How IMF shock therapy created the current Russian crisis

by William Engdahl

The recent dramatic crisis in Russia is a lawful consequence of the imposition by the Group of Seven (G-7) powers of International Monetary Fund "shock therapy" economic policies on Russia for the past two years. The resulting social chaos and collapse of living standards, and the imminent outbreak of Weimar-style hyperinflation, have created the preconditions where Russia today is being turned into a dictatorial imperial state once more. Here in outline is what IMF policies have produced in Russia.

On Jan. 2, 1992, the new economic team of Russian President Boris Yeltsin announced drastic measures of price decontrol and other steps allegedly intended to revitalize the collapsing Russian economy. The program was designed by 36-year-old Harvard economist Jeffrey Sachs. Sachs was brought into Russia by speculator George Soros, to impose his "shock therapy" as he had done in Bolivia, Yugoslavia, and Poland.

As part of the package, the government reversed more than 60 years of state price controls and began to unfreeze prices on 90% of consumer goods and 80% of industrial goods, allowing "markets" to decide the new price levels. For the rest, by state fiat, prices rose immediately by some 350%. By the end of that January, overall consumer price inflation had increased 500% as a result of the first stage of shock therapy. But simultaneous with the mandated freeing of prices, the income levels of the broad population were effectively frozen, resulting in a collapse of living standards unlike anything since 1917.

At the same time, under orders from the IMF and Sachs to attack this state-created explosion of inflation (output of goods in industry did not increase 500% at the same time), the Russian central bank simply stopped printing money. This meant that prices zoomed, while money in circulation to buy necessities, contracted. The 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, meaning that new ruble credits for investing in rebuilding industry were impossible to pay.

Next, on Jan. 29, 1992, Yeltsin and Deputy Prime Minister Yegor Gaidar issued Presidential Decree No. 65 which said, "Everyone has the right to trade anywhere in whatever they wish." In short, unbridled free market chaos was also unleashed, in the name of "economic reform." At the same time, Gaidar introduced liberalization of 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, oil and gas as well, to rise to "world market" price levels by the end of 1993.

To an understandably desperate Russian population, the slogans of Sachs's IMF shock therapy promised a miracle cure. The IMF and the G-7 states, led by Washington, immediately held out the carrot of $24 billion in western credits as soon as Russia agreed to formalize its shock reform by signing the dreaded IMF letter of intent. In April 1993, the size of the western aid "carrot" was increased to $43 billion, even though no money in any significant amount had yet reached Russia from the promises made in 1992.

IMF out of control

What has transpired since the Yeltsin government foolishly agreed to go with the IMF shock therapy is predictably tragic. The Russian program of "shock therapy reforms" was the boldest attempt in history to restructure an entire national economy at a single blow. It has been an utter disaster. By December 1992 the economy was in a shambles and hyperinflation was threatening, and 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 first weeks of 1993 by a staggering 85 times, or 8,467%. Fuel for tractors or truck transport became prohibitive. This was all part of IMF "world market price" demands.

The IMF also demanded as a precondition to its recommending release of the promised G-7 funds, that first the Russian state cut its budget deficit. But the IMF made no provision for ensuring that Russia had a modern functioning economic infrastructure in place beforehand, so that the underlying causes of 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 a balanced budget by April 1992 was not reached, but it claimed an impressive state deficit of 3.5% of Gross National Product (GNP) by April, some 50 billion rubles.

But sharp cuts in government spending were the only means to cut the deficit, since company "profits" in a western sense were nonexistent in the inefficient economy, and taxation of income was not successful with falling living standards. The result was that the state performed 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 (or credits) to each other.

The "state" deficit was merely shifted to become "enterprise" debts, despite the fact that these enterprises were totally state owned. Companies which suddenly had credit cut off by the central bank under the Gaidar shock therapy, simply refused to pay other enterprises the amounts owed for purchases. Inter-company debt of state firms to one another and to the central bank jumped from R 40 billion in December 1991 to R 3,200 billion by July 1992, an 8,000% increase in some six months! Major state enterprises at that point were forced to rely on central bank printing of rubles to bail them out of the unpayable debts, creating a general monetary inflation and collapse in value of the ruble for ordinary purchases, further enhancing the frantic efforts to get hard dollars at any cost.

In this situation, the possibilities for criminal, "mafia" groups to loot the resources of the country and sell them at below world market prices to unscrupulous western speculators such as Marc Rich, became irresistible. Russian aluminum has been dumped onto western markets in the past months, collapsing prices here by 30% or more. Similarly with oil exports and other raw materials such as timber, aggravating an already severe postwar unemployment crisis in western Europe.

Had this shift to ballooning of inter-company debts not taken place, given the impossible IMF conditions, more than one-third of all producing enterprises in all of Russia, maybe half, would have been forced immediately to shut down and fire all their employees, creating a widespread social explosion, because the IMF state deficit constraints allowed no increase of social security spending for mass unemployment. Not surprisingly, local company managers and others opted to at least keep production going, however inefficiently, in order to maintain employment levels.

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 1992. But confidence again broke down and inter-company debts mounted again, along with inflation, to previous levels by December 1992.

Harvard snakeoil salesman Jeffrey Sachs. He promised Russia that shock therapy would bring a miracle cure, and instead it has brought utter ruin.

Because the Gaidar government's monetary 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 a credit cutoff by the central government and a breakdown of supply deliveries, the state-owned companies raised their prices and cut production to meet the crisis. Industrial production in 1992 dropped 20%, by official data. For 1993, industrial production is expected to drop another 15%, for a combined contraction of 35% in two years of shock therapy. On top of this there has been a negative investment in industrial capital goods. In 1992, according to data from the Geneva-based Economic Commission for Europe, gross fixed investment decreased 45% over the year before. In 1993, it will fall another estimated 50%. This is indeed a "shock" treatment.

The Harvard computer model of Sachs and the IMF had no response to this situation, except to demand more shocks. Prof. Klaus Laski of the Vienna Institute for International Comparative Economics correctly points out the absurdity of the IMF and the G-7 insisting on rigid monetary shock in 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.

Deficit out of control

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 then also began to explode, going from R 50 billion in the first quarter, and reaching R 301 billion by July 1992. By December 1992, combining the state budget deficit with "extra-budget" credits to Gaidar's Finance Ministry, and the advance draw on expected January 1993 tax revenues, the actual total state deficit for 1992, the first full year of the IMF shock therapy, rather than the target of 3.5% as demanded by Sachs and the IMF, was instead 17% of GNP, or a staggering R 2.6 trillion. By the end of 1993, it is estimated that the state deficit will reach a total of R 16 trillion, more than 100% of the entire GDP of Russia!

Price levels have already risen by Weimar-style dimensions. In February 1992, at the start of the IMF shock therapy program, consumer price inflation was on the level of 40-50% annually. Total price inflation in 1992 was an estimated 920% under shock therapy. By August 1993, consumer price inflation exceeded 1,250% annually.

In this situation, the real economy and living standards plunged. But, of course, this is not the International Monetary Fund's concern. Real wages after inflation fell by an estimated 50% according to data compiled by the Economic Commission for Europe. The ECE estimates a level of poverty in Russia, defined as income below "living minimum," to have included "over 40% of the population" by the end of 1992. Today it is far higher.

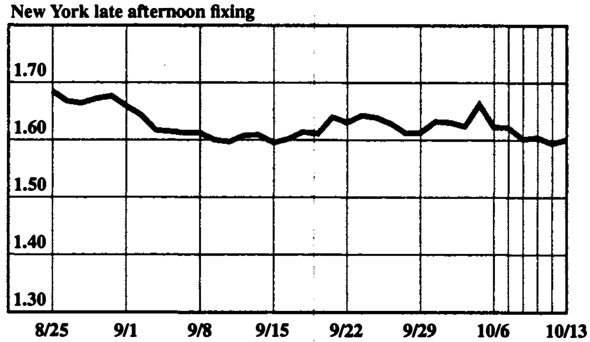
The ruble-dollar exchange rate also collapsed in the last quarter of 1992. The government's much-publicized issuing of "vouchers," or small-share ownership certificates, in state companies to the population by the end of 1992 was a thinly veiled political attempt by the Yeltsin-Gaidar government to calm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

Shock therapy has failed in all respects in Russia to improve the domestic economic condition. But the nations of the G-7 persist in adhering to the dangerous and foolish IMF demands on Russia, because this is what certain powerful voices in the Anglo-Saxon establishment desire.

Currency Rates

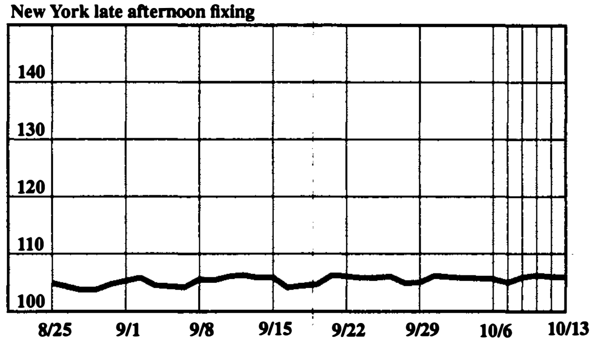
The dollar in deutschemarks

New York late afternoon fixing



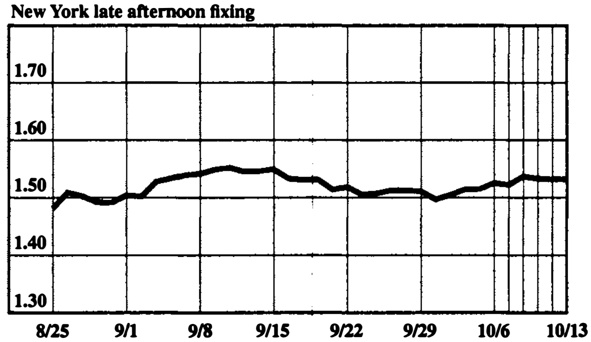
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing