

The Russian Republic: Issues and Opportunities

A Conversation Between Jeffrey Sachs and Frank Yans

Jeffrey Sachs is currently leading a team of economic advisers to Russian President Boris Yeltsin. Frank Yans is a vice president of Arthur D. Little, Inc. This conversation took place on April 30 at Professor Sachs' home in Newton, Massachusetts.

Frank Yans You've been working very hard to help the Russian Republic make the transition from a disastrously inefficient centrally planned economy to a viable market economy. I assume you think it will succeed.

Jeffrey Sachs I think there's a reasonable chance of that.

Frank Yans What are the primary obstacles?

Jeffrey Sachs First, one has to define what it is the Russians are trying to do right now. Basically, there are two tasks at hand. One is to escape from the absolutely horrendous financial crisis that the communists left to this new democratic government – a crisis of domestic indebtedness, hyperinflation, shortages, and international debt. The second, of course, is to make the long-term systemic change to a market economy. What we're observing this year are actions taken not just to attain that long-term goal, but also to overcome the emergency. Since the beginning of the year, the Russian Government has taken extremely resolute actions to get the financial situation under control. It's making enormous progress in very difficult circumstances. The budget deficit at the end of 1991 was on the order of 20 to 25 percent of GNP, and the government was financing all of that by issuing rubles. Now, the budget deficit is about 5 percent of GNP, and the government will start to cover some of it through non-ruble means, such as international financial assistance. As a result, they're in a good position now to nip the hyperinflation right at the beginning and move quickly to an environment of at least rough macroeconomic stability.

At the same time, the printing of rubles in recent years, combined with administrative price controls, had caused not only explosive inflation but massive and intensifying shortages. By the end of last year, nobody wanted to sell goods at the official prices, so there was a breakdown of the economy. The official system was quickly coming to a halt and transactions were occurring, if at all, only in the black market or through barter. In response, at the beginning of this year the government freed up virtually all prices. That has had the effect of allowing markets to start to function and reestablishing a balance of supply and demand. So, where there were intense shortages before, enterprises now are finding that they can't sell everything they produce. They're facing demand constraints rather than supply constraints, as is typical. There are goods in the shops, albeit at very high prices. Although living standards for the Russian people are still low, there is an incredible proliferation of new wholesale and retail trade. So, basically, the Russians have made remarkable progress in overcoming this intense financial crisis, and that's given them the start on the longer-term transformation to a market economy. They're planning to consolidate the gains they've made on the fiscal and monetary side in an IMF agreement which they're planning to negotiate soon.

Specifically, in the next few months they are aiming to move to a convertible currency with a unified exchange rate, an open trading system, low budget deficits, and free and stable prices. Then they'll move on to the real structural issues that are the key to making a market economy work. Principally, that means massive privatization. They have an extremely ambitious privatization program, which is going to move faster than in any of the countries in Eastern Europe. They also have an industrial adjustment policy that will focus on some of the key sectors in the economy, mainly energy, agro-industry, and military conversion. And third, they plan to construct a social net to help absorb the social cost of this adjustment.

Frank Yans You mention industrial adjustment. A tremendous amount of the Russian economy is involved in very capital-intensive activities: oil, steel, aluminum, etc. My experience in Russia suggests that virtually all of that industry needs complete redevelopment to meet current standards for efficiency, economy, and ecology. Is it realistic to expect that the Russians will be able to generate the capital that's required, or even to set up the national systems to guarantee outside investors the kind of security they need, to carry out this redevelopment?

Jeffrey Sachs I think that one will see differences in different sectors. Already, of course, there's a boom under way in metal ores and other metal products, now that the exchange rate has been moved to a realistic level and the trading system has been opened up. That, I think, augurs well for further development in primary metals, where there's high profitability and real potential for new investment.

There's also enormous interest in investing in gas and oil. There has already been an extremely competitive process for development of the offshore Sakhalin fields, which will involve at least several billion dollars and by some estimates as high as \$20 billion. It seems clear that Western firms are very eager to be involved in that project on a very large scale. And so I think we'll see lots of capital flowing into the energy sector.

Steel production is probably another story. Russia is by far the world's largest steel producer. One can only surmise that they produce far too much steel relative to the real needs of the economy, now that the incredible overemphasis on military production is coming to an end. So I would expect significant cutbacks in overall steel production. I find it hard to imagine that they're going to continue to devote so many resources to that sector, under new market conditions.

