Yeltsin's shock therapy applie

Boris Yeltsin's canning of Prime Minister Yegor Gaidar is an ominous signal. It was not without advanced warning. And Gaidar was not the perfect architect of economic reform, in fact, he lacked much of the imagination needed to construct the structural reform package needed in Russia to set the country on the path toward growth and prosperity. But Dec. 14, 1992, was a sad day for the Russian people as the old cadre reasserted itself and the status of real economic reform became doubtful at best.

Peter J. Boettke

During the reign of Mikhail Gorbachev at least 10 packages for radical restructuring of the Soviet economy were introduced. Not a single one was implemented. Even if such reform packages as the Shatalin 500-day program had been implemented fully, however, the desired results would not have followed because of its conceptual flaws. The issue of "destatization" of enterprises, for example, was not clarified and it certainly did not mean privatization.

But the problem is not just limited to design flaws within the reform program. The continuous back and forth over reform generates an unhealthy economic and political climate. Within such a climate it is irrational for private investors, both domestic and foreign, to enter the economic game en masse. As a result, capital is not made available and the economic situation grows worse and opposition voices against reform grow louder. Despite his break with the previous system of government, Yeltsin continued along this Gorbachevian path.

On Oct. 28, 1991, Yeltsin announced his economic reforms. "The period of moving in small steps is over." "Under conditions of political freedom," he added, "we must provide economic freedom, lift all barriers to the freedom of enterprises and entrepreneurship, and give people the opportunity to work and to receive as much as they can earn, casting off bureaucratic constraints." Yeltsin's program was to consist of 1) macroeconomic stabilization, including the "unfreezing" of prices; 2) privatization and the creation of a healthy "mixed economy" with a strong private sector; and 3) foreign trade liberalization.

Yeltsin followed this speech with 10 presidential decrees on Nov. 15, 1991, which placed full economic power in his hands over the Russian territory. Then, on Jan. 2, 1992, Yeltsin's government acted unilaterally and freed most consumer-goods and producer-goods prices from administrative regulation. But right from the start the Yeltsin program was attacked from all directions.

Vice President Aleksandr Rutskoi, on Jan. 30, accused Yeltsin of "seeking to conduct yet another experiment on the Russian people." And the congress of People's Deputies challenged Yeltsin's authority as early as April last year because many of its members are managers of state enterprises unsure of where the reforms will leave them. We know this debate quite well. The West myopically portrayed debate in Russia as between Yeltsin and the conservatives (Rutskoi, the Civic Union, or worse). But Yeltsin's reforms were attacked from liberal reformers as well.

The free-market liberal, Larisa Piyasheva, for example, argued from the beginning that Yeltsin's package lacked a foundation in free-market economics. Both the 28 percent value-added tax and the liberalization of prices before privatization made no sense to her. Upon examination of the Yeltsin program in January last year, Piyasheva concluded that 95 percent of what the Russian government was doing represented "economic exercises devoid of common sense." Unfortunately for the Russian people, Piyasheva was right.

Yeltsin's reform package, though much better than anything that emerged during the Gorbachev era, was still both conceptually flawed and implemented poorly. In fact, Yeltsin the populist may have been one of the strongest opponent of Yeltsin the reformer. Yeltsin was clearly better than Gorbachev. At least reform of communism was rejected by Yeltsin.

But, like Gorbachev before him, Yeltsin did not provide clear signals to potential market participants nor did he move quickly enough to guarantee the proper implementation of market reforms. The main problem was not one of personalities. The main problem was, and remains, the system of governance and the inability to change that basic system to establish the appropriate political infrastructure for economic development.

By March 1992, Yeltsin already had backed away from some of the harsh short-term realities of liberalization. Yeltsin gave speeches, for example, where he severely criticized profiteering. Restrictions on trading practices were established right from the beginning. Not only were quantity limits placed on the amount that could be sold to individual consumers, but his policy was reinforced by placing a 25 percent mark-up ceiling on retail prices.

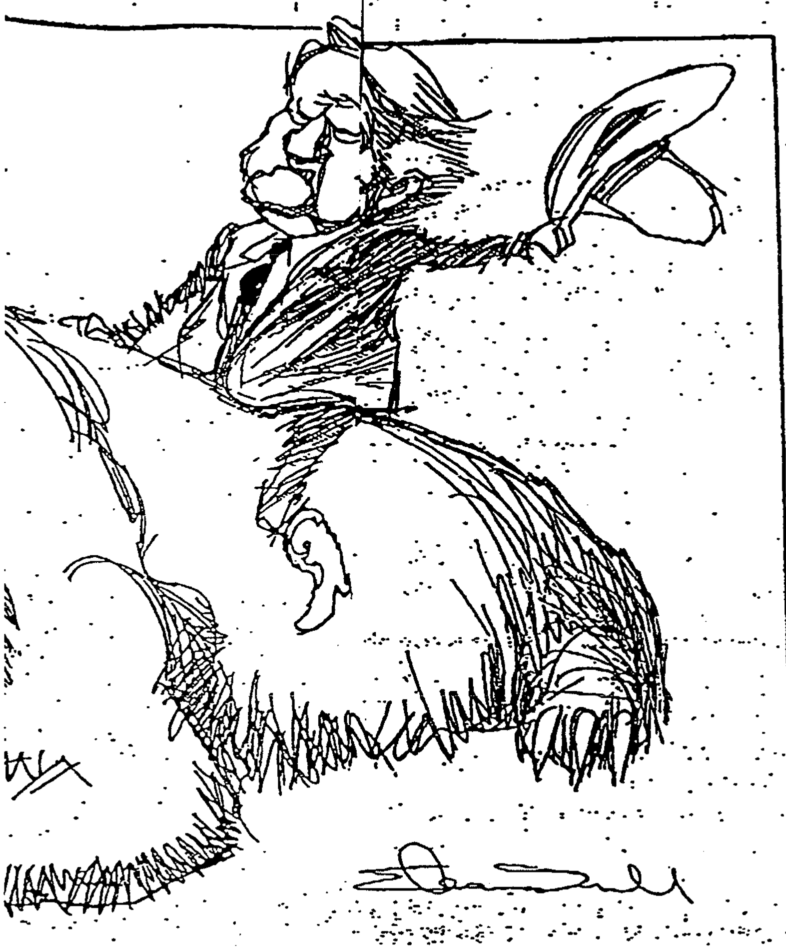
Obviously, much of Yeltsin's movement was dictated by the political struggles he faced inside the government. And it would be a huge mistake to overestimate how much control or power Yeltsin had to push through his reforms. Many of his decrees, for example, were simply ignored.

Shock therapy, if by shock therapy we mean the liberalization of the economy from state control, simply did not take place. Privatization moved slowly, the supply network was not freed to respond to market forces, and the tight monetary policy advocated by Gaidar was not followed as the Central Bank issued an ex-

applied too little voltage

"Yeltsin's Shock Therapy Applied Too Little Voltage"

Orange County Register. Sunday January 31, 1993.



h to guarantee the proper
on of market reforms. The
was not one of personal-
ain problem was, and re-
stem of governance and the
ange that basic system to
appropriate political infra-
economic development.

1992, Yeltsin already had
from some of the harsh
ealities of liberalization.
speeches, for example,
erely criticized profiteering.
m trading practices were es-
it from the beginning. Not
antity limits placed on the
could be sold to individual
ut his policy was reinforced
25 percent mark-up ceiling
es.

much of Yeltsin's move-
tated by the political strug-
inside the government. And
huge mistake to overesti-
ich control or power Yeltsin
hrough his reforms. Many of
or example, were simply ig-

apy, if by shock therapy we
eralization of the economy
ontrol, simply did not take
tization moved slowly, the
rk was not freed to respond
ces, and the tight monetary
ated by Gaidar was not fol-
Central Bank issued an ex-

plosion of state credits to prop up failing state enterprises throughout the summer and fall. As a result, the ruble fell at one point to somewhere around 400 to a dollar, only small-scale enterprise emerged, and corruption and theft thrived as markets without clearly defined property rights emerged.

These aspects of Russian reality are not the consequence of free-market reform, but the result of the lingering of state control over the economy and the unstable political and legal environment.

In other words, it is not free-market reforms that generated Russia's problems, but their absence. Without a free supply network, for example, entrepreneurs must rely on the state for resources. Resources are obtained through corruption of state officials or outright theft. Moreover, without well defined rights to resources the enforcement of contracts takes on the unsavory characteristics of mafia markets.

An appropriate analogy would be to consider the difference in the market for alcohol under prohibition versus the market for alcohol today. The prohibition market was not a free market, just as the emerging market economy in Russia is not free.

The Yeltsin-Gaidar reform team lacked the requisite imagination to design and implement an appropriate reform package, one that would address both the problems of the old system and solicit the support of the old beneficiaries of the system. Partly this was a fault of the West, who provided the same stale advice that had been thrust upon the developing world without success for a generation. Foreign loan and credit programs from the West would not have lead to the needed structural changes.

An examination of the record of the IMF and World Bank loan and restructuring programs in Latin America and Africa does not generate confidence in the ability of these institutions to accomplish what they promise. Even Jeffrey Sachs has admitted that the critics have a point when they argue that "there are almost no success stories of countries that have pursued IMF austerity measures and World bank structural adjustments to re-establish creditworthiness and restore economic growth." Western aid would not have done the trick.

What was needed was imagination combined with a commitment to radical free-market reform. This was not supplied, and unfortunately recent events do not increase the likelihood that such a program is in the offing in the near term. Yeltsin's loss at the recent Congress was severe. Gaidar at least understood the importance of market reform in theory; the Civic Union and Viktor Chernomydrin do not appear to understand at even that level, let alone in the realm of policy design and implementation. State credits will continue to flow to inefficient enterprises and hyperinflation will threaten to rule the already destroyed Russian economy.

Like Gorbachev before him, Yeltsin finds himself at the helm of an economy descending further and further into an abyss of despair and deprivation.

Prosperity, on the other hand, will come from creating opportunities for investment of private capital, both foreign and domestic. That requires more than the rhetoric of radical market reform. The change required demands that the government establish rules that successfully "tie its own hands" to eliminate the arbitrariness of government activism in the economic system.

Such arbitrary intervention not only distorts the market's allocational function, but also destabilizes the investment environment and discourages the in-flow of vital capital. Establishing such a credible commitment to liberalization, however, is the major political economy problem of our time. It also happens to be the one serious problem that Western institutions like the IMF or World Bank remain silent about. Without such a credible commitment, though, Russia's economy will remain moribund and its people will continue to suffer needlessly.

Mr. Boettke is the author of *Why Perestroika Failed* and *The Political Economy of Soviet Socialism* and is a national fellow at the Hoover Institution at Stanford University and an assistant professor of economics at New York University.