy homes or apartments, or it could be a result of other changes. The problem is that for the enterprises to be able to borrow to purchase new capital goods, these savings need to be placed in financial institutions. And this is not happening. In fact, about 2/3 of the savings were held by households either as domestic currency or as foreign currency. And of the 1/3 that was saved in financial institutions, most was saved in the government-owned Russian Savings Bank, not in the new privately owned banks.

**Compounding the problem is the fact that those private banks that did have funds to lend have been very reluctant to lend them to the new enterprises.** Russian enterprises have not made good potential borrowers as they have commonly incurred debt that they cannot pay. The total debt of Russian enterprises is extremely high. And a considerable amount of all wages and salaries have been unpaid. (See below) Most of the banks, fearful of the uncertain political climate and of the inability of enterprises to repay loans, have refused to make loans for longer than one year.

There is yet another way for companies to obtain the funds they need to finance their purchases of new capital goods. They can sell shares of stock to the public. This necessitates the development of **a securities, or stock, market.** By 1995, there were some 66 different stock exchanges operating in Russia. Foreigners have been very important buyers in these markets, especially for the stock of energy companies. **Yet, the Russian stock markets have not become as significant as had been hoped (as of the date of this writing). One reason is that information to potential buyers of stock is inadequate.** Information is inadequate for at least two reasons. **First, most trading is done on an over-the-counter basis.** There is no equivalent of the American Dow Jones Average or NASDAQ that is relayed to potential buyers all over the world. Therefore, it is difficult for potential buyers to know what is occurring on the Russian stock markets in a timely manner. **Second, information about the companies is also difficult to interpret.** The Russian accounting system is different from that used in the United States

or Europe. In Russia, the goal of the accounting system is to find ways to understate profits so as to reduce corporate taxes, not to accurately measure the profits of the company. **A second reason that Russian stock markets have yet to become a significant factor is that potential buyers of stocks in Russian companies are hesitant to buy while the rules of operation of Russian stock markets are still evolving. And yet a third reason is that relatively few Russian enterprises are actively traded on stock exchanges and, for these enterprises, management is likely to hold the majority of the shares (as noted above).**

**Because of the problems of capital markets and securities markets, the buying of new capital goods by enterprises declined significantly in the 1990s.** This decline has been a main reason for the economic disaster suffered by Russia in the 1990s. As of the date of this writing (1999), almost 2/3 of new capital goods are paid for out of the profits of the Russian companies. Less than 10% of the capital goods are paid for by borrowing from the new banks or by selling shares of stock. Developing institutions that will allow the newly privatized enterprises to borrow to pay for capital goods remains a challenge for Russia. But without a large increase in the buying of capital goods, Russia's economy will not perform well.

Another major aspect of the transition from communism to a market economy was expected to be the **opening of Russia to the world economy**. We know that resistance to international trade (autarky) had been part of the communist economy. In the communist period, the ruble exchange rate had been set arbitrarily by the government. Russian people had been prohibited from owning foreign currencies. If the new Russia were to become open to international trade, the Russian ruble had to become convertible. This means that the ruble had to be traded freely in the foreign exchange markets of the world.

The creation of a convertible Russian ruble has been only partially accomplished. In April of 1991, the Russian government authorized currency exchanges. Russians were permitted to hold foreign currencies for the first time. However, for much of the 1990s, there were limitations on these holdings of foreign currencies. Those who earned foreign currencies by selling abroad were required to sell a portion of them to the Russian Central Bank. This, of course, reduced the incentive to earn foreign currency. Although there are still restrictions, the ruble does trade in foreign exchange markets. **Throughout most of the 1990s, the ruble depreciated in relation to the dollar.** This depreciation has resulted from the very high inflation rates experienced in Russia. In 1998, there was a major economic crisis in Russia (to be discussed below). **The ruble was converted into the New Ruble at the rate of 1000 old rubles to 1 new ruble.** At the time of this writing (1999), it took about 25.4 new rubles to buy \$1 (this would be 25,400 old rubles). You can see the depreciation of the ruble in the following table:

	<b>Rubles Per Dollar</b>
1992	179
1993	572
1994	1582
1995	4562
1996	5126
1997	5785
1998	9965 Old Rubles (9.965 New Rubles)
1999	25,400 Old Rubles (25.4 New Rubles)

In 1998, the Ruble was not sold on foreign exchange markets at all for awhile due to the great political uncertainty in Russia. The depreciation of the ruble, the high inflation rates in Russia, and the restriction on holding foreign exchange have made it difficult for the new Russia to become fully engaged in international trade.

In addition to the problems of making the ruble convertible, there has not been a strong commitment on the part of the Russian government to open Russia to international trade. **Exports have been regulated by export taxes, quotas, and licenses.** (These quotas and licenses have been a source of income for government officials through the receipt of bribes.) **Domestic producers in many Russian industries have also been protected from imports through tariffs and import quotas.** It should be no surprise that the amount of trade has actually fallen since 1990. This decline in trade has also contributed to the economic disaster of the 1990s in Russia. However, that trade that has occurred has followed the law of comparative advantage quite well. **Russia has been exporting those goods for which it has a comparative advantage (natural resources such as oil) and has been importing those goods for which it has a comparative disadvantage (consumer goods).**

Russia's opening to the world economy has also been impaired by **Russia's foreign debt.** Russia took over the debt of the former Soviet Union and then added some of its own! By the mid-1990s, this debt of the Russian government exceeded \$100 billion dollars. The need to pay this foreign debt is the reason that those who earn foreign currency by selling products abroad have to sell part of that foreign currency to the Russian Central Bank. In spite of this requirement on its exporters, Russia has been unable to meet its principal or interest obligations on its foreign debt. (See below.)