So I think we'll see a mix of conditions in the different sectors. Of course, attracting any foreign investment capital will depend on the Russians' success in achieving financial stabilization and getting the ruble to be a working convertible currency, so that there's a chance of creating profits. And of course they must establish a stable political order. There are lots of hurdles ahead. But I'm suggesting that if the Russians work diligently and rapidly to overcome the internal obstacles, there will be no shortage of interested investors on the outside.

Frank Yans Many of the readers of *Prism* are business people. Many of them are likely to be looking at Russia and wondering whether in fact this economic liberalization will turn out to be an opportunity or a threat. For example, you mentioned that in some areas there are too many goods. I'm sure you are aware that the Russians have exported into the West an extraordinary amount of aluminum, with the result that the price of aluminum has plummeted and inventories have soared. In Western Europe, particularly, there have been concerted efforts to control the effects of this on the market. At the same time, the Russian aluminum industry needs an incredible amount of money. It's a real mess. Do you see any resolution?

Jeffrey Sachs Well, look, as a general proposition, the West can't have it both ways. If we want Russia to become a market economy, we have to accept that there will be consequences for some of our industries.

And I think it's actually quite horrendous, if I may say so, that the first success Russia had in exporting under the new system led to all sorts of protectionism on the Western European side. That pattern is simply going to have to end. The Western Europeans are going to have to exercise self-restraint. They're going to have the big Russian market to export into and they're going to have to accept significant increases of Russian exports the other way.

As a general matter, I do expect Russia to become a significant exporter, and not just of raw materials. There is a tremendously large and varied manufacturing base. Some of it is in high technology, much of which has been hidden from the outside world because it was part of the closed cities and closed enterprises of the military-industrial complex. At present the Russian economy is exporting virtually no manufactured goods, except for some processed raw materials and some military machinery. I expect that in the future we'll see lots of different kinds of Russian products – manufactured goods and machine tools, construction equipment, chemical processes, new materials, synthetics, electronics, and so on. That's going to be the sign of success. And there is going to be a lot more of it than people recognize right now. Of course, the Western markets will have to adjust.

Frank Yans Returning to the aluminum industry as an example, I think that most responsible Western business leaders would in fact like to see the Russians get the money they need to refinance their aluminum industry, because if they did, they'd have to pay that money back, and the pricing of their product would be on a more even footing with their Western competitors. It's the question of even footing, I think, that is the source of tension. But that's inevitable, isn't it?

Jeffrey Sachs What is inevitable is that when a huge economy that has been artificially closed off from the outside world is suddenly opened up, there are going to be significant adjustments. Aluminum is just one case. There will be adjustments both inside Russia and internationally. But I believe very strongly that Russia will benefit enormously by moving to comparative advantage. One of the primary causes of the fundamental failure of the communist period was closing Russia off from the outside world. The Russians will benefit enormously by opening up, and I believe that the whole world will benefit by having a stable and prosperous Russia.

Frank Yans As the Russians work toward that eminently desirable outcome, I wonder whether you would be willing to comment on the „softer side“ of economics – the impact of Russia's national traits or national personality on the country's ability to implement economic reform.

Jeffrey Sachs I think that there are surely cultural differences that have an important effect on how economies work. But I would say that it's a far cry to jump from those obvious differences to try to guess who can succeed and who won't succeed with a market economy.

What I reject out of hand is the idea that somehow the Russian character is ill-equipped to function in a modern capitalistic system. Scholars and commentators who have tried to make such judgments in the past in other countries have been proven wrong – and drastically wrong – time and again. One of the most famous examples in economics was a fairly widespread prediction in the 1950s that Korea was a long-term basket case – that the Korean culture, religion, temperament, and traditions just made it impossible to have a working market economy. Of course, that was one of the greatest failures of prediction in the postwar period, as Korea became probably the most successful developing country in the world in that period. I think if we were in Japan in 1868

at the time of the Meiji restoration, when Japan embarked on its modernization in a market setting, we could have argued long and hard why the traditions of the Tokagawa regime and Japanese religion – Shinto and Confucianism and all the rest – made it impossible for Japan to use Western institutions. Obviously, it would have been another pretty poor prediction.

My bottom line is that I believe that the core institutions of capitalism – private property ownership, corporate governance, capital markets, convertible currencies, and international trade – are transferable and are enormously powerful instruments of economic development. I believe that Russia can and will function with a prosperous market economy, and that introducing these core features of modern capitalism will be a fundamental benefit to them.

I also believe that even if one were to rewrite the entire commercial law of Russia exactly on U.S. lines, what would emerge would be something very different from the United States. There will be a Russian-style capitalism, there's no doubt about it. What it's going to look like is something that we're going to have to wait around to see, because it's going to be very hard to predict. But it's clear, as one looks around the world, that there really is a Japanese model of capitalism, a German model of capitalism, and a distinctive U.S. model of capitalism. They're all different, and I expect that Russia will have its own variant.

Frank Yans Almost no matter what country you go to, there are vibrancies of character that really do come through. I certainly think they're very clear in Korea. In Russia, it seems that every taxi cab driver is an entrepreneur. It's quite credible to me that the Russian people are going to turn that country into a market economy with or without governmental help.

Jeffrey Sachs In 1989, when I started advising the Polish government, many people explained to me that there were deep characteristics in Poland that made it impossible for them to really function in a market setting. They didn't like trade, they didn't like commerce, they wouldn't have entrepreneurial spirit, the period of socialism had destroyed initiative, and so forth. Every one of those assertions has proven to be just myth. In Poland today, a little more than two years since the reforms started, more than 600,000 new private businesses have started up. There's been a complete revolution in wholesale and retail trade, private construction, transport, and even manufacturing. One is seeing a remarkable amount of energy being unleashed and put to good use. And I think we'll see the same in Russia.

Frank Yans Russia's chances for success may even be greater because of the country's tremendous diversity.

Jeffrey Sachs That's another point. If you look at China since 1978, the introduction of the market has had very positive effects overall, but they're quite different in different regions of the country. Certainly the seaboard provinces are booming most rapidly. They're the ones with the tightest connections to offshore capital, foreign markets, and so forth. And I'm sure that in Russia we'll see those kinds of disparities as well.

Frank Yans The international community is getting ready to dump a lot of money into Russia. One concern is whether the economy is ready to absorb it.

Jeffrey Sachs Well, first let me say that no major reforms can be successful without significant international assistance. Every country that has had to make a fresh start after a calamity has required international help. That was true of every one of the Western European countries after World War II. It was absolutely necessary for the German economic miracle that the United States gave the support through the Marshall Plan to help Adenauer and Erhard get started on a market economy. It was vital for Japan after World War II that the United States gave significant assistance. And foreign help was critical in Mexico's turnaround in the last four to five years.

These countries need financial aid before private investment money starts coming, in order to help currency stabilization, to give the reforms time to take hold, and to provide a social cushion for the population. Financial aid gives a government that is battling against very difficult circumstances the opportunity to design the policies, to implement them, to see them take hold, and then to allow them some time to work. And so, the first point is that this kind of package of support that the G7 has announced is absolutely vital for the reforms.

Now, of course this support alone is not sufficient. It really is possible to dump in a lot of money and have it wasted. I hope that the model won't be dumping in money, but rather making money available on highly conditional terms. The intention – and I hope the fact – is that Western support should be linked to rigorous agreements reached between the Russian Government and the International Monetary Fund at the World Bank.

On our side, the West ought to take care that the Russian reforms really are taking hold, that they're really being implemented. There ought to be prior actions to make sure that the ruble is really working as normal money. There ought to be careful scrutiny of how the money is used and it ought to be linked explicitly to the reforms. It doesn't do the reformers any good if we make a lot of money available without conditioning it on the reforms' actually being implemented. Opponents to the reform then say, „Well, let's take the money and have some fun,“ and the internal support for the reform is actually undermined.

I am satisfied that the mechanisms that the international community has for implementing conditionality can work here. I think we ought to take care not to write blank checks at the beginning. But I don't see any danger of that, actually. I think the money's all going to come in distinctly phased payments that will be linked to the actual fulfillment of the reform program.

Frank Yans When I first started working in Latin America, I recall the international money-lending agencies saying, „Well, we have finally learned our lesson. We're not going to just dump money into these governments. All the money now is going to be related to specific projects. Then we can see where it's going and measure its effect, the efficiency of its use, etc.“

Jeffrey Sachs I'm not sure that's the right lesson, though. It's not a matter of project finance versus general balance-of-payments support. What's really at issue here is whether the money is going into an environment in which overall economic policies are decent or not. That's as important as the specific target of the aid. What do I have in mind? Well, a large part of the assistance that is needed right now is actually to help make the ruble a stable and stronger currency. That can be done without directing the money specifically at a particular target project, but rather just allowing the Russian government to sell foreign exchange reserves into the foreign exchange market, to help strengthen the currency and give it stability. Putting the money into the economy in a market-oriented way, but in a way that is supportive of financial stabilization can be absolutely crucial. On the other hand, you can have wonderful projects, but if they're overwhelmed by terrible macroeconomic policies, then the projects are going to fail and the money is going to be wasted. In Russia, the funds are to be used in a variety of ways: some general budgetary support, some balance-of-payments support, some support for currency stabilization, some specific project financing, some reserves for the banking system to allow the central bank to have a somewhat easier monetary policy than it otherwise would have, and so forth. In some cases we'll need to have good specific projects, no doubt. But it will be important to ask whether the money is coming in the context of a sound macro-economic framework, including the legal and institutional structure, so that the money can be absorbed.

