

Russian Reforms: Comparing the New Economic Policy Period (1921-1928) to Post-Soviet Russia (1992-2007)

Yury Goland

For many years I have been studying period of New Economic Policy –NEP in twenties of the last century and in parallel reforms in post-soviet Russia. Now I decide to combine these directions and compare reforms in these times. It would be useful, considering that Russia is a special country, historically it moves in circle-wise. In both periods the task was to change over from a central bureaucratic system to market economy. Usually reforms imply transformation of institutions. But for Russia economic policies pursued in that period of transformation are equally important and also political and ideological aspects of reforms. Consequently, reforms should be considered in conjunction with all sides of the process. I'll single out several directions of changes and compare each of them in different periods.

Ideological basis of reforms.

Transition to NEP happened in spring 1921 after the civil war when a wide spread discontent with the poverty in the war devastated country and the policy of military communism deepened. Its initiator chairman of Sovnarkom V. Lenin called for rehabilitation of economy not through enthusiasm alone, as they tried to do it in the period of military communism, but on the principle of personal incentive, which implied restoration of market relations. The economic development was a priority, and ideological factors, including the rejection of the private sector became less relevant. It was decided to restore organizational infrastructure of developed capitalism – banks, stock exchange, shares, which existed in one form or another in the pre-revolutionary Russia. The state ownership remained for so called "commanding heights" - big industrial plants, railroads, Gosbank.

Moreover it was stressed from the very beginning of the reforms that peculiarities of current situation in Russia would have to be taken into consideration. A few original ideas were put forward, which had not been implemented in the capitalist system. In particular, there were the idea of parallel currency and concept of having state enterprises work on market principles. Thus, the line adopted was to use a combination of state regulation and market principles. At the same time a concept of incompatibility of the market with socialism prevailed in the party ideology. Some party leaders considered NEP as a temporary trade off that can be eliminated once the state power strengthens.

Successful implementation of monetary reform in spring 1924 brought stable currency as a base for the economic recovery. However, the problem of the fixed assets renewal became more and more acute. In 1926, in spite of successful development of NEP in the early years, under the influence of various political and ideological factors, deviation from the initial concept of NEP emerged. The idea of parallel co-existence of state and private economy was replaced by the idea of their incompatibility under the motto "Who win whom". Priority of economy development was rejected in favor of different preferences for the state sector. A line towards ousting private capital from trade and industry by administrative methods was adopted, regulation of activities of state enterprises increased. This policy led to the crisis in the end of 1927.

In this period there was a choice between returning to the initial key NEP ideas with the development of market relations (as the best economists suggested) and moving further away from NEP. Stalin government preferred the latter executing the policy of emergency measures and closing down the NEP. To justify this choice they proposed an idea that NEP is outdated and can't be used as a basis for industrialization, and market elements have to be replaced by planning economy.

Market reforms of the 90s were called for not by any catastrophic deterioration of the situation, but by the gradual slowing down of economic growth and decreased efficiency of the economy and standards of living of the population. Many economical problems in 1991 were related first of all to the political factors, the fight between republican and central authorities, especially after August putsch. Also, in the autumn 1991 Russian president Eltsin officially announced coming price liberalization, and that caused quite expected reaction from the population and the enterprises. People rushed buying the products, while producers and retailers tried to keep the stock at their warehouses until they get the right to increase the prices. Store shelves became empty. Here it is worth noted that this difficulties can't be even compared to the deepest political and economical crisis before NEP.

By that time understanding emerged of the need to change over to market relation. As a model to follow, Polish reform of "shock therapy" was chosen augmented by an idea of fast privatization of enterprises. In addition, a great number of foreign advisors were involved, from the International Monetary Fund in particular, who were suggesting that a line should be adopted that would confirm to the requirements of the Washington Consensus. A line towards minimum involvement of the State in the Economy was adopted.

Given such approach, the most fitting characteristics of the Soviet period of the country's development was to regard as an unsuccessful experiment, from which nothing useful could be drawn. It is natural that there was no attempt made to use positive experience of NEP. The task was to embark on a traditionally capitalistic road of development as soon as possible. The authors of the reform wanted to achieve market economy forgetting that the ways to reach that target had to be different from country to country depending on the country's specific features. What they did not take into consideration was the peculiarities of the structure of the Russian economy, population's mentality; hidden traps on the way to reforms were undervalued. Also, implementing some reforms, for example, choosing the method of the privatization, the reformers prioritized political factors and the necessity to ensure support for the authorities, rather than setting up the conditions for the economic growth. The result was long-term high inflation together with significant decline in production.

The new stage of reforms began after the crisis of 1998, which prompted an adjustment of the economic course. The policy line was adopted to strengthen the role of the state, create state corporations and large holding companies in major industries controlled by the state. To some extent those policies remind of NEP "commanding heights".

Achieving financial stabilization.

The crucial task of macroeconomic policies after transition to NEP was combating inflation. From autumn 1921 effect of terrible shortfall in crops and over issue of money began to show. Hyperinflation lasted for half of year. But after it high inflation continued. To combat inflation the key element was to cut government spending. At the same time representatives of the industry demanded that government financing should continue claiming that, if it does not, inflation might increase as a result of short supply of merchandise to the market. They believed that under continuing issue ruble becomes stable, if parallel to the monetary supply growth, the supply of the goods grows as well.

Specialists of industry said that first of all the government should build the production, rather than stabilize the financial system. The head of Narkomfin G. Sokolnikov called such contrast meaningless. He emphasized that production process happens in the market and through the market, i.e. through the money. Stabilization of the currency was necessary for the normal development of this process, and in his opinion, issue was opium for the economy. Finance specialists proposed to stop the issue when goods turnover is squeezing and to cut the budget appropriately. They thought that temporary cut can create conditions for the healthy economy and real increase of expenses in the future.

Sometimes issue helped indeed to stop production crisis. The government tried to find a balance between the views of finance and production specialists ensuring the growth and preventing inflation acceleration. The problem was to meet the most important state needs within the limited financial resources. Important conclusion was made then: when you combat inflation, you should select not cutting all the expenses (the most simple way), but determining the priorities that still to be financed.

To resolve that contradiction, an original solution was suggested. In autumn 1922, a parallel currency was introduced – chervonets, which was ? backed up by precious metals and hard currency. The previous falling currency – sovznak – remained in use for budget purposes, including financing of heavy industry. Gosbank was giving credit in chervonets, in part to trade and industrial enterprises aligned to market demand. Introduction of chervonets provided a solid base for settlement and gave a possibility to expedite restoration of economy. Bit in length of time it was more difficult to provide necessary ratio between amount of chervonets and sovznak and system of parallel currency became to cause a negative effect. It was necessary to change over to one currency. Monetary reform was successfully completed in spring 1924 in spite of retention of budget deficit –near 10% of expenses was covered by issue. So budget deficit don't prevent stabilization of currency if economy develops promptly.

The country got one hard currency – chervonets. Economy began to develop successfully on its basis. However, the success achieved gave way to a form of conceited elation. Unrealistic plans of economic development were adopted in summer 1925, which lead to over issue of money and brought about inflation. In the autumn of 1925 the specialists of finance and industry started again their sharp discussions about the ways to combat inflation, and in many instances those discussions repeated the ones from the monetary reform period. Top managers of industry stated that the reason for inflation was the deficit of goods (due to the weak industrial development) and spoke against credit crunch. Representatives of Narcomfin proposed refusal from unrealistic plans and credit squeeze as main methods to combat inflation. In the end of 1925 this point of view won. By review of plans inflation was liquidated in 1926, but in 1927, due to some political and economic reasons a balance in the economy was upset, an acute crisis developed and phasing out of NEP began the next year.

In the post-Soviet Russia financial stabilization was considered the first priority task from the very beginning of the reforms. They began from liberalization of prices in January 1992. Reformers were hoping to keep the price rise within a 2-3 fold limit by maintaining strict monetary-credit policies. In effect those hopes were dispersed as early as January 1992 when consumer prices grew 3.5 times. Nevertheless the rate of increase of consumer prices reduced to 12% in May.

However such favorable performance was achieved by drastic reduction of working capital of enterprises. As a result, things that began to be used extensively were barter, money surrogates, default on payments. Long delays with salary payments began. It was that danger they tried to avoid in the years of monetary reform of the 20s, when, on one hand, they wanted to make sure that the money quantity is not too compressed and on the other hand – tried to use various economic and administrative measures not to allow the use of money substitutes and default on payments. Wide use of barter may even be worse than open inflation, which allows realistic assessment of the economy and working out of a remedy.

These negative phenomena brought to sharp resistance. Supreme Soviet of Russia disputed against government policy. In the middle of 1992 Supreme Soviet which controlled the Central Bank changed management of the CB and monetary policies grew softer. The CB explained this policy as in the prevailing conditions of stagflation concentration of efforts to fight inflation would only result in irrevocable destruction of the country's potential. There were grounds for those concerns as GDP fell through 1992 by 14,5%.

But not enough attention was paid to the usage of the CB credits. Part of them was used to satisfy the needs of the top managers and bureaucrats, rather than for the production purposes. As a result inflation has accelerated. The reformers explained the refusal from the tight monetary

policy by the change resistance from the conservators. Such resistance took place indeed, but it was caused by the objective factors. It takes a while for the population to get used to the new reality. The intention to stop the production slowdown was quite natural. At the same time softening of the monetary policy was obviously excessive. The pendulum of monetary policy swung from the extreme tightness to the extreme softness.

Such swings were explained by the fact that none of the parties tried to reach the economical optimum. If during the NEP period supporters of the production and finance views debated with the economic arguments and tried to reach the consensus, in the beginning of 90s government and Supreme Soviet were in the political war. The winner tried to take full advantage of the victory not taking into account the interests of the opponents. The reforming government bet on the market mechanism expecting that the market solves all the problems, including non-payments, barter and troubles with salary pay out. Concessions to the Supreme Soviet were considered to be necessary by political reasons and were supposed to be cancelled as soon as possible.

Drastic tightening of the monetary policies happened after crashing of the Supreme Soviet in October 1993. Monthly rise of prices flattened from 16% in November 1993 to 4% in August 1994. Those positive results were achieved at a high price of the continued fall in production. The Ministry of Finance wrote in its supplementary note submitting its draft budget to State Duma in April 1994: "Fall in production is an unavoidable price of improved efficiency of the national industry, strengthening of the financial system, transition from extremely high rate of inflation to moderate and then low".¹ We saw on the example of period of NEP that such fall was not unavoidable.

From March 1995 a ban was introduced to use direct credits of the Central Bank to finance deficit of the federal budget, which was an important means of reducing inflation. But, as those credits were the source of financing for some 1/3 of expenditures, to replace those short term treasury bills (GKO) were extensively used. Still, it helped to reduce inflation in 1997 to the level of 11%.

But reduction of inflation was accompanied by higher government debt and fall of production. Since the start of the reforms GDP fell 37% by 1997. All those contradictions against the background of deterioration of economic situation outside the country led to the crisis of 1998 and a new round of inflation. Retail prices rose 84%. The crisis was overcome at the expense of further reduction of government spending, but the situation drastically improved only after the rise of prices for our main exports.

However, though the situation improved, it was not possible to reduce inflation to the level of developed countries. It seems that the failure was the result of a too simplified approach to the problem of inflation. History indicates that, to combat inflation, one should not limit oneself by monetary measures. Inflationary influence of growth of money supply caused by acquisition of foreign currencies by the Central Bank can be neutralized, if funds issued for circulation are effectively used both by private business, as well as state companies, to increase merchandise turnover and cutting costs of production. This efficiency depend upon the conditions that government create for the productive activity.

Regulation of foreign trade and currency regulation

Well thought regulation of foreign trade and currency regulation policies accounted for the success of monetary reform during NEP. Its basis was the principle of state monopoly of foreign trade. The bulk imports were subject to licensing and export of goods regarded as essential for the domestic market were restricted.

Monopoly allowed protecting the domestic industry against the competition of imported goods. Having the monopoly it was easier for the state to restrict the import with the purpose to

¹ Yu.Goland, *Diskussii ob ekonomicheskoi politike v gody denezhnoi reformy 1921-1924* (Moscow, 2006) p.621

keep the currency reserves. It was favorable for keeping the stability of chervonets, especially on the final stage of monetary reform when the policy of import limitation was performed in order to provide the faith in chervonets.

Currency regulation was favorable for this aim also. Chervonets was brought into being not to allow the dollarization of economy. To speed up its introduction, legislation was adopted aimed at removing competition from foreign currencies on one hand, and assure stable rate of exchange for the chervonets – on the other by reducing demand for foreign currency. State and cooperative organizations could buy and sell foreign currencies at stock exchanges only subject to obtaining license. Free currency market existed also though in limited size. To maintain the rate of exchange, in addition to legislative measures mentioned above, a mechanism of currency intervention was used at the free market. As a result relative exchange rate of chervonets against foreign currencies was very stable, in spite of increase in commodity prices, and that applied both to the official as well as free rate which deferred no more than by 3%.

Creators of the monetary reform were striving to achieve the situation whereby chervonets would have win confidence abroad and become a world wide accepted currency. In spring 1924 chervonets began to be introduced in quotations at gold parity at some foreign stock exchanges, first in the Baltic Sea countries and later in Turkey, Persia, China and Italy.²

But reduction of currency reserves in the beginning of 1926 lead to the tightening of foreign currency legislation. Free currency market was forbidden. Authority refused to quote chervonets on foreign exchanges. A new idea was put forward to the effect that it was not correct to introduce chervonets into the international circulation system in a situation of state monopoly of foreign trade. Thus a premise of closed monetary system was proclaimed.

If in the 20s a threat was looming all the time of too much administrative interference, in the 90s – quite to the contrary – there was not enough regulation. Liberalization of the foreign trade activity and currency market was one of the main directions of market reforms. Foreign trade monopoly had gone by that time, but it was necessary to use the other ways of currency and customs control. In practice there were no custom taxes in the first half of the 1992 because of the break of the USSR and the absence of borders between new neighbors. Further the taxes were taken incompletely. Granting of privileges on export and import tax payments took the large-scale form. Cheap goods were imported in the country on the large scale; they competed with the domestic production and promoted its decrease. A system of customs-bank control based on the use of transaction passports started to operate only from 1994.

Dollarization process reached an unprecedented scale. In 1993 there were several times more dollars than rubles in market ruble terms.³ An effective tool of fighting dollarization was suggested some times since the beginning of the reforms – introduction of parallel currency as was the case in the monetary reform of the period of NEP. However reformers never considered that proposal seriously. They decided to set a currency corridor in summer 1995. Development of stock market helped maintaining the currency corridor, especially market of GKO. Commercial banks began to sell hard currency to Central Bank to convert funds in GKO.

However, the Asian crisis which broke down in autumn of 1997 changed the situation on the currency markets. Departure of non-residents and local commercial banks from GKO market began. Much of released funds went into the currency market. In 1998 situation got worse as a result of lower export earning due to the fall of the world prices for the main exported items from Russia. To get out of the crisis, the Government and Central Bank adopted a declaration on 17 August where they announced set of measures, in part freezing of payments on GKO. The currency corridor had to be abolished from the 1st of September. The dollar rate grew from 6.29 rubles as of 15 August to 15.9 rubles on 1 October. Under the influence of the crisis currency regulation was reinforced, which was a major factor in slowing down the exchange rate growth.

² Yu.Goland, Currency regulation in the NEP period, *Europe-Asia Studies*, v.46, No.8, 1994, p.1259

³ Yu.Goland, *Dostizheniya i provaly v protsesse rynochnyh reform v Rossii. V cbornike "Makroekonomicheskaya i finfnsovaya politika v krizisnyh situatsiyah: mirovoi opyt i rossiiskaya deistvitelnost"* (Moscow, 1999), p.133

The situation on currency market began to improve from 2000 with rise in prices for oil. As currency reserves were building up liberalization of currency regulation began. Gradually limitations were removed on current and capital transactions. A reverse problem of large scale inflow of hard currency emerged.

Ways to organize the production sector on a marketable basis

After transition to NEP the idea to establish trusts that would operate on commercial basis was accepted in summer of the 1921. Trusts were deprived of state provision and were put in conditions of competitive struggle. In tough conditions of hyperinflation and lack of circulating funds some trusts succeeded to get work up and running and to enhance the production. For that they had to exhibit much of inventiveness, in part adjusting long chains of commodity exchange operations.

Such success was achieved in the fields focused on market requirements, first of all – in light industry. With that, the first year of NEP showed that the transition to the market itself could not solve all the problems even in these branches. It was necessary to improve simultaneously the external conditions of the activity of enterprises, establishing the corresponding form of organization. In capacity of such form many trust executives suggested to take the model of joint stock company as this idea could give the possibility for initiative and self-activity for trusts. These suggestions were rejected but nevertheless the edict about trusts admitted in April 1923 kept some definite analogy with the joint stock company. In particular, in its first article it was noted that state trusts operated on commercial basis in order to be profitable.

In practice after this edict was admitted trusts in attempts to increase the benefits started to increase the prices overestimating the potential demand. That led to the sales crises in autumn of the year 1923. It was not a long one but it was followed by tightening of administrative control over the activity of trusts. At the end of the year 1923 the Politburo admitted the resolution in which the focus of trusts to maximize the profit was rejected. Refusal of profit as the main criterion of the activity of enterprises meant that one of the main ideas of NEP about the expedience of industry enterprise operation on the basis of state capitalism was left in doubts.

After the completion of monetary reform in May 1924 the industry was quickly restored on the basis of hard currency, but gradually the administrative control over the enterprise operations was tightened, especially when the macro economical stability was destroyed. Meticulous guardianship paralyzed the initiative and actually the enterprises could not work on market principles in the last years of NEP.

A different route was chosen from the outset of reforms of the 90s. Privatization of not only services sector and small enterprises, but major industrial enterprises was regarded as a necessary condition for success of the reforms. Officially economic substantiation of such policies was put in the forefront – the need to create environment for market economy, the assumption that private enterprises were more efficient than state owned. But to create market conditions no large scale privatization was needed. With the advent of reforms enterprises were given opportunities to show initiative thanks to abolition of the system of centralized planning and procurement and transition to market economy.

The premise that private enterprises are always more efficient than the state ones is oversimplified. As experience of different countries shows, efficiency of various major organizations depends first of all on qualifications and motivation of the management and not on the form of ownership. Forced privatization distracted the attention of plant managers from handling immediate production problems and pushed them towards the fight for ownership.

In reality, a more important aspect was the political side of privatization. Reformers recognized that it was needed to create a layer of owners who would support the authority. Predetermined buyers from commercial structures got state shares at negligible price. From a short term point of view such policies were fruitful, but they made the results of privatization

questionable from the legal point of view in the long run. It is no surprise that, when power changed hands, redistribution of ownership increased using administrative methods. In the absence of a court system which would be independent from the authorities and money, inadequate protection of ownership rights is one of major deterrent to economic growth. And that is reminiscent of the situation in which private sector found itself in the last years of NEP.

With that from the very beginning of reforms it appeared that the transition to market and privatization itself couldn't guarantee the successful development of industry. The industry production decreased from the beginning of reforms so in 1997 constituted only 46% of the 1990 level. The reformers did not set a target to find an optimal level for industry support to stop its decrease as the government did it in NEP period.

The growth of industry began only in 1999. However it did not touch all the branches. Export-focused raw-material branches showed quick growth. Hi-tech capital-intensive branches, such as civil aircraft industry and shipbuilding remained in tough situation till the last time. Private capital doesn't go to such branches with the long recoupment period. Their restoration is impossible without the state fund inputs. In such conditions the organization of state corporations and holdings under the state control has begun in some hi-tech branches for the last years. State controls oil and gas industry also. State banks enlarge their share. Such practice resembles the idea of command heights in NEP period. As in those times, the provision of conditions for the effective functioning of large corporations under state control comes on the first place. As the historical experience shows, they have incentives to effectively work when they operate in competition environment.

Process of state decision making

Reforming results to a large extent depend on whether the conditions for finding and implementing optimal state solutions have been created. The first successful period of NEP was remarkable because an aggressive search for the way out of crisis was going on as in government as in press. Leading experts took part in these discussions.

It was generally recognized that it would be possible to improve the country's economy only by rationalizing the economic policy basing on comprehensive discussion all problems. The political system was not yet ossified then. The establishment, including the top party and government officials were still able to react to signals sent from beneath, and some kind of feedback existed. Single-party system of the first years of NEP, which was non-democratic in substance, but still able to take different points of view into account, allowed to successfully performing the monetary reform and starting the economy restoration. Specialists could influence the decision making, because the key economic positions were held by the officials, who were ready to listen to expert opinions.

As Stalin was working his way forward to individual rule, he replaced qualified and independent managers of economic authorities with obedient people. Certainly, due to this process influence from the experts was weakening, and the number of erratic decisions increased.

It would seem that it was possible to avoid mistakes in the process of reforms during democratic 90-s. The experts could express any point of view at that time. But if the authority does not feel any need for alternative points of view, then the freedom of discussion will simply turn into empty talk. As a result, such a vague democracy proves to be of low efficiency. It is important that a system of checks and balances was applied. Before the dismissal of the Supreme Soviet, it was the counterbalance to the government voting against the extremities of the shock therapy. However even at that time there was no desire to achieve a compromise, and therefore the economic policy was violently fluctuating under the influence of political factors.

Later ideologically unified power was established, and it lost any desire to listen to any alternative approaches. This led to the crisis in 1998. After this crisis the government attention to different ways of solving the economic problems increased, however it is still not sufficient.

There is still no mechanism of finding a compromise between different approaches. In order to find optimal solutions at the state level it is important that democracy functioned at the top level, like so to say census democracy, which could be stable and long-term, if it relies on a developed democracy within the whole society.

Conclusions

Comparing the New Economic Policy (NEP) of the 1920s and the economic reforms undertaken by Russia in the 1990s can lead to a better understanding of economic reforms. It becomes clear, that the transition to the market is, speaking in mathematic language, necessary, but an insufficient condition for increasing the efficiency of the economy. Also needed a well thought-out economic policy of the state. From here outflows an important role of the government in the transitional period, not hoping for automatically acting regulators.

At the same time it is important to prioritize economy growth rather than political and ideological aspects. Such approach was taken in the beginning of the NEP, and it turned out to be very productive. Refusal from it in the 2nd half of 20s led to the big scale economical crisis and NEP closure. Similarly, many problems of the modern reforms are explained by the dominance of the political and ideological factors in the post-soviet Russia, in part by stress on privatization rather than increasing production.

NEP was more successful than the “shock therapy” of the 1990s in boosting economic output and achieving financial stabilization. The reasons for this relative success included NEP more flexible approach for combining economic growth with financial stability and its taking into account of local Russian conditions in spite of theoretic schemes. Such an ability has not be shown in 90’s.

The mechanism of combining state regulation and market methods has proven its efficiency on the first stage of NEP. And these ideas were fruitfully used and developed in the Chinese reforms. Their initiator, Deng Xiaoping lived for a while in the USSR in the 20s, and the Chinese reformers carefully studied the experience of NEP.

Together with this, experience shows that excessive intrusion of the state into the market processes may break the whole course of the reforms. It happened so on the conclusive stage of the NEP. The same danger we are faced with on the modern stage of development of Russia. As opposed to the 90s the pendulum of economic policy started deviating extremely into the opposite direction. State corporations receive such preferences, which actually take them out of the sphere of competitive battle. In these vibrations of the pendulum we observe an absence sense of proportion, which is in general typical for residents of Russia. To avoid such fluctuations the democratic decision-making process should be in place, at least at the top level.