Why Market Liberalism and the Ruble's Value are Sinking Together

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Steven Solnick has already posed a version of the question I would like to address: How will the current crisis affect the potential for creating a political base out of which an effective Russian state could arise, one capable of sustaining a national market economy? My remarks—penned in St. Petersburg in early November—echo many of his observations but seek to put them in a somewhat different context.

In my view, the August crisis shattered the fragile institutional base of liberal capitalism in Russia and, with it, the narrow and fractious coalition that had dominated Russia for the previous five years. The cement of this coalition was a stable and extremely strong ruble–dollar exchange rate. The five-year dominance of the strong-ruble coalition was tightly circumscribed in both territorial and institutional terms, and it proved unable to harness its power to a coherent state project for a capitalist reconstruction of Russia on a national scale. Indeed, beyond Moscow, most of Russian industry moved to the rhythms not of the ruble but of other, lower-value means of payment, such as barter and the money surrogates issued by local governments. The exchange-rate collapse of late August and early September (the ruble sank from approximately 6 to the dollar to nearly 20 to 1 before recovering slightly to around 15 to 1) led not only to the fragmentation of the hard-money coalition, and the weakening of its members, but also undid many of its limited successes in unifying the Russian economic space. All that the hard-money coalition has bequeathed to its successors is an enormous fissure between the practice of economic exchange and the national institutions intended to regulate and tax it, a fissure overlapping with the analogous breach between money and barter, and between the federal and provincial levels of government.

The most prominent members of the strong-ruble coalition were the big Moscow banks, which (as Solnick notes) could borrow dollars abroad at low interest rates, convert them into rubles, and loan them to the government at extraordinarily high rates. The central bank's commitment to maintain the exchange rate let the banks do all this in confidence that the ruble receipts thus earned could be converted back into dollars to pay off their loans. In fact, the banks were so sure of their position that they even sold insurance against a fall in the ruble's value to all who asked, treating the premiums as free money. The banks' incomes allowed them to pursue empire-building schemes in the Russian provinces as they sought to construct "finance-industrial groups." This brought them into conflict with the efforts of local authorities to dominate industry. Norilsk Nikel, for instance, belongs to the Moscow-based Oneksimbank and cannot be said to be under the thumb of the Krasnoyarsk government.

The strong and stable ruble also benefited a few flourishing regions and cities, above all Moscow, where it sustained high levels of consumption of imported goods and enabled local governments to borrow abroad. Moscow's spectacular growth differed sharply from the rest of the country: Moscow came to resemble an enclave, buying mostly foreign goods with income deriving chiefly from the financial flows that connected the domestic and international economy. In many cases, opportunities to sell domestic goods—and labor—in the huge Moscow market came, in important measure, under the control of Mayor Yuri Luzhkov. This enclave economy, to no small degree, provided the fiscal base for the federal government, which displayed an extraordinary financial dependence on the city. In 1997, about 45 percent of the cash spent by the federal budget, on expenses other than debt payments, was either collected in Moscow or derived from the sale of GKOs to the domestic and foreign investors clustered there.

In the Moscow-centered money economy, interest rates were remarkable—to pay "only" 20 percent a year on government debt and interbank loans was considered a major victory, because usually the rates were far higher. Add the very strong exchange rate for the ruble, which offered great benefits to importers, and one can—with very little exaggeration—describe the situation as follows: Moscow was running a monetary policy that was ruinous for most Russian industry, since it made credit available at only the most usurious rates, while putting what consumer-purchasing power was available at the service of foreign firms. Moscow's monetary policy created a monetary system in which the vast bulk of Russian industry, focused on the internal market, simply could not survive.