Some money is going to be wasted, there's no question. Naturally, some of the many projects now getting started may fail. But one can also say that the amount of waste is going to be less costly to the U.S. economy, for example, than the hundreds of billions of dollars that Americans were spending per year to pay for the Cold War. And so, from the Western point of view, there's a lot of self-interest in this money. Even if some of it's wasted, even if it doesn't have an absolutely commercial rate of return, if it succeeds in helping to solidify Russian democracy and market reforms, the long-term savings to the West, compared to the alternatives, will be absolutely enormous.

Frank Yans I have no doubt of that. It's just that, although you make a very good case for some balance between fundamental macroeconomic investments and projects, in this particular case, the vast preponderance seems to be going into the former.

Jeffrey Sachs I think that's because we're at the beginning of the process. In the first year, you would expect the aid to be more heavily geared toward macro-economic stabilization and emergency humanitarian assistance. If we're still in that situation three years down the road, we've got a problem. In three years' time, we'd better be doing mostly project financing and very little general balance-of-payments support.

And so I'm anticipating a process whereby the focus of assistance shifts, over a period of, say, five years, from emergency support and macro support to almost strict project financing at the end.

Frank Yans You mentioned a social safety net. In many countries – I'm thinking of Latin America, for example – despite much focus on macroeconomic issues, the safety net never falls into place. Furthermore, I'm sure that establishing a social safety net in Russia is going to be a very sensitive issue in the international community, given the economic and social difficulties most Western countries are struggling with at home.

Jeffrey Sachs Sure. While constructing a social support system is vital, it's also very hard, as you point out. One of the major themes of the transformation is to shift from incredibly expensive general subsidies to targeted subsidies for vulnerable groups: low-income groups, pensioners, and so forth. But targeting is very hard in a situation of considerable social turmoil. The experience in Latin America certainly points to these difficulties. In one sense, Russia may actually be better placed than Latin America to succeed. In Latin America, the inherited inequalities in income are the largest in the world. Of course, these inequalities are insinuated very deeply into the politics of the region, where they give rise to instability, swings of populism, and so forth. There's very much an „us versus them“ attitude in many of these countries.

I believe that the starting point in Eastern Europe and in Russia is better than in Latin America for an ironic reason: there is far more equality, because everybody's poor. Communism did succeed in one thing: by taking away wealth from everyone and lowering living standards pretty much across the board, it ended inequalities. And while that's a very unhappy situation in most respects, it reduces the „us versus them“ politics, allowing the transformation to go forward somewhat more smoothly.

Of course, the big fight ahead – the one that all of Eastern Europe is engaged in right now – is what to do with the overbuilt heavy industrial sector. Communism wasn't just inefficient; it systematically distorted how resources were used. A few days in the region convinces you very strongly that Stalin loved steel mills a lot more than he did pizzerias and travel agencies. Russia's resources were systematically diverted to heavy industry. Now, what to do with all that heavy industry? Of course, it's got to taper down significantly in order to free up resources for normal life, so that there are more shops and plumbers and woodworkers and other people doing housing construction and offering personal services, including bankers and lawyers. (They especially need lawyers right now. The vital role of the rule of law really strikes you when you see a country that doesn't have it.)

What all of that means is that there will be a significant decline in the amount of resources in the heavy industrial sector. And the fight over how to make that transition – at what pace, and with what subsidies to the industries on the way down – is already under way. The same issue is at the core of the politics that every Eastern European country is grappling with right now.

Frank Yans In some sectors, the transition may prove less costly than we fear. In the steel industry, for example, new mini-mill technology allows you to put together a very interesting economic plan based on actually consuming existing steel mills to provide raw materials for new steel mills. By doing that, you can produce steel with virtually no raw materials cost for years.

Jeffrey Sachs Really? That's very interesting.

Frank Yans One of the advantages is that you get a huge payback right up front. We've been looking at that very carefully for Czechoslovakia. The real problem is the effect on the Western European steel industry. But the technology itself is well-established. If a country is careful and judicious, and if they're willing to discard some of their old facilities in a creative way, they could use new technology to do some great things for their economy.

Jeffrey Sachs Well, that's consistent with my overall view that there are gems all around. Once the place is properly up and running, hidden strengths will appear. I leave a lot of that to the businessmen. As an economist, I'm just confident that the market will find these profit opportunities and then you and the business community have to go out and exploit them.

Frank Yans Actually, that brings up an interesting point. You know, Arthur D. Little has offices all over the world, and I think people in our business have a strong desire to „do good as we do well.“ Any comments on how our role can make some progress toward the kind of objective you've described?

Jeffrey Sachs There's no question that much of the success of this reform depends on the fact that international expertise is a tradable commodity, and that management consultants and industrial experts flow across national borders. Because Russian managers all too often are still caught up in the old system and blind to new market possibilities, it is important to be able to rely on firms like yours to make in-depth analyses of individual enterprises and figure out what they can do to survive, how they should restructure, what kind of market contacts they need. In Poland, management consulting firms played a very important role in making contacts between Western firms and Polish enterprises, making the „marriages“ and helping Polish enterprises discover new markets for their activities. That kind of market-building expertise is going to be vital in Russia.

I think it's an incredible opportunity. There are, according to the most recent count I've seen, 132,000 state enterprises in Russia. Of course, many are small, but there are thousands and thousands of large enterprises, most of which have no market experience whatsoever. They're all going to need some help with internal restructuring and discovering how to function in the market environment. Thank goodness a lot of that help will come from indigenous resources. But there's no doubt that international expertise in helping enterprises find their way and exploit new technologies will play a central role.

Frank Yans You yourself certainly personify the international flow of valuable expertise. I understand that your work in Russia and elsewhere is entirely supported by the United Nations, the Finnish Government, and that you are able to provide this assistance free of charge to the governments that you work with.

Jeffrey Sachs Yes, I'm grateful to be able to do that, and it's important to be financially independent of the local political process.

Frank Yans In that role, you're trying to convince governments to do things because you believe that if they do, they'll achieve certain economic objectives. I wonder whether they sometimes find that even if they achieve those objectives, they haven't found nirvana?

Jeffrey Sachs Oh, very much so. I very strongly believe that these reforms give these countries the chance of a way out. But they don't provide solutions by themselves. They just provide an opportunity for hard work to translate into the future gains in living standards. My understanding of the historical record says that this approach gives countries a reliable way forward. I am confident that integration in the world system with the

market economy does its job. But it does over the course of many years. And the early years are the hardest, because of course there are losers in the transformation process and there are costs. And sometimes the winners keep their heads down. They don't want to announce how much money they're making. Sometimes they're politically weak at the beginning. Sometimes the public doesn't recognize how much success is going to cost. So at the beginning you tend to get a great deal of focus on the costs and an insufficient recognition of the enormous and profound benefits that are going to come. Virtually every reformer has faced this political challenge. Erhard, the father of the German economic miracle, was very controversial and unpopular during the early years. He was accused of having done little more than fomenting high employment. It was only ten years later, when the fruits of those reforms really took hold, that he was hailed as the champion of the German economic miracle.

In my experience as an adviser, I've had an especially deep sense of fulfillment when enough time has gone by that the people in the country can see that this was the right way. I very much cherish the fact that in Bolivia, where I started working in 1985, I am regarded as a friend and adviser by all the major political parties in the country. I think that is testimony to the strength of the basic strategy and also to the fact that after a few years, the results really do work. In Poland right now, after two years and some months of reform, while to my eye there are great successes, there is also a great deal of anxiety and controversy. Poland is now at the difficult stage where many hard things have to be done, while the great benefits have not yet fully materialized. This is a hard stretch.

For Russia, it's going to be years and years of this process, especially given the deep structural imbalances that Soviet communism created. It was a much worse breed of the disease than in Eastern Europe. And so this is going to be a very difficult process to manage politically. It's one of the reasons why I put a lot of stress on the need for Western assistance during this critical phase, when they are starting to implement reforms, and when there is still some time before the real fruits of the reforms become clearly evident.

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Frank Yans, a vice president of Arthur D. Little, Inc., has specialized in the economic aspects of the capital-intensive, resource-based industries, with particular emphasis on the development of new projects, mergers and acquisitions, restructuring, and profitability studies. He has led major assignments for many large corporations in the United States, Europe, Australia, the former Soviet Union, Latin America, and the Asia Pacific region.