

Replacing Potemkin Capitalism Russia's Need for a Free-Market Financial System

by Kurt Schuler and George A. Selgin

Executive Summary

On August 17, 1998, Russia devalued the ruble and stopped payment on its government debt, creating a financial crisis that continues today. Some observers have blamed the financial crisis, and the poor performance of the Russian economy generally, on government policies that they claim are rigidly *laissez faire*. However, a closer look at the Russian financial system reveals that it remains fundamentally socialist, though it has superficial capitalist features.

Attempts to preserve the value of the ruble and to prop up Russia's ailing banking system are misguided. The ruble is a currency of socialism; the government uses it as a tool for making forced transfers of wealth from the Russian people to inefficient enterprises that are holdovers from the socialist era. Russian banks likewise have been

mainly vehicles for subsidizing enterprises.

Russia needs a genuinely capitalist monetary system. The system should have two pillars: the U.S. dollar, Russia's *de facto* free-enterprise money, and sound banks. Foreign banks should be allowed to compete on equal terms with Russian banks. The central bank should be eliminated, and with it the privileged access of some Russian banks to the resources of the Russian government. Similar reforms have been implemented at least in part in other former socialist countries with good results. In addition to fostering economic growth, the reforms have been politically popular. The U.S. government and international institutions should learn from the experience of those countries and stop supporting Russia's current monetary institutions.

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Introduction

On August 17, 1998, Russia entered a financial crisis that continues today. The Central Bank of Russia, yielding to speculative pressure that had been building for months, allowed the ruble to depreciate against the U.S. dollar. The ruble quickly plummeted from about 6.3 per dollar to 10 per dollar. (The ruble has since depreciated further, to about 25 per dollar. Given that a new ruble worth 1,000 old rubles was introduced at the start of 1998, the ruble today is worth, in dollars, about one-thousandth of what it was at the end of 1990.) The depreciation left many of the largest Russian banks in effect bankrupt because they had large dollar liabilities backed by ruble assets that overnight became much less valuable. The government for its part defaulted on its bonds.

The financial crisis has plunged the Russian economy back into recession. According to official statistics, in 1997 the Russian economy grew slightly for the first time in this decade. The growth was less than 1 percent, but it gave hope that the Russian economy had finally turned the corner. The financial crisis has smashed that hope. The International Monetary Fund estimates that the Russian economy shrank 5.7 percent in 1998 and will shrink 8.5 percent in 1999. Inflation, which looked like it would be in the mid single digits before the crisis, ended up at 84 percent in 1998.¹

A number of Russian and foreign observers are blaming the financial crisis, and more generally the Russian economy's wretched performance in recent years, on the government's allegedly rigid laissez-faire approach to economic reforms.² Many Russians are even nostalgic for the Soviet era. A return to a more Soviet-type government, with less economic freedom, less democracy, and a belligerent foreign policy, is readily imaginable, given that so many Russians are worse off today than they were under socialism. So the debate about economic reforms is

important, not just for Russians, but for the world.

Despite the appearance of reform, in important ways Russia's financial sector is little changed from the Soviet era. Other former socialist countries that have made more thoroughgoing market-oriented reforms of their financial systems have enjoyed monetary stability and economic growth. Their experience indicates that the proper financial reforms in Russia can be politically popular as well as economically beneficial.

Russia's Financial System

To understand the causes of the financial crisis, one must understand the Soviet, socialist roots of Russia's financial system. Under socialism, the ruble was an inconvertible currency, meaning that people could not legally exchange it for foreign currency and it had practically no value outside the borders of the Soviet Union. Inside the Soviet Union, monetary exchange did not work the way it does in market economies. For consumers, money was necessary but not sufficient to buy goods through official channels. Many goods could be purchased only on the black market or bartered for through an elaborate network of favors. State-owned enterprises were not free to spend the money in their bank accounts; they needed permission from the central planning bureaucracy to spend money on anything other than wages and routine purchases of materials from suppliers. Lack of funds in the bank did not necessarily constrain enterprises, for if they could convince the planning bureaucracy that they badly needed the money, the bureaucracy would order a state-owned bank to credit the enterprises with funds.

Under socialism, the banks were not real banks. State-owned banks were merely conduits for conveying funds from the government to enterprises and taxes from enterprises to the government. The banks were the bookkeepers of socialism. Unlike banks in market economies, they did not compete for

deposits; the state had a monopoly of banking. Nor did they assess the risk of lending to various enterprises; there were no differences in risk because the state owned all enterprises. Because the Soviet Union had no financial markets, banks did not speculate in foreign exchange, bonds, or other areas in which banks in market economies commonly do. As a result, when Russia emerged from the collapse of the Soviet Union at the end of 1991, it had nobody experienced at commercial banking as it is practiced in market economies.

Even the central bank was not a typical central bank such as Western economists were familiar with. Like the state-owned banks, the central bank was an agent of the central planning bureaucracy and had no independence to conduct a monetary policy different from what the government wanted. The separation between the central bank and the state-owned commercial banks was one of administrative convenience, not of independence in management or ownership. The central bank had no experience in using most of the tools of monetary policy used by Western central banks, such as the discount rate, reserve requirements, and open market operations (influencing the supply of money indirectly by buying and selling bonds). Nor did the central bank have experience with Western-style supervisory functions such as auditing commercial banks and setting requirements for the minimum capital or reserves they should have.

Socialism worked poorly, but it was a relatively coherent system. Financially, it derived its coherence from making consumers bear the burden of its mistakes. A market economy revolves around consumers. Businesses try to please consumers, suffering losses and eventually ceasing to exist if they are unsuccessful. In contrast, the Soviet economy revolved around the government's plan. If additional resources had to be used to achieve some goal of the plan, consumers paid because the availability of goods was reduced.

As crude as the financial logic of socialism

was, it kept inflation low. Officially, there was no inflation. In reality, inflation averaged a few percent a year, but the government masked it by keeping administratively set prices constant and confiscating people's currency from time to time. Hidden inflation finally came into the open near the end of the Soviet era, when the government allowed more and more prices to be set freely.

Russia's financial system today has neither the crude coherence of a socialist financial system nor the more polished and efficient coherence of a market-based financial system. It is in a chaotic state somewhere in between, what might be called Potemkin capitalism. Superficially, the financial system looks market based, which helps explain why so many foreign observers thought Russia was getting its financial problems under control and why a former adviser to the Russian government could write a book entitled *How Russia Became a Market Economy*.³ Closer inspection reveals that the Russian financial system retains key features of the old socialist system. Whereas retaining socialist elements in other sectors of the economy, such as agriculture, hampers those sectors but can leave the rest of the economy free to grow, retaining socialist elements in the financial system hampers the whole economy. To work well, a market economy needs a sound currency, a rapid and error-free payments system, and a banking system that can gather savings and lend them to people who will use them efficiently. Without those things, prices are not reliable guides for economic calculation; payment through the banking system is uncertain; and savings are wasted, kept under mattresses in foreign currency or stored in foreign bank accounts, when they could be put to productive use locally.

Underlying Causes of the Crisis

This brings us to the underlying causes of Russia's current financial crisis. Like Thailand, South Korea, South Africa, and

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other countries that have experienced financial crises since July 1997, Russia has lacked what one might call free trade in money. It restricts freedom in currency and banking in ways that weaken its financial system. The International Monetary Fund and other local and foreign advisers to the Russian government have unwittingly helped keep the financial system weak by failing to understand the importance of free trade in money. There are six main types of restrictions on free trade in money in Russia today.

An Unsound Ruble

The ruble suffered high and variable inflation in the early 1990s and appears ready to suffer again. The exchange rate of the ruble against major foreign currencies has also been highly unpredictable, falling 20 percent or more in a single day on a number of occasions. In contrast, for major currencies, such as the dollar and the Japanese yen, a change of 2 percent in a day is large and 5 percent in a day is extraordinary. Because the ruble is an unsound currency, it has no credibility, so interest rates in the ruble have also been high; when the financial crisis began, short-term Russian government securities bore interest rates of 170 percent. As explained below, high interest rates increase the difficulty of stabilizing the currency.

Exchange Controls

To support the ruble, the Russian government imposes exchange controls. The controls are not as restrictive as those that existed in the Soviet era, but unlike the dollar, the ruble cannot legally be traded for some purposes without special permission. In particular, Russians cannot legally send capital abroad, which would improve their security by allowing them to diversify their portfolios. However, restrictions have not prevented a massive illegal flight of capital, estimated by some sources to exceed \$100 billion. (Such statistics are little more than guesses, but it is evident that the amount involved has been large.) When the financial crisis started, the Russian government imposed new restric-

tions, forbidding nonresident investors to take money out of Russia less than one year after they had put it in.

Restrictions on Foreign Currencies

The dollar is the preferred currency in Russia. Russians are estimated to hold \$40 billion or more in U.S. dollar notes (paper money) alone, which is more than the entire supply of ruble notes and ruble-denominated bank deposits. A Russian government official has estimated the value of internal trade in dollars at twice the value of trade in rubles. (Still more trade—about 70 percent of the total—is estimated to be done by barter, partly because it helps companies avoid taxes.)⁴ In addition, companies and wealthy individual Russians hold billions more dollars in foreign bank accounts. Russians use the dollar despite the government's efforts to discourage them from doing so. Officially, all payments within Russia are supposed to be in rubles. In contrast, in the United States and many other Western countries people are free to make contracts specifying payment in any currency and banks are free to take deposits and make loans in foreign currency.

Banks as Agents of the Government

During the last few years of the Soviet era, the government allowed small cooperative banks to open. After the Soviet Union dissolved, the Russian government allowed privately owned banks and fully or partly privatized state banks. (Sberbank, a savings bank that has thousands more branches than any other bank in Russia, remains majority owned by the Russian government.) Many of the larger banks are still at least partially owned by government, either the federation or local governments. Moreover, most Russian banks are not operated in the way that Western banks are. The largest banks in particular are not agents for mobilizing savings and lending savings for productive activities; rather, they are conduits through which the government redistributes public funds to favored firms. The parliament will pass, and the executive branch will endorse, a law

directing the central bank to grant subsidies to a particular industry. The central bank will then lend money at a favorable rate to banks connected to that industry; in fact, those banks are often owned by firms in the industry. A recent study has appropriately termed Russia's banks "ersatz."⁵

Foreign banks, which in countries as diverse as Argentina and Zimbabwe have provided stability in the domestic banking system, face a variety of obstacles in Russia. As of March 1999 Russia had 21 foreign banks, but they had only about 4 percent of the total capital of the banking system. Russia's depressed economy and unstable currency—which more than once has nearly wiped out the dollar value of ruble assets—have made foreign banks cautious about doing business. Even if economic conditions improve, foreign banks face restrictions that limit their potential for serving the Russian people. They are forbidden to have more than 12 percent of the capital of the banking system, which in effect limits their market share to a similar amount. They must wait at least two years after establishing operations in Russia before they can even be considered for a license enabling them to serve retail customers. Even the largest and most reputable international banks must wait if they are only recently established in Russia. Furthermore, foreign banks are not allowed to buy Russian banks. As a result, Russia has a banking system that is weak because it lacks the experienced bankers, access to large amounts of capital, and international diversification that many large foreign banks have.

Slow Payments System

Back in 1992 and 1993, Russia's central-bank-dominated interbank payments system (the system for clearing checks, wire transfers, and the like) was atrocious; payment could take weeks. Today it is better, but it is still considerably below Western standards. Some banks delay payments to earn more interest on the "float"—the

funds in their possession between the time a payment leaves the account of one customer and enters the account of another customer or another bank.

Soviet-Inspired Central Bank

Central banking in Russia does not work as it does in the West. Rather, it continues to operate in the spirit of the *Communist Manifesto*, which called for "centralization of credit in the hands of the state, by means of a national bank with state capital and an exclusive monopoly." The Central Bank of Russia, created in 1991, absorbed most of the staff of the Soviet central bank and continues to operate with a Soviet mentality. Unlike central banks in the West, which generally only influence overall conditions in credit markets, the Central Bank of Russia directs credit to particular favored firms through the banking system. Many of the firms are former state enterprises that are now nominally private. Their ability to obtain credit from the central bank has enabled them to avoid the discipline of profit and loss, so they behave in the same inefficient ways they did when the state owned them. Indeed, in important respects they face less discipline than they did under socialism, because the government and the central bank accept some responsibility for financing them yet cannot exercise the oversight that existed when the state was the ultimate owner of all property.

Russia has one of the world's oldest central banks, founded in 1860. Only from 1897 to 1914 did it perform well. The rest of its history, whether under czarism, socialism, or democracy, has been marked by devaluations, inflations, restrictions on convertibility, and currency confiscations. Although the central bank has been nominally politically independent of the government since 1995, in practice it has yielded to pressure from the government to finance budget deficits by inflation. Through indirect lending to the government and to enterprises, it accomplishes what it formerly did through direct lending to them.⁶ Moreover, the central bank is not transpar-

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ent or accountable. A recent internal audit leaked to the Russian parliament, for example, showed that the central bank moved \$37 billion over five years through a shadowy offshore money management firm and used part of the funds to invest in Russian government bonds from offshore, which was illegal at the time. The profits from the bond speculations appear to be missing.⁷

The Road to Default

Russia has modified rather than dismantled the centralized control of credit that the Bolsheviks established. The ruble is, so to speak, a currency of socialism: the government uses it as a tool to redistribute wealth from the great mass of Russians to politically powerful groups, notably unproductive firms. The banking system, which also operates in socialist fashion, increases the waste of resources. Real banks would cut off lending to unproductive firms, but many Russian banks serve as conduits for subsidies to such firms rather than as market-oriented allocators of credit.

So, even before the August financial crisis, the financial system was poorly run, weak, and not well integrated with world markets and the liquidity they can provide. Two other factors affected the system at vulnerable spots to precipitate the current financial crisis. The first factor was the shaky finances of the Russian government. In the early 1990s the government had budget deficits in double digits as a percentage of Russian gross national product. It financed them by printing money, causing inflation that peaked at 2600 percent a year in 1992. Starting in 1994 the government made great progress in reducing inflation through a combination of measures: reducing spending; delaying payment of wages to government employees and pensions to old people, thus creating arrears; borrowing from private investors at home and abroad; and borrowing from official sources, notably the International Monetary Fund. The government gambled that a combination

of borrowed money and delayed payment of arrears would work long enough to allow the economy to recover, start generating more taxes, and repay the government's debt.

Some observers, including the present authors, were skeptical that Russia could have a sound currency and a good banking system with its current institutions.⁸ However, as recently as a year ago the gamble was looking successful. Then came the second factor precipitating the financial crisis: the spillover from the Asian currency crisis. That other developing countries with better government finances and better run central banks were experiencing trouble made investors look more carefully at Russia's situation. The arithmetic of the government debt did not add up. The government was borrowing rubles at annual interest rates in the mid double digits. At the same time, the Central Bank of Russia was maintaining the exchange rate of the ruble within a narrow target zone against the dollar, the world market price of oil—a major export and source of tax revenue—was falling, economic growth in Russia was unimpressive, and growth elsewhere was slowing. Unless the government devalued the ruble or defaulted, its real (inflation-adjusted) debt would increase at double-digit rates while its ability to repay the debt would hardly grow at all.

From August 1997 to August 1998, the average weighted interest rate on short-term government debt in rubles rose from under 19 percent to 135 percent. The government was unable to repay its accumulated debt from current revenue, because it was running substantial budget deficits (equal to 6.8 percent of official gross domestic product in 1997 and 4.9 percent in the first half of 1998). Very high interest rates further increased the burden of refinancing the debt. On July 20, 1998, the International Monetary Fund gave the government a loan of \$11.2 billion, to be disbursed in "tranches" (slices). The Central Bank of Russia almost exhausted the first tranche of \$4.8 billion within three weeks

trying to prevent the ruble from being devalued. Since it was spending its reserves of dollars without correspondingly decreasing the supply of rubles, the demand to exchange rubles for dollars continued to deplete its dollar reserves. On August 17 the central bank gave up supporting the ruble at the then-current rate of about 6.3 per dollar. The central bank also imposed exchange controls on short-term investment by nonresidents, and the government defaulted on its debt.

The devaluation and default in effect bankrupted many of the largest Russian banks. They had a large proportion of assets in Russian government debt, and some had large unhedged dollar liabilities. They found their assets suddenly worth much less, in rubles and especially in dollars. The central bank and the government have since announced plans to help the worst affected banks but lack any way other than inflation to provide substantial help.

A Program for Reform

The August financial crisis might seem to make Russia's prospects for economic reform dimmer than ever. However, the crisis creates a fresh opportunity for change, for it reveals more clearly than ever the socialist underpinnings of Russia's financial system and that system's uselessness as a foundation for developing a true market economy. Setbacks to the ruble and to the Russian banking system chip away at the remnants of socialism. They also push efforts at reform in a more beneficial direction, namely, toward building a capitalist monetary system in which the currency is sound and markets rather than the government allocate credit.

Building a capitalist monetary system in Russia does not require starting from scratch. The necessary institutions already exist in Russia or can be imported. The main obstacles to a capitalist monetary system are political rather than technical.

Sound Money

A capitalist monetary system requires a sound currency (a monetary base) for use in hand-to-hand payments and as reserves for banks, and good banks that accept deposits and make loans in that currency. A sound currency should maintain substantial value over time, unlike the ruble, and should be widely and voluntarily accepted in payment. Russia already has a reliable base money: the U.S. dollar. Recall that Russians are estimated to hold \$40 billion or more in dollar notes alone, which is more than the value of all ruble notes and deposits combined, and they hold billions of dollars more in foreign bank accounts.

Russians favor dollars, not just as a store of value (as is the case in some Latin American countries), but for use in hand-to-hand payments. The more important the payment is, the more likely Russians are to make it in dollars rather than rubles. Ruble payments persist mainly in small transactions, such as grocery shopping, and in transactions in which the government is directly involved or when it has some ability to monitor payments. Larger transactions beyond the easy reach of the government are made in dollars. The dollar is the preferred currency of Russia's emerging capitalist economy, while the ruble is the preferred currency of its decrepit socialist economy.

Russia's currency crisis stems from the government's attempt to force Russians to use only rubles, despite the availability of the dollar as a higher quality currency. To promote a capitalist monetary system, the government should remove all barriers to using dollars or other foreign currencies in all transactions. That means repealing the "de-dollarization" measures of 1997 that, at least on paper, restricted the ability of Russians to hold dollars and use them within Russia. It also means abolishing taxes on converting rubles into foreign currency, ceasing to require that Russians convert into rubles the foreign currency they receive, and removing the new restrictions that the government has imposed since last August on foreign-currency transactions. Contracts specifying payments in dollars should be just as legal as

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contracts specifying payments in rubles; moreover, the Russian government itself should consider receiving dollars in payment, instead of or along with rubles. (For example, when the United States was off the gold standard during and after the Civil War, the U.S. government accepted only gold—an internationally acceptable currency—in payment of customs duties, while it accepted dollars for other payments.) Finally, foreign banks in Russia should be free to accept deposits and make loans in foreign currency subject to regulations no more restrictive than those that apply to rubles.⁹

Making the dollar an official currency should be a permanent measure, not a stop-gap pending reform of the ruble. The ruble as it now exists is a remnant of socialism that deserves to perish. Radical reform of the ruble to end its role as a currency of socialism is desirable; for example, the Central Bank of Russia could be replaced by a currency board, as we discuss below. But Russia's economic development does not have to wait for the government to get its act together on the ruble, since Russians already use the dollar widely. Indeed, making the dollar an official parallel currency may hasten reform of the ruble by reducing the benefits the Russian government can expect to obtain from creating inflation with rubles.

Good Banks

A sound currency is a good first step to promote economic growth in Russia, but it needs to be complemented by good banks. That is especially true, given the lack of well-developed capital markets in Russia, such as markets for corporate bonds, that could substitute for banks as devices for financing businesses. Most Russian banks have not functioned as banks at all. They have not gathered savings from depositors, screened borrowers, and directed savings to the most profitable investments. Instead, between 1992 and 1995, they provided indirect subsidies by lending funds provided to them by the Central Bank of Russia at low rates of interest, relative to inflation at the time.

Managers at some enterprises then diverted the subsidies to buy dollars as a speculative hedge, rather than pay back wages owed to workers. When inflation fell and real interest rates charged by the central bank rose after 1995, Russian commercial banks borrowed dollars from abroad, to capitalize on the high real interest rates they could earn by buying government securities. In effect, the banks gambled that the central bank would not depreciate the ruble much. The Russian public was less trustful and refrained from entrusting much of their savings to Russian banks except Sberbank, the state-owned savings bank. The August financial crisis amply confirmed the public's judgment.

Unlike most Russian banks, the handful of foreign banks operating in Russia both enjoy the confidence of consumers and lack access to subsidies from the Central Bank of Russia and the Russian government. Consequently, they have functioned as banks in a genuine capitalist monetary system do, channeling savings from depositors to borrowers capable of turning a profit. As they are in many other countries where local banks are a powerful lobby, in Russia foreign banks are severely restricted in the extent to which they can compete with local banks. Outside Moscow and St. Petersburg foreign banks have little presence. They are not allowed to establish big branch networks that could compete with Russian banks in attracting deposits from consumers and small businesses. Foreign banks have been legally prevented from attracting scarce Russian savings and converting them into productive investments, while Russian banks have failed to do so because Russians do not trust them and because dealing in subsidies has been more lucrative than ordinary banking.

Because Russian banks had been systematically wasting resources, their collapse in the August financial crisis was a blessing in disguise, except to the extent that the government is spending more money to rescue them. The collapse of the banks weakens support for Russia's protectionist banking policies, opening the way for more foreign banks.

Foreign banks can function as genuine gatherers of savings and allocators of investment. To enable them to do so, the Russian government should liberalize its licensing procedures for foreign banks, eliminate limits on foreign ownership of stock in Russian banks, allow foreign banks to establish branches anywhere in Russia, and eliminate the two-year delay it imposes on foreign banks wishing to do retail banking business. Foreign creditors of failed Russian banks should be allowed to receive up to 100 percent stock ownership in the failed banks in compensation for overdue loans.

The combined effect of those changes will enable foreign banks to enter retail banking more quickly. Although retail banking is not especially profitable in developed nations, it is potentially lucrative in Russia, since the country is underserved by good banks. A Citibank or Deutsche Bank could attract as deposits billions of dollars that Russians now stuff under their mattresses or stash in bank accounts abroad.¹⁰ It will still take time for foreign banks to establish broad networks in Russia, but it could take much longer to rebuild confidence in a protected banking system that remains overwhelmingly owned by Russians.

Deposits at foreign banks should carry no Russian government guarantee. It would be preferable if deposits at Russian banks carried no government guarantee either. The sole exception may be Sberbank, the government-owned savings bank that has the only comprehensive nationwide branch network. Preferably, Sberbank should be sold to a sound foreign bank or banks, in which case it should not be insured. But if that is not politically possible at present, a second-best policy would be to operate it like a postal savings bank, meaning that it would offer low interest rates on deposits but would invest only in very low-risk securities. (Under current conditions, that would imply that it would not invest in Russian securities.)

An Efficient Payments System

Russia lacks an efficient payments system.

Payments can be delayed for days or weeks in transit, often by banks that profit from using the float in the meantime. Delays remain despite efforts by the central bank, which operates the heart of the system and regulates the rest. This is yet another monetary problem best corrected by getting government out of the way. Private enterprise has developed and operates efficient payments systems in many Western countries. It can do likewise in Russia, if permitted. The central bank has discouraged competition with the payments system it operates.¹¹ The central bank's own clearinghouse facilities should be privatized, and it should allow other clearinghouses to be established without requiring them to obtain a special license.

All these reforms must originate with the Russian government. However, Western governments and international financial institutions can encourage reform by ceasing to provide foreign aid that props up the ruble, the Central Bank of Russia, and Russian commercial banks in their current condition. Merely attaching to loans "conditions," like those of the International Monetary Fund that have not been taken seriously, has worked badly so far and will not create the fundamental changes necessary to introduce a capitalist monetary system.¹² As the Russian economist and reform politician Grigory Yavlinsky has said, past loans to the Russian government have only served as a drug helping to maintain an unhealthy system.¹³ True reform requires changing Russia's monetary institutions rather than propping them up.

Effect of the Reforms

Intensifying dollarization of the Russian economy, as we propose, will reduce the demand for rubles. Unless the government takes counteracting steps, such as establishing a currency board (described in the next section), the real value of existing ruble notes and deposits will fall. Contrary to conventional wisdom, under existing arrangements

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The current monetary system perpetuates the socialist charade in which workers pretend to work and the government pretends to pay them.

a decline in the importance of the ruble would ultimately help Russia. The less people use the ruble, the less ability the Central Bank of Russia will have to finance government spending by printing more rubles. The government will have less ability to subsidize enterprises: even if the amount of rubles printed remains the same, the real value of the subsidies will tend to fall. Formerly subsidized enterprises will have to stop wasting resources or go out of business.

Many workers and pensioners depend on newly printed rubles to survive. Eliminating the ruble does not have to jeopardize them, however; in fact, it can help them. The underlying problem of the Russian economy is that many workers are unproductive. The current monetary system perpetuates the socialist charade in which workers pretend to work and the government pretends to pay them. Resources continue to be wasted on unproductive activity in part because government uses the monetary system to muddy the distinction between productive and unproductive activities. Intensifying dollarization would make the distinction clearer, aiding considerably the movement of resources out of unproductive activity and into productive activity. That potentially means a better standard of living for most Russians, including pensioners and unemployed or underemployed workers. The more productive the economy is, the more resources there are to provide for the old, the sick, and the jobless.

The current monetary system mixes support for workers and pensioners with subsidies for “investment” by enterprises. Less than half of all credits that the Central Bank of Russia grants to enterprises (through commercial banks) are used for paying workers. Enterprise managers use the rest to buy foreign currency as a hedge, to buy materials or machinery, or to line their own pockets—none of which helps workers and pensioners.¹⁴ Intensifying dollarization would force the Russian government to replace its inefficient, opaque welfare apparatus with a more

efficient, transparent system, financed by tax revenues, that provided money directly to needy people.

Fully dollarizing the Russian economy will eliminate the government’s ability to profit by printing money but will tend to increase the government’s ability to borrow. Before it defaulted in August, the government was paying interest rates in dollars roughly one-tenth of the rates it was paying in rubles. Dollarization will eliminate the huge devaluation risk premium that the government was paying on its ruble securities, though dollarization will not eliminate default risk.

Some people may claim that the Russian government cannot survive without resort to the printing press, since it spends more than it collects in taxes. The official 1999 budget projects a deficit of 105.5 billion rubles, which is roughly 2.5 percent of GDP and, at the current exchange rate, amounts to roughly \$4 billion. Moreover, the budget projections almost certainly overstate tax revenue and understate spending. But to claim that Russia’s problem is insufficient tax revenue, and to justify keeping the ruble as a way to supplement tax revenue, is to overlook the government’s real problem, which is that it spends too much on subsidies and entitlement programs that are legacies of Russia’s socialist past.

Another criticism of dollarization, and of related proposals for a Russian currency board, is that it will leave the Russian government unable to cushion the economy against external shocks. The experience of Russia in the 1990s—indeed, throughout this century—has been that central banking has created far more shocks than it has absorbed. That is why, despite efforts by the government, the free-market sector of Russia’s economy already uses dollars more than rubles.

Permitting foreign banks to establish branches all over Russia will draw billions of dollars now stuffed in mattresses or stashed in bank accounts abroad. It also may facilitate increased foreign investment, since foreign companies considering doing business

in Russia will have trustworthy banks in which to keep funds for payrolls, payments to suppliers, and so on. Banks will have available a substantial pool of savings to lend for productive use. Resources will cease being channeled to unprofitable enterprises through loans from the central bank and will instead find profitable employment in a variety of new industries. The transition to a more productive economy will be difficult, but, as described below, the experience of some other former socialist countries suggests that respectable economic growth can begin quickly.

The Central Bank of Russia, if it still exists, will not be a lender of last resort to the dollarized banking system because it cannot print dollars. Since the main justification given for central banks today is that commercial banks need them as lenders of last resort, it may seem that a dollarized banking system would be unstable. Experience indicates that the opposite is true. Many, if not all, foreign banks that enter the Russian market will be globally diversified firms that can draw on substantial foreign reserves to protect themselves from local shocks. In August, when Russian banks defaulted, foreign banks carried on thanks to refinancing by their large, globally diversified parent companies. A dollarized banking system with extensive foreign participation will be much less vulnerable to systemwide failure than is the current ruble-based system dominated by home-grown banks. Indeed, lack of a lender of last resort in Russia will encourage all banks to adopt conservative lending practices that reduce the likelihood of failures.

The Ruble and National Pride

Russians are unable to take full advantage of a perfectly good money, the dollar, because their government demands that they use a bad money, the ruble; Russia has a bankrupt banking system because the government restricts competition from foreign banks; and

Russia lacks an efficient payments system because the government prevents private entrepreneurs from creating one.

Why has the Russian government erected so many barriers to monetary reform? After all, the government would ultimately benefit from dollarization. If it could regain access to credit markets, it could replace the high-interest ruble debt that led to the financial crisis with comparatively low-interest dollar debt. The economic growth that dollarization would encourage would also help the government more easily meet its targets for tax collection.

There are two reasons for the government's behavior. First, the government is unwilling to resist pressure from interest groups that benefit from subsidies and from the monetary system that administers the subsidies. Eliminating the central bank would solve much of the problem by eliminating a channel for subsidies that is not transparent and not well understood by the public. Second, government officials have misplaced national pride in the ruble. They believe that Russia cannot be a world power unless it has a distinct currency, issued by a Russian central bank and used by a banking system that is owned mainly by Russians.

Although dollarization may be a sensitive issue for political reasons, the Russian government and its foreign providers of financial support have failed to recognize that the case for free trade in currencies is as strong as the case for free trade in bananas or automobiles. Nobody would insist that Russia grow its own bananas or that Guatemala produce its own automobiles. Each country is better off producing the things it makes most efficiently and trading for the things it makes less efficiently than other countries. It so happens that Russia has long been and remains an inefficient producer of monetary policy, owing to the socialist elements that still exist in its monetary system. Russia would be better off ceasing to produce monetary policy at home and instead importing it from the United States (or from Western Europe or Japan, to the extent Russians want

The experience of Russia has been that central banking has created far more shocks than it has absorbed.

Other former socialist countries have already undertaken some of the reforms we suggest and have enjoyed success.

to use the euro, yen, and other foreign currencies beside the dollar).

To acknowledge that Russia is not a good producer of monetary policy need not be shameful or imply a violation of national sovereignty or pride. Money, after all, is a resource that should be subject to the laws of competition. A country does not surrender its sovereignty by allowing its citizens to use a foreign currency, any more than it surrenders it by respecting internationally recognized human rights. In both cases, the aim is to protect citizens from arbitrary encroachments by the government. Sovereignty should not be viewed as a license for a government to do whatever it wants in monetary policy, human rights, or other areas.

Forcing Russians to use rubles instead of dollars is not something in which to take pride. It is rather like forcing them to fly Aeroflot instead of safer airlines. And, as the situation stands now, forcing Russians to use Russian banks amounts to depriving them of banks altogether—again, hardly something of which to be proud. Rather than stake its pride on the particular monetary arrangements that exist in Russia today, if the Russian government really wants something to be proud of, let it establish an open monetary system that allows Russians unfettered access to the best currencies and the best banks in the world, and the prosperity that such a system will foster.

If Russia wishes to preserve a role for the ruble for the sake of national pride, the best way to do so is to replace the Central Bank of Russia with an orthodox currency board. The currency board should back the entire ruble monetary base (notes plus deposits at the Central Bank of Russia) 100 percent or slightly more with high-quality dollar assets, such as U.S. Treasury securities. The exchange rate of the ruble against the dollar should be fixed, and all exchange controls on the ruble should be removed. A currency board will ensure that the ruble becomes a good currency and that the supply of rubles is determined entirely by market forces. The

ruble will then be, so to speak, the dollar in Russian dress. If Russia establishes a currency board, it should not on that account restrict use of the dollar. Giving the dollar full recognition as legal tender will induce the currency board to keep the ruble as good as the dollar.¹⁵

Will These Reforms Work?

The big questions about the reforms we propose are whether they will work and whether they are better than other approaches. For answers, we can draw on something more solid than mere assertions, namely, the experience of other former socialist countries.

Other former socialist countries have already undertaken some of the reforms we suggest and have enjoyed success. The experience of Estonia, Lithuania, and Bulgaria is particularly relevant. Like Russia, Estonia and Lithuania were among the 15 republics of the Soviet Union. Although Bulgaria was not a Soviet state, it was so closely linked to the Soviet Union politically, economically, and culturally that it was dubbed “the 16th Soviet republic.” Before undertaking their monetary reforms, all three countries had even higher inflation than Russia now does, depreciating currencies, shaky banking systems, and shrinking economies. Estonia established a currency board-like system on June 20, 1992, to issue a new national currency in place of the ruble; Lithuania replaced its central bank with a currency board-like system on April 1, 1994; and Bulgaria did likewise on July 1, 1997.

As Table 1 indicates, the results have been striking. Year -1 is the year before the currency board-like system was introduced in each country, year 0 is the year of introduction, and subsequent years are labeled +1, +2, and so on. Estonia, Lithuania, and Bulgaria have all maintained fixed exchange rates with the foreign currencies to which their currencies are anchored (the German mark for Estonia and Bulgaria, the dollar for Lithuania).

Table 1
Performance of Currency Board–Like Systems of Estonia, Lithuania, and Bulgaria

	Year								
	-1	0	+1	+2	+3	-4	+5	+6	+7
Inflation (%)									
Estonia	211	1069*	89.8	47.6	28.8	23.1	11.2	11.0e	8.2e
Lithuania	410	72.1	39.7	24.6	8.9	8.1e	8.0e	--	--
Bulgaria	123	1095	30.0e	10.0e	--	--	--	--	--
Real GDP growth (%)									
Estonia	-11.8	-19.3	-8.5	-2.7	2.9	3.7	11.4	5.1e	3.6e
Lithuania	-30.4	1.0	3.0	3.6	5.7	5.3e	4.0e	--	--
Bulgaria	-10.9	-5.7e	5.0e	3.7e	--	--	--	--	--
Budget balance (% of GDP)									
Estonia	0.4	1.2	-2.1	1.4	-0.4	-1.5	-0.5e	1.5e	--
Lithuania	1.8	-1.5	-1.8	-2.3	-1.9e	-1.4e	--	--	--
Bulgaria	-13.4	-3.5e	-2.0e	--	--	--	--	--	--
Interest rate(%)									
Estonia	--	--	--	5.7	4.9	3.5	6.5	10.0e	--
Lithuania	--	69.5	26.7	20.3	9.6	6.0e	--	--	--
Bulgaria	120	66.4	2.5e	--	--	--	--	--	--

Sources: International Monetary Fund, *International Financial Statistics*; Economist Intelligence Unit country reports; and press reports.

Notes: Year 0 is the year the currency board–like system was introduced: 1992 for Estonia, 1994 for Lithuania, 1997 for Bulgaria. Exchange rates: 8 Estonian kroons = 1 German mark, 4 Lithuanian litas = US\$1, and 1000 Bulgarian leva = 1 German mark. The exchange rate in terms of the anchor currency has remained stable since Year 0 in all cases.

Inflation is change in consumer price index, GDP = gross domestic product, interest rate is average interbank rate, e = estimated, * = liberalization of prices from centrally planned levels occurred in this year.

Inflation has come down and stayed down. Their economies began to grow within two years after monetary reform occurred. Because their currency board–like systems cannot finance government budget deficits, they have kept deficits low and have financed them without resort to inflation. Estonia, Lithuania, and Bulgaria have not only performed much better economically than Russia has, they have performed better than

most other former socialist countries. Neighboring countries that like Russia have practiced extensive financial protectionism, such as Belarus, Ukraine, and Romania, have suffered the same financial problems as Russia.¹⁶

The only significant financial problem Estonia, Lithuania, and Bulgaria have encountered is bank failures. However, almost all other former socialist countries

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have either experienced similar problems or, like China, have banking systems plagued by extensive bad loans but have propped up the banks at a high potential cost instead of letting them fail. Estonia and Lithuania are now attracting foreign ownership interest in local banks; in Bulgaria foreign interest in banking has been limited because the economy has only recently begun to grow again.

The reforms we have suggested for Russia are somewhat more radical and comprehensive than those undertaken in Estonia, Lithuania, and Bulgaria. In particular, dollarization may mean doing without a distinct domestic currency unit. But the overall implications of dollarization are otherwise similar to those of switching to a currency board, except for a loss of seignorage (the revenue from creating currency), which would be offset by a gain in credibility and correspondingly lower real interest rates.

Prominent people have nevertheless offered a number of criticisms of the idea that Russia should import sound money from abroad, either through dollarization or by establishing a currency board. A typical criticism is that a currency board is undesirable because the Russian government's budget and system of tax collection are disorderly. The criticism arises from a misunderstanding of the difference between a central bank and a currency board. Because central banks can and do finance government budget deficits, especially in developing countries, in a central banking system inflation is likely to be high and the exchange rate depreciating unless government spending is already under control before monetary reform begins. An orthodox currency board, however, cannot finance government spending, so it forces the government to get spending under control even if spending is out of control when the currency board is established. Needless to say, comprehensive dollarization also rules out the financing of government deficits by resort to the printing press.

Another criticism is that Russia lacks the credibility to establish a currency board. But how much credibility does the Central Bank of Russia have? A currency board is

the only institution likely to produce a sound locally issued currency in Russia today. Anyway, critics of a currency board are strangely silent when it comes to dollarization, which works much like a currency board.¹⁷ Perhaps that is because the Russian people have already unofficially dollarized the economy. Official dollarization would not require big changes in the habits of the people, big foreign loans, or high costs. It can proceed without foreign assistance even in Russia's current circumstances, for it involves little more than making legal what Russians are already doing illegally to preserve their remaining wealth from the depreciation of the ruble.

Finally, there are the questions of whether free trade in money will work and if it can find enough political support to be implemented and to endure. Here again, there has been encouraging experience in other former socialist countries, particularly Estonia, Lithuania, and Bulgaria. In all three, the governments of the day were able to pass monetary reform laws (all based on currency board-like systems) and implement them. The governments found that sound currencies enhanced their popularity, and the economic growth that followed helped them further. The popularity of sound currencies enabled governments that sponsored them to make other reforms that otherwise might not have been possible, such as closing insolvent banks rather than subsidizing their continuing losses. By and large the voting public has understood that sound currencies have costs but that it is necessary to pay the costs to enjoy the benefits of higher economic growth. In Estonia and Lithuania the currency board-like systems have been sufficiently popular that the governments succeeding those that established the systems have left the systems in place. (In Bulgaria there has not yet been a change of government, but the currency board-like system is popular.) As with anything in politics, free trade in money will be unpopular with some Russians, such as bankers who will face competition from

foreign banks, or fanatical devotees of central banking. But can policies that have worked well in other former socialist countries possibly be more unpopular than the policies that have created Russia's current financial crisis? The gravity of the crisis is precisely what makes thoroughgoing reform feasible.

Approaches that do not eliminate Russia's socialist monetary institutions are unlikely to put the monetary system on a sound basis for the long term. There have been a number of proposals about how Russia should handle the current financial crisis. Some favor a so-called controlled emission of money, by which they mean that the central bank should print money for back wages and other ruble payments the government owes. The central bank has already begun doing that, so in the coming months we will see just how well it can retain control. Other people have suggested reestablishing the target zone for the ruble exchange rate that existed until August but using a more depreciated rate against the dollar and perhaps making the target zone wider so as to allow greater day-to-day fluctuations. Still others have advocated that the exchange rate be allowed to float and that the central bank somehow establish the credibility of a free-floating ruble. There are also various ideas about recapitalizing banks with government funds or by debt-for-equity swaps, toughening regulatory supervision, and so on.¹⁸

As ingenious as some of those ideas are, they would merely tinker with a system that has clearly not worked well, rather than overhaul it. They would leave the central bank in place and allow (though not necessarily approve of) continued restrictions on the ability of foreign banks to compete with Russian commercial banks. But the central bank and Russian commercial banks alike have performed wretchedly, and there is no reason to expect them to change anytime soon. To work, reform of the financial system has to change the behavior of the people who manage the system. Advocates of approaches

not based on free trade in money have not explained how their approaches will do that. In contrast, free trade in money will change the behavior of the central bank by either eliminating it at once or reducing the demand for rubles, thereby reducing its managers' power to divert resources through inflation. It will also give Russians legal access within their country to foreign banks of recognized competence, which will force Russian banks to become better managed or to cease business.

Conclusion

Russia has not had for decades and does not now have anything close to free trade in money. It is therefore grotesque to blame *laissez faire* for the current financial crisis and for Russia's wider economic problems since the Soviet Union dissolved. Russia's problem is that it has retained many socialist practices in its financial system yet eliminated others that gave the system some orderliness. To reestablish orderliness—this time the superior orderliness of a capitalist monetary system—Russia needs to replace protectionism in money with free trade in money.

The most effective thing that foreign governments and international financial institutions can do is to stop supporting both the Central Bank of Russia and attempts to reform Russian banks from within. Russia's current financial institutions have not worked and will not work well. The sooner people understand that, the better off the Russian public and taxpayers in Western countries will all be.

Notes

1. Recent economic statistics on Russia can be found in *Russian Economic Trends*, a publication resulting from the joint efforts of the Russian government and the European Union. Monthly updates are available, after the hard copy version has been distributed, at <http://www.hhs.se/site/ret/update>. See also International Monetary Fund, *International Financial Statistics*, much of

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which is based on the statistics in *Russian Economic Trends*. The IMF's Web site, <http://www.imf.org>, contains details of IMF programs with Russia and papers by staff members about Russia and other countries.

2. The most thoughtful analysis from this perspective that we have seen is Alexandr Nekipelov, "The Nature of Russia's Economic Collapse—An Alternative Diagnosis," *Transition: The Newsletter about Reforming Economies* (World Bank), October 1998, pp. 5–12.

3. Anders Åslund, *How Russia Became a Market Economy* (Washington: Brookings Institution, 1995).

4. George Melloan, "Another Russian Crisis? Define 'Crisis' Please," *Wall Street Journal*, June 2, 1998.

5. Michael S. Bernstam and Alvin Rabushka, *Fixing Russia's Banks: A Proposal for Growth* (Stanford, Calif.: Hoover Institution Press, 1998), pp. 2, 36.

6. Information about the Central Bank of Russia can be found at <http://www.cbr.ru>.

7. David Hoffman, "Central Bank Hid Investments of Russian Funds," *Washington Post*, March 8, 1999, p. A1.

8. Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance: A Currency Board Approach to Reform* (London: Routledge, 1993), pp. xvi, 14–16. Hanke has reiterated his stand in Steve Hanke, "The Case for a Russian Currency Board System," Cato Institute Foreign Policy Briefing no. 49, October 14, 1998, available at <http://www.cato.org>.

9. Dollarization could occur along lines similar to those that Kurt Schuler has proposed for Indonesia. See "Dollarizing Indonesia," <http://www.erols.com/kurrency>. A condensed transla-

tion was published in the newspaper *Bisnis Indonesia*, July 31, 1998, p. 5.

10. See Margaret Coker, "Help from Afar," *Russia Review*, November 1998, pp. 30–31.

11. Jeanette Van Winkle, "Capital Accumulation, Financial Reform, and Investment Planning in Russia," RAND Corporation paper, 1995, p. 92.

12. See Andrei Illarionov, "Russia and the IMF," Testimony before the Banking and Financial Services Committee of the U.S. House of Representatives, September 10, 1998. Illarionov, of the Institute of Economic Analysis in Moscow, has also written other useful work, still only in draft form, analyzing the financial crisis.

13. Grigory A. Yavlinsky, "Western Aid Is No Help," *New York Times*, July 28, 1993, p. A19.

14. Van Winkle, p. 92.

15. Again, on a currency board, see Hanke, Jonung, and Schuler.

16. For statistics, see International Monetary Fund, *International Financial Statistics*. National governments and central banks in many former socialist countries also now post many statistics online.

17. For examples of criticisms of a currency board in Russia, see Andrew Balls, "Unpalatable Truths of a Currency Board," *Financial Times*, August 31, 1998, p. 2; and Graham Bowley, "Pöhl Skeptical on Currency Board," *Financial Times*, September 8, 1998, p. 2.

18. See Bernstam and Rabushka, pp. 90–98; "The Crisis: What Is the Damage? What Are the Options?" *Russian Economic Trends*, October 1998, pp. 5–7; and "Resolving the Banking Crisis," *Russian Economic Trends*, November 1998, pp. 1–8.

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