Finally, let us consider **Russia's agricultural sector.** It had long been noted that, under communism, Russia was an importer of grains despite having some of the best agricultural land in the world. **Yet in the new Russia, reforms of the agricultural sector have been minimal.** Most farms are still either state farms or collective farms. Agricultural performance in the new Russia has been poor. **Meat, milk, egg, and grain production all declined considerably in the 1990s.** This reduction in supply has raised prices. Since the demand for these products is relatively inelastic, the higher prices have caused the share of income that a typical Russian family has to devote to food to rise to

over 50%. This compares to 36% in Russia in 1990 and about 15% in the United States! The decline in agricultural production has also contributed to the economic disaster in Russia in the 1990s.

### **Economic Performance in the New Russia**

In assessing the performance of the Russian economy, some writers have used the analogy of a freeway. One can drive around for many miles on city streets, getting lost, in order to find the entrance to a freeway. But once one does find the entrance, one can usually travel at great speeds. Using this analogy, Russia has been “looking for the entrance to the freeway” by trying to change its institutions. As with the driver, its economic performance has not been good. When it does “find the freeway”, it is hoped that the Russian economy can grow very fast. At the time of this writing, it is too early to say much about the long-term potential for Russian economic growth.

**One thing we can say, though, is that overall production in Russia declined greatly through most of the 1990s.** There have been various measures of the decline in production. These tend to vary from a decline of 25% to a decline of 50%. The decline in production largely resulted from the decline in production of new capital goods, as noted above. (Purchases of capital goods in 1997 were only 17% that of 1990.) But it also resulted from the decline in international trade and in agricultural production. The decline in production in Russia in the 1990s is substantially greater than that experienced by the United States in the Great Depression of the 1930s. It is true that all of the Eastern European countries that also shifted to a market economy experienced a similar decline in production. But for most of these other countries, the decline ended in about two years and was followed by growth. For Russia, the decline has continued for nearly a decade. By 1993, Russian income per person was well below the level of Turkey and Mexico and was about one-fifth the level of the United States! Even if the transition to a market economy is ultimately very successful, the Russian people have paid an enormous cost.

**Another thing we can say is that Russia has experienced very rapid inflation during its transition.** For 1992 – 1994, Russia experienced *hyperinflation*. Prices in Russia rose at the following rates:

1991	122.9%	1996	21.7%
1992	1,700%	1997	10.9%
1993	919%	1998	84.4%
1994	257%	1999	29.5% (through September, 1999)
1995	125%		

**In 1998, there was a major crisis in the Russian economy.** As of the time of this writing (1999), the effects of this crisis are still being felt in Russia. When exactly the crisis began can be debated. It may have begun in late 1997 when the Russian stock market prices fell as foreign stockholders decided to sell their shares of stock. They did this because they were nervous about owning share in foreign companies after the

economic crisis in Asia. It may have begun in the spring of 1998 when President Yeltsin fired his Prime Minister. This created political uncertainty. Or it may have begun in May of 1998 when the coal miners, tired of having their wages go unpaid, began a strike, blocking the Trans-Siberian Railway. But whenever it actually began, the crisis was well underway by the summer of 1998.

The uncertain economic situation caused many people, both Russians and foreigners, to sell their rubles. To maintain the exchange rate, the Russian government would buy up these rubles, paying with dollars. In July of 1998, the Russian government was running out of dollars to sell. So it borrowed \$11.2 billion of these dollars from the International Monetary Fund, adding to its total debt. In August of 1998, the Russian government finally allowed the value of the ruble to fall. The government also effectively defaulted on its debt, both to Russians and to foreigners. Accounts at banks were frozen and banks were closed.

What had gone wrong? There are several possible causes. **First, the government had very high budget deficits.** This means that the Russian government was spending much more than it was receiving in tax revenues. Taxes had been hard to collect in a country where so many people refused to pay. The government had paid for some of the difference by borrowing. Most of this borrowing was in short-term loans. When they came due, the government simply did not have the money to pay. The government had paid for the rest of the difference by creating new rubles. People would try to spend these new rubles but, since there were fewer goods and services, the result was a large rise in prices (inflation). These deficits have been reduced by the fall of 1999, but are still relatively large. **Second, the banks and the corporations had also borrowed heavily from foreigners.** They too could not meet their payments. Near the end of 1998, Russians owed foreigners about \$214 billion in total. **Third, Russia's main export product has been oil. In 1998, the price of oil fell considerably,** reducing Russia's ability to earn dollars and other foreign currencies. Oil prices rose in 1999 helping the economic performance of 1999 to be better than the crisis year of 1998. **Fourth, there has been great political uncertainty in Russia.** While President Yeltsin has maintained his position (despite an impeachment attempt in 1999), the rest of the government has been changed several times. In a year and a half, there were four new governments.

The decline of the value of the ruble was enhanced by expectations. As the ruble declined in value, buyers refused to buy rubles and sellers sought to get rid of rubles, lowering the value of the ruble even more. For those retailers who sell imported goods and for those companies who buy imported parts, the decline in the value of the ruble raised their costs of production. They responded by raising their prices, sometimes daily or even hourly. This caused buyers to rush out to buy, causing prices to rise even more. The strikes of miners reduced the supplies of fuels and raised their prices. The result has been a very rapid inflation once again (84% in 1998, as shown above). Consumers in today's Russia sometimes find that the price of a basic product, such as flour (or vodka), has doubled in just a week. **The rapid rise in prices has virtually wiped out the value of the savings of the people** (which, remember, were held in currency). The reduction in

the value of the ruble has also made it harder for the Russian foreign debt to be paid. Despite the rise in prices, **almost half of Russian enterprises reported losses in 1998.**

The wage arrears problem is worse than previously. About half of Russian workers have not been receiving their paychecks when they are due. Many wait for months. As of 1999, the Russian government owed an estimated 60 to 75 billion rubles to its workers. Private businesses owed another 70 billion rubles. Adjusting for inflation, the average monthly wage in July of 1999 was only 65% that of December of 1997. As of July of 1999, over 12% of all workers are unemployed. A person on a pension received, on average, \$18.40 per month in July of 1999, as compared to \$64.40 in July of 1998. The people have no money. Unpaid soldiers reportedly sell their weapons and uniforms. Many Russians resort to barter (the trading of goods for goods) to survive. Russian companies have also resorted to barter, paying their suppliers and even their taxes in kind! And many people have moved into self-sufficiency --- growing their own food in small gardens near the cities, making their own clothes, and so forth.

The Russian people were told that the economic reforms would make their lives better. As of this writing in 1999, their lives are much worse. It is not inconceivable that there could be a revolt in Russia. Given that Russia has some 22,000 nuclear warheads, this thought would be frightening to all in the West.

Russia is a country with the potential for great wealth. It has abundant natural resources, good agricultural land, a considerable amount of capital goods, and a reasonably educated population. But it cannot really begin its path to realize this wealth until some major changes in its economic system have occurred. Most importantly, there needs to be the creation of political stability and a system of well-defined property rights. Also there needs to be a large reduction in the amount of criminal activity. Enterprises need to be changed so that those who run them profit only if the enterprise performs well in markets. (That is, the principal – agent problem, described in Chapter 13, needs to be eliminated.) Banking and other financial institutions need to be developed. A climate needs to be created that will encourage people, both Russian and foreign, to invest in new capital goods. In the first decade of reform, little of this occurred. The task will be a daunting one for President Putin, elected the new President of Russia in the year 2000.

#### **\*Internet Assignments\***

1. Go to the following site: <http://www.hhs.se/site/ret/update/default.htm> . Choose the most recent month. Write a few short paragraphs describing the current state of the Russian economy. (You may also get considerable information to do this at [http://headlines.yahoo.com/Full\\_Coverage/World/Russia](http://headlines.yahoo.com/Full_Coverage/World/Russia).) Based on this description, what policies would you recommend be done by the new Russian government that was elected in 2000? In each case, briefly explain why this policy should be undertaken.

#### **\*Test Your Understanding\***

1. You are asked by a local company about doing business in Russia today. Assume that this company actually had decided to do business in Russia. What do you believe they need to know in order to have a chance to be successful in their business there?

2. Read once again the section on property rights in Chapter 10. It has been said that the problems of Russia's economic reform have resulted from the failure to properly specify property rights. Write an essay as to how property rights might not have been properly specified in Russia and why this improper specification might have contributed to the economic problems of Russia.
3. Read once again the section on the nature of the business in Chapter 13. It has been said that Russian enterprises have performed poorly so far (1) because of a principal – agent problem, (2) because they are too vertically integrated, and (3) because they are too large. Write an essay as to the ways by which these three points may have contributed to the economic problems of Russia.
4. Russia was not the only country to attempt to shift from a communist economy to a market economy. Choose one of the following countries: Poland, The Czech Republic, Hungary, or China. Find information on the shift to a market economy for this country. You can find information on the Internet by starting with a search engine. Or you can find information in the library in any newsmagazine, the Wall Street Journal, or any business oriented magazine, such as The Economist or Business Week.
  - a. Has your country of choice performed better or worse than Russia during the years it has been shifting to a market economy? Provide some evidence for your answer.
  - b. Explain why the performance of your country has been different than that of Russia. Name a few reasons with a brief explanation for each.
5. Find the article “The Process of China's Market Transition (1978-98): The Evolutionary, Historical, and Comparative Perspectives” by Yingli Qian on the Internet. Read the article. Then, write an essay contrasting the transition from a planned economy to a market economy in China with that of Russia (described in the chapter). What are the similarities? What are the differences? How has the performance of the two countries differed?