How 'shock therapy' has ruined Russia

by William Engdahl

It is now more than one year since the austerity program known as "shock therapy" has been in place in Russia. The program has been an unmitigated disaster, as the following review documents.

On Jan. 2, 1992, the new economic team of Russian President Boris Yeltsin announced dramatic measures of price decontrol and other steps apparently intended to stop the collapse of the Russian economy. The program, designed by 36-year-old Harvard University economist Jeffrey Sachs, in concert with the International Monetary Fund (IMF), was labeled "shock therapy." Like its counterpart for treatment of severe psychosis, this economic shock therapy is utterly incompetent in the task of obtaining a healthy economic organism.

On Jan. 2, 1992, the Russian government began to implement the bold program of economic czar Yegor Gaidar, reversing more than 60 years of state price control and beginning to unfreeze prices on 90% of consumer goods and 80% of industrial goods. On the rest, prices rose immediately by some 350%, by state fiat. By the end of that January, consumer price inflation had increased 500%.

At the same time, to attack this state-created inflation explosion, the state bank simply stopped printing money, meaning prices on goods soared while money to buy the necessary goods contracted. The Russian Central Bank in the first quarter of 1992 increased its interest rates to local (state-owned) banks from 2% in late 1991 up to more than 80% by April 1992, and removed interest restrictions on member banks altogether, which meant that ruble credits for rebuilding industry were impossible to pay.

On Jan. 29, 1992, Gaidar and Yeltsin issued Presidential Decree No. 65, which said, "Everyone has the right to trade anywhere in whatever they wish." Unbridled free-market chaos was unleashed, in the name of "economic reform." At the same time, Gaidar liberalized foreign exchange and foreign trade, allowing local producers to import and export at will, with the exception of oil and gas. Gaidar's program called for all export prices to rise to world market levels by the end of 1993.

To an increasingly desperate Russian population, the slogans of Sachs's IMF "shock therapy" promised a miracle cure. The IMF and the Group of Seven (G-7) industrialized states, led by the United States, held out the carrot of $24 billion in credits as soon as Russia agreed to sign the IMF's letter of intent.

The state budget deficit

By December 1992, the economy was in a shambles and hyperinflation was exploding, as the Congress of People's Deputies finally forced Yeltsin to dump Gaidar, though not the reform. As a result of government decisions, domestic oil prices increased between December 1991 and the begin-

Banque de France like Federal Reserve?

A bill granting autonomy to the Banque de France will be presented to the French cabinet on May 12. One of the first items on the agenda of the incoming Edouard Balladur government, this measure to give the French central bank a status similar to the U.S. Federal Reserve was already largely prepared by the previous Bérégovoy government, which fell when the Socialist Party was trounced at the polls on March 28. This makes it a bad sign of monetarist continuity.

As in many other areas, the new government is adapting to pressures from the outside instead of responding to the real challenges of the day. Its "logic" is purely financial. This measure is being taken, first, because it is totally in line with the "single market" framework of the Maastricht treaty; second, because the German Bundesbank is demanding it; and third, because the "markets" expect it.

In fact, without the Maastricht blueprint for overall financial contraction in Europe and "sacrifices" imposed on labor and industry in order to preserve the financial speculative bubble, there would be no need to change anything. But in order to eventually create a European Bank and to use it to impose a deflationary outlook, a European monetary institution must be set up. By officially giving the Banque de France more autonomy, its representatives and governor will be set up to fully play their role in that scenario.

'Price stability'

Article 105 of the European Union Treaty (Maastricht) stipulates that "the principal objective of the European system of central banks is to maintain price stability." Edmond Alphandéry, France's new economics minister, in a recent interview with the newspaper *Le Monde*, stressed that the future statutes of the Banque de France would confer monetary policy on a council independent of the politicians in power, whose objective will be "price ning of 1993 by a staggering 85-fold, or 8,467%. Fuel for tractors or truck transport became prohibitive. This was part of the IMF's "market price" demands.

The IMF also demanded, as a precondition to its "recommending" release of the promised $24 billion of G-7 funds, that Russia dramatically cut its state budget deficit. The only problem was, the IMF made no provision for ensuring that Russia had functioning economic infrastructure in place beforehand, so that the underlying reasons for the budget deficit could diminish along with the deficit. The result was predictable chaos. On paper, the Gaidar government cut the state budget deficit. Its stated goal of zero deficit by April 1992

stability." So "price stability" is the watchword, as if this were in itself an objective of economic policy, instead of merely a means to an end, which ought to be the harmonious growth of the economy as a whole.

The hoax of Maastricht is that such "stability" is *not* imposed on the financial derivatives markets (options markets, where one can intervene for sums ten times or more than those one possesses)—the markets which are the primary source of the speculative bubble and attacks on currencies and the main cause of monetary instability.

This exposes how a pseudo-technical argument cloaks the hypocrisy presiding over the so-called depoliticization of the Banque de France. Since what is being proposed is to cut ties, not with the state, but with the reigning political power, what is going to be put in its place? Absurdly, a financial power. It is said that it is not "privatization," but the conditions are being created for the preponderance of a "private" financial oligarchy.

It hardly matters whether the members of the future Council on Monetary Policy are named by the cabinet or by a high "independent" authority, or that formally it is established that the Banque de France has the duty (like the Bundesbank) of "supporting the general economic policy of he government." In giving the governor a onetime six-year term and in accepting the objective of price stability, the bank is decoupled from national policy, which aims at assuring economic growth and development, and handed over to a different logic. The "irrevocable" governor with his long term will naturally tend to adapt to the views of the governors of the Bundesbank, the U.S. Federal Reserve, and other colleagues, themselves all totally immersed in the commercial banking universe.

Of course, the Banque de France—according to Mr. Alphandéry—will be subjected to the "watchful examination of Parliament," which can require its governor to "testify." But no arbitration procedure is foreseen, in case the government and the bank disagree on fixing interest rates.

In fact, this "fixation" on the Banque de France statute is the proof of what everyone knows but few are saying in Paris: Prime Minister Balladur's government, which came to power in a wave of national revulsion against the Socialist Party, is not Gaullist—not even Gaullist-flavored. The Banque de France was nationalized in 1945 by Charles de Gaulle, and this was a victory for democracy. It made available, to elected and other national officials, the tools needed for creating a coherent economic policy. In contrast, Banque de France autonomy fits right into the logic of those oligarchist congresses, from Vienna to Versailles, Saint-Germain, Trianon, and Yalta, which Prime Minister Balladur cited during his inaugural speech.

Not comparable to Germany

The argument of alignment with the Bundesbank is worthless, for two principal reasons. First of all, France's history and tradition are different from Germany's. The Bundesbank, with its present statute, came out of a history in which 1923 and its sequels remain a traumatic memory. The "never again" revulsion against Weimar hyperinflation remains deeply anchored in the German mind, and the German model rests on a unique history, popular support, and monetary efficiency. So far, the Bundesbank has been able to favor a policy of growth; it was not created with a view to carrying out the Maastricht financial contraction policy. "The German equation" is the belief that jobs equals low inflation equals central bank independence. France has no such credo and to impose it artificially would be absurd.

Secondly, this "German tradition" developed through the pressures of an occupying authority. In fact, the Bundesbank is independent because the Allied authorities stationed in Germany found it prudent to disperse power in that country as much as possible.

Moreover, "independence" is not even necessary to obtain good results in the domain of inflation and exchange rates: The Japanese example proves this, and no one would dream of demanding the independence of the Bank of Japan.

This is a signal from he French government to the international banking fraternity that France will adapt and play the game by their rules. Whenever, historically, France has made that kind of choice, war has always been on the horizon, determined by the acceptance of a financial malthusian logic, which creates the conditions for a showdown between nations for a shrinking "whole."

—*Jacques Cheminade*

was not reached, but it claimed an impressive state deficit of 3.5% of Gross National Product (GNP) by April, some 50 billion rubles.

Sharp cuts in government spending were the only means to cut the deficit, since company "profits" in a western sense were non-existent in the rotted economy, and taxation of personal income was not successful, so quickly were living standards falling. The result was that the state did a bookkeeping trick to try to appease the IMF. It cut state allocations to industry, but at the same time it let state-owned industries run up huge new debts to one another. The "state" deficit was thus shifted to become "enterprise" debts, despite the fact that these enterprises were totally state owned. Companies that suddenly had credit cut off by the Central Bank under the Gaidar shock therapy program, simply refused to pay other enterprises for purchases. Debt of state firms to one another and to the Central Bank went from a level of R 40 billion in December 1991 to R 3,200 billion by the end of June 1992, an 8,000% increase in six months!

Had this shift not taken place, given the impossible IMF conditions, more than one-third of all producing enterprises in Russia, maybe half, would have been forced to shut down, creating massive social explosions, as the IMF state deficit restraints allowed no social security spending for mass unemployment. Not surprisingly, local company managers and others opted to at least keep the enterprises operating, however inefficiently.

To alleviate this unstable social situation, the Central Bank decided to extend "soft credits" to help settle inter-company debts, reducing them to a nominal R 1.2 trillion by September, but confidence again broke down and debts mounted, along with inflation, to previous levels by year end.

Because the Gaidar government's shock recipe called for severe contraction of money supply, while a 655% consumer price inflation existed by March 1992, ruble cash for payment of employee wages was not available, and the wage arrears for workers began to balloon also. The arrears in wages exceeded R 21 billion, or 8% of the population's monthly income by that April, and rose to R 65 billion by July 1, almost one-fifth of nominal (depressed) monthly wages in the entire economy. Faced with credit cutoff by the central government and breakdown of supply deliveries, the state-owned companies raised their own prices and cut production. Industrial production in 1992 dropped an official 20%.

'No precedent'

Sachs and the IMF had no idea what to do. Prof. Klaus Laski of the Vienna Institute for International Comparative Economics correctly pointed out the absurdity of the IMF and the G-7 arrogance in imposing rigid monetary shock on Russia: "There exists no precedent for the transition from a command economy to a market economy. The IMF and World Bank give the impression of having the right answers. But the outlook of these institutions is thoroughly monetarist. The prime focus of the IMF is to correct temporary imbalances in a country's national balance of payments," not to manage the most complex economic national restructuring ever undertaken.

Former Acting Russian Prime Minister Yegor Gaidar on a visit to the White House in April 1992. What does he have to smile about?

Because of the explosive social situation facing the Gaidar government by May 1992, it decided to relax enforcement of new value-added taxes and income taxes. The state deficit exploded from R 50 billion in the first quarter, to R 301 billion by the end of June 1992. If the official state budget deficit is combined with "extra-budget" credits to the Finance Ministry, and the advance draw on expected January 1993 tax revenues, the total state deficit for 1992—the first full year of the IMF "shock therapy"—was 17% of the GNP, or a staggering R 2.6 trillion, rather than the target of 3.5% demanded by Sachs and the IMF.

The real economy and living standards plunged. Real wages fell by an estimated 50%, according to data compiled by the Geneva-based Economic Commission for Europe, one of the few international agencies producing useful analysis of the Russian economy. The ECE estimates a staggering level of poverty in Russia, to include "over 40% of the population" by the end of 1992.

The ruble-dollar exchange rate collapsed as well in the last quarter of 1992. The government's much-publicized issuing of "vouchers," or small share ownership certificates in state companies, was a thinly veiled political attempt by the Yeltsin-Gaidar government to calm popular discontent by giving people an illusion of ownership, and paper which could be traded as a money substitute. But with no decision on final ownership rights over property, the shares are ultimately worthless.

But the nations of the G-7 persist in adhering to the dangerous and foolish IMF demands on Russia, as evinced in the most recent "pledge" of $43 billion from the Tokyo G-7 meeting in April, conditional on Russia's strict adherence to IMF conditionalities.