The Soviet Economic Crisis: Steps to Avert Collapse

EXECUTIVE REPORT 19
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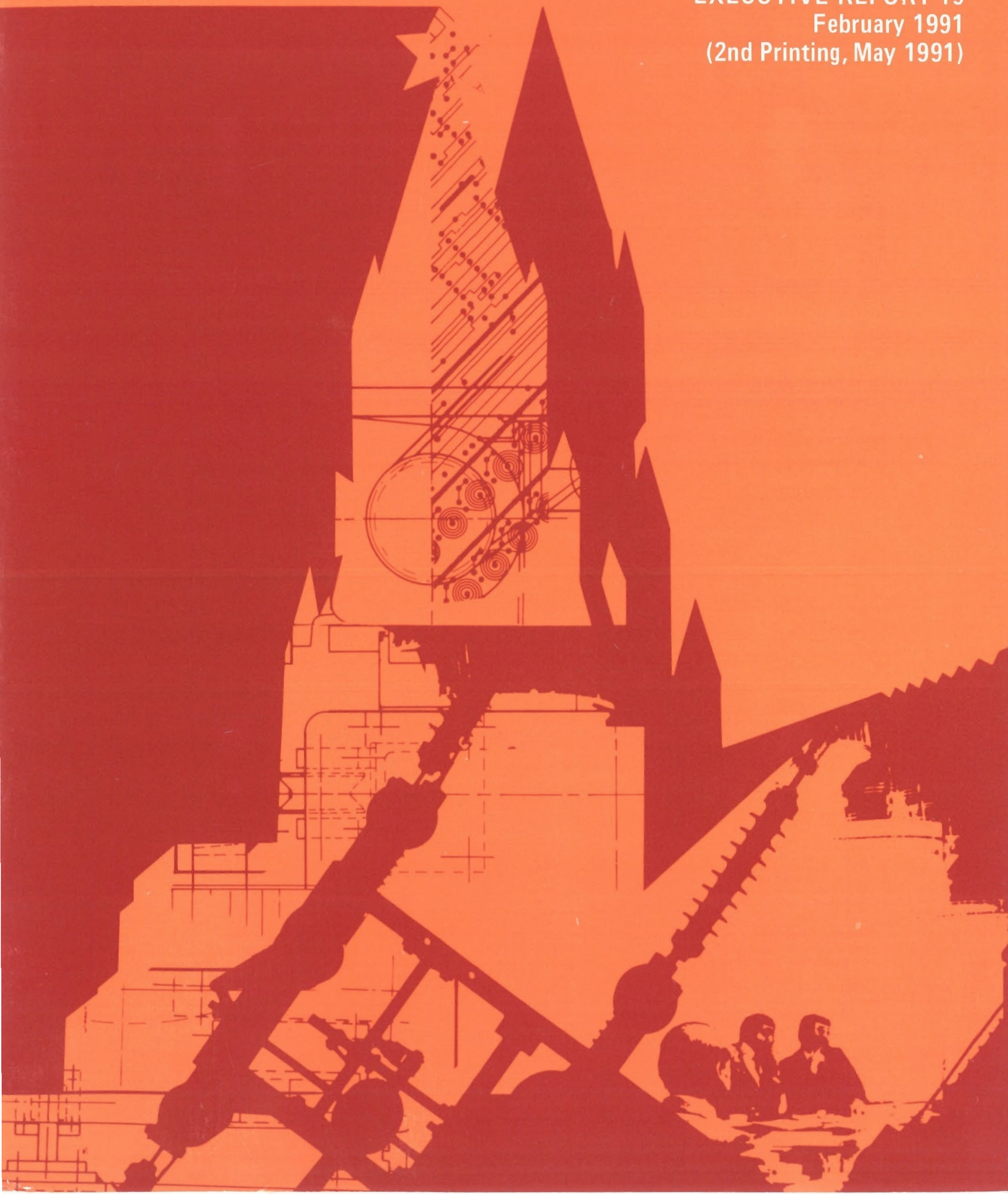

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INTERNATIONAL INSTITUTE FOR APPLIED SYSTEMS ