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Russia and the Monetary Fund

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The news from Russia seemed to improve dramatically in the past year. Boris Yeltsin recovered from his ailments, was re-elected as president, agreed to let Nato expand (for a price), appointed a “reform” government, signed a peace treaty with Chechnya, and finally allowed enough reform to let the oil pipeline negotiations proceed. Is Russia now on its way, slowly, toward stability under democratic capitalism?

Look again through the eyes of Alexander Solzhenitsyn, writing in the New York Times in January. Solzhenitsyn spent enough time either imprisoned in the gulag or exiled to the United States to know democratic reforms when he sees them. He is unpersuaded with the alleged progress toward democracy. He writes: “Two strongly held opinions are widely shared in the West: that during the last two years democracy has unquestionably been established in Russia, albeit one under a dangerously weak government, and that the effective economic reforms have been adopted to foster the creation of a free market, to which the way is now open. Both views are mistaken.”

The imperfect measures used to judge progress of the Russian economy have stopped declining. Output has started to increase from very low levels, but it will take until well into the next century before living standards can return to the pitiable levels reached in the last year of communism. Goods, especially imports, are available. Store shelves are no longer empty, as they were under communism. Many people have started businesses, and some have grown rich in the new regime.

Missing from Russia are many of the prerequisites of democratic capitalism that we take for granted. These include the rule of law, administered by an independent judiciary, and protection of property rights by police, not hired thugs. Free markets function best when there is a commercial code, to assure delivery according to contract, a bankruptcy law, to apportion assets in the event of failure, and accounting and financial systems to keep records and permit asset transfers.

Most of these prerequisites either do not exist except on paper, or do not exist at all. Guided by the International Monetary Fund (IMF) and the World Bank, Russia has made the mistake of equating capitalism with the use of prices and markets to allocate goods. As Hayek taught so often and so well, markets function well under capitalism only if there is a capitalist infrastructure to enforce laws, contracts, and property rights so that markets can work efficiently.

After years of deprivation under communism, followed by the brutal “transition” of this decade, Russian financial wealth and saving is extremely low. Foreign capital is
the only likely source of development finance. The Russian government has not been willing to establish rules under which capital will come. Taxes, repatriation of profits, safeguards against confiscation, agreement about regulation are only a few of the standard safeguards that foreign investors seek, but do not find. The result: foreigners have invested only $7 billion in the past six or seven years.

One reason for the delays and hesitation to reform is that many nationalists are reluctant to sell rights to develop Russia’s mineral wealth. Another, no less important, is that these assets remain under the control of the state bureaucracy, where the incentive to privatize is weak or non-existent, unless sizable bribes are paid. Some sign of a break in this stalemate has recently appeared, but it is too soon to know whether recent, more promising, negotiations over the Caspian pipeline are an isolated event.

Role of the IMF

The IMF is the principal international agency charged with responsibility for helping Russia convert to democratic capitalism. The IMF began as part of the post World War II agreements about postwar financial and trading arrangements. Its original responsibility was to foster and manage the fixed exchange rate system. That system ended when President Nixon closed the gold window in 1971. Since that time, the IMF has been looking for something to do. When communism ended, western governments chose the IMF to help Russia (and other countries) through the transition. It has been busy at the task ever since. In the next three years, the IMF and its sister institution, The World Bank, plan to lend an additional $20 billion to the government.

Much of the IMF’s effort has gone toward trying to get budgets balanced, ending price controls, and getting state-owned businesses into private hands. Many of these steps would have been taken without the IMF. Much of the alleged progress toward a balanced budget and monetary stability in Russia is illusory. The government plays the dangerous game of not paying suppliers and workers, including the armed services. Many of these payments are overdue for six months or more. It is not surprising that such tactics give the current government a bad name.

No less serious is continued high crime rates and favoritism. State industries have been sold on favorable terms to insiders. And Solzhenitsyn estimates that no less than $25 billion a year is sent abroad into private bank accounts. Some of this money came from Western taxpayers, via the IMF and the World Bank.

Privatization in Russia has shifted ownership and control of many assets to present and former officials and bureaucrats or their friends. Alexander Lebed, the former general who ended the Chechnya war, wrote in The Wall Street Journal last winter that the government “torpedoes direct foreign investments and denies investors basic guarantees. Private capital, whether foreign or Russian, is steered exclusively into projects controlled by the groups in power. ... Criminal syndicates and cartels play the role
that regulators should... Criminal organizations deprive citizens of their property... even their lives."

What has happened in Russia is shameful. The IMF bears much of the responsibility, as do the Bush and Clinton administrations, because we have the largest vote at IMF meetings and could insist on a more rational, effective program. Both administrations have been reluctant to criticize the IMF. They are happy to transfer money to Russia through the IMF, thereby avoiding the budget process and Congressional scrutiny or investigation of where the money goes and what it achieves. Congressional investigation is long overdue.

What's Wrong?

One of the IMF's main functions is to give advice or counsel to governments. Although some critics think that too much emphasis is given to balancing the budget and too little attention is paid to incentives for growth, the technical quality of the advice is often very high. Yet, there is an odd feature. Private consultants charge fees for their advice; the IMF not only gives the advice away, but it pays the client state to accept the advice by dangling subsidized loans at below market interest rates. And the borrowing country often agrees to follow the advice as a condition for the loan. Once it has the money, or the promise of money, it can ignore the restrictions it promised to meet.

After fifty years, the IMF has not found a way to enforce the conditions effectively. The borrowers understand that enforcement is weak. That may explain why studies of enforcement find that compliance has declined over time.

The most effective way to force the borrower to live up to the contract is refuse additional lending or call outstanding loans, if that option is available. The incentive system at the IMF (and the development banks) rewards making loans, not calling or refusing loans. Russian officials, like other borrowers, understand that they can punish visiting IMF officials by refusing to meet with them when they come to Moscow. Some junior employee is assigned to the meeting instead.

Failure to meet with senior officials, ministers or their deputies, is taken as a sign of failure by the visiting official. This sanction by the borrowers, coupled with the IMF's incentive to make and renew loans, has been more powerful than the incentive to enforce the conditions of the loan.

Although the IMF has been slow to reform, incentives could be changed. It would be more difficult to change the mindset of the officials from concern about budget balance to concern about developing capitalist infrastructure in Russia and elsewhere.

The IMF, and other international lenders, owe their existence to the type of thinking characteristic of the 1930s depression. Risks were high, and capital flows were small. The early postwar generation expected that capital flows would remain small, so
they developed international lending agencies to fill the gap. These lenders make primarily
government to government loans. The IMF lends only to governments.

Those days should be over. Private capital flows to developing countries are now
many times the size of IMF and World Bank lending. And, unlike IMF loans, private
capital flows mainly to private investors, not to governments. The eagerness with which
private lenders have gone to Russia suggests that much more capital would flow there, if
the IMF stopped propping up the government “reformers” and transferring funds to cover
part of state spending and deficits.

Real reform in Russia won’t come until a capitalist infrastructure is in place. That
won’t happen until there are stronger incentives for making the needed changes in laws,
taxes, and regulations. The IMF has shown little ability to get those reforms. Eliminating
the IMF, and forcing Russia to look for capital in the marketplace, seems a surer path
toward democratic capitalism and the rule of law.

Evidence of successful reform will be large flows of private capital to Russia and
its neighbors. Russians who have hidden money abroad will bring it home, as Chileans,
Argentineans, Mexicans, and many others have done when they sensed real reform. It is
time to end the IMF and the use of public money distributed by state bureaucracies.