It is in this context that barter and money surrogates arose. Essentially, they allowed for both a private devaluation of the ruble, negotiated among the parties to particular exchange circuits, and the creation of alternate monetary systems with lower interest rates. Nonmonetary exchange—perhaps as much as 70 percent of intraindustry exchange—existed in a constant state of war with both the formal institutions of taxation, which sought to tax nonmonetary receipts as if they were higher-valued rubles, and with the rules of bankruptcy, since for complicated reasons, the accumulation of debt played a critical role in facilitating barter transactions. As a result, virtually any firm operating in the massive barter economy was formally liable to punishment as a tax deadbeat and to reorganization under bankruptcy legislation. In this context, it is perhaps unsurprising that the regional governments had no wish to become agents of the central one, by implementing a coercive model of tax collection in which bartering firms would be driven out of business. Instead, regional governments taxed in kind and thereby forced the federal government to do so as well. In other words, I would see regional opposition to federal taxation efforts not as an unwillingness to recognize that the federal government provides needed services, which must be funded, but rather as an effort to compensate for a federal economic policy fundamentally at odds with the interests of most regions.

If the federal authorities, big banks, and Moscow were firmly within the strong-ruble coalition, while most of the regions with domestic-market industry were clearly outside of it, the position of the country's exporters and the regions linked to them was more ambiguous. Russia's exports consist substantially in oil, gas, and metal. Normally we expect exporters to support a weak exchange rate, since it lowers their domestic costs and thus increases their profits. But in Russia this has generally been true only of the metals industry, which sells the bulk of its production abroad. When the protests of the metal firms against the exchange-rate policy were stymied, they cooperated with local authorities to use nonmonetary exchange to achieve a private devaluation, at the cost of incessant friction with tax and bill collectors.

Facing a somewhat different situation were the energy exporters—oil companies and the enormous parastatal natural-gas firm, Gazprom. These firms had substantial domestic sales and faced relatively strong constraints on the expansion of sales abroad. Thus, unlike the metals industry, they were willing to give at least tacit support to the strong-ruble coalition because of the prospect of profiting from sales to ruble-holding consumers. Although most of the customers in these sectors were paying in kind or with money surrogates rather than cash, the oil and gas firms did not seek a general devaluation that would have eliminated nonmonetary exchange by dropping the ruble's value to that of these alternatives. Instead, they sought to make their customers more competitive at the existing exchange rate. This could be done by helping energy customers sell their product and replacing the implicit price cuts given through barter and similar mechanisms with explicit price cuts—and both the oil companies and Gazprom lobbied to be allowed to charge lower prices to domestic consumers.

Energy exporters had an uneasy relationship to the strong-ruble coalition. Their high share of nonmonetary receipts for domestic sales led them to demand that they be taxed in kind, a demand that the federal government could not always afford to accommodate, given its need for cash for salaries and debt payments. Indeed, in 1997, Gazprom and some major oil companies took out large foreign loans to pay taxes in cash when the federal government limited the share of taxes in kind it would accept. Federal fiscal authorities were resistant to allowing price cuts for domestic consumers, fearing that this would lead to even worse tax evasion, since low prices declared on the books could be accompanied by unregistered side payments. The IMF made the friction regarding both these points much worse, by insisting that domestic consumers pay world prices for energy and by trying to convince the government to make no tax concessions to nonmonetary exchange whatsoever. Nevertheless, Gazprom and (generally) the oil companies did not attack the exchange-rate policy and remained members of the hard-ruble coalition.

If I have recounted exchange-rate politics at such length, I do so in order to emphasize the existential significance of the strong ruble for the institutional and political base of market liberalism in Russia—a significance that became painfully apparent after the August crisis. That Russia needed to devalue its currency had been apparent to many, from early 1998, when it became clear that falling oil and gas prices would hit Russia's export receipts and thus make sustaining the old rate impossible (though many foreign investors assumed that an IMF bailout could prop up the ruble despite the so-called fundamentals—as did the IMF itself). The big banks, for their part, bet all the money they had, and much they did not, on the continuing stability of the exchange rate. As a result, in the run-up to the August crisis, Russia's leaders faced a horrible dilemma. Devaluation appeared necessary, yet it would be tantamount to the destruction of the banking system, and would bring down the whole configuration of forces fighting to unify Russia under the aegis of market liberalism. It was thus convenient to think that the IMF could sufficiently calm market psychology to avoid a devaluation. But delaying the inevitable only made the collapse of the banking system more all-encompassing than it might have been otherwise.

The amorphousness of the present government's intentions stems, I submit, from the enormous weakening of most of the key members of the strong-ruble coalition and the failure of any new ruling coalition to institutionalize itself. In late August, Yeltsin dismissed Prime Minister Kiriyenko and renominated Viktor Chernomyrdin for the post. Chernomyrdin's program, badly misunderstood by most commentators, was a bold and novel attempt to build a new coalition for market liberalism around a far, far lower ruble exchange rate. Thus the program's division into two phases. First, an inflationary burst that would wipe out old debts, eliminating with them much nonmonetary exchange, while driving the exchange rate ever downward. Then—as Chernomyrdin told the Federation Council, composed of provincial governors and legislators—there would follow an "economic dictatorship" in which tax and bankruptcy laws would be enforced with unprecedented ferocity. That this program drew strong support among provincial leaders suggests the extent to which many of them could indeed be brought into a coalition for upholding the economic powers of the national state—if that state were to run a policy under which a greater share of Russian industry could compete.

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In mid-September, however, Chernomyrdin's candidacy was blocked by an alliance between the Communists and Moscow mayor Yuri Luzhkov, a man with much to lose from the massive devaluation Chernomyrdin sought to organize. Yet Luzhkov and the Communists ultimately share little beyond their hostility toward Chernomyrdin. Thus the incoherence of present policy announcements, as the government finds itself between conflicting impulses to prevent, on the one hand, a further erosion in the exchange rate and, on the other, to embark on an inflationary forced march in the direction of a command economy. The experiment with multiple exchange rates, as well as calls to tether the purchase of hard currency to imports of consumer goods, results in a fragmentation of the ruble's exchange rate that corresponds to the new political fragmentation. Meanwhile, Luzhkov pushes for early presidential elections, before the "Moscow Miracle" sinks to the depths along with the ruble that had buoyed it up.

As for other members of the hard-currency coalition, Gazprom and the oil companies have gone their separate ways. In an effort to prevent a further erosion of the ruble's value, Gazprom is preoccupied with offering taxation in kind as an alternative to compensating for lagging tax receipts by printing money. Oil companies, by contrast, are ready to turn their back on the domestic market and have been calling openly for taxation by inflation so as to lower their own tax burden while weakening the ruble still further in order to increase export opportunities. Most of the big Moscow banks were horribly damaged by the crisis and can do little but seek to convince the central bank that they are too big to fail. Meanwhile, in the provinces the local authorities are both blocking bank transfers to other regions to halt the spread of financial contagion and, at the same time, taking the opportunity to roll back the Moscow banks' empire-building acquisitions of plum, local enterprises.

In short, the old strong-ruble ruling coalition is dead, and its spectacular demise brought down what limited structures of national economic integration it had erected. Compounding this new fragmentation is the state of affairs left behind by the unfinished work of the strong-ruble coalition—a bifurcation of the monetary system between rubles and barter, or locally managed surrogates. The key ambition of market liberalism—to provide the institutions that at once ensure formal calculation of economic advantage, contract enforcement, property rights, and tax collection—seems further off than ever, and an inheritor to market liberalism's mantle has yet to emerge.

Yet on the basis of on-the-spot observation and several more weeks to watch events unfold, I would disagree with Professor Solnick that this is the worst crisis since Hitler's invasion. Unlike, say, the crisis of late 1991, the economy's provision for basic human needs has not broken down, however badly the economic actors accomplishing this are regulated and civilized by the state. The Primakov government, paralyzed by contradictions within its own political base and the magnitude of the tasks before it, at least has the sense not to interfere with existing structures of provision or to indulge command-economy fantasies laughably beyond existing state capacities. This laissez-faire (or rather *faire rien*) policy will prevent a short-term catastrophe; it is no long-term solution.

Everyone awaits elections—and this may be the most significant outcome of the August crisis. The hard-money coalition pursued its agenda through the financial system and the executive branch of government, marginalizing elected institutions and ignoring the historic association between capitalism and law. With the demise of the extraparliamentary coalition for market liberalism cemented by the strong ruble, elected legislators will for the first time have a chance to take the lead in devising a program that sustains both the economy and an effective national state. Wish them wisdom and luck.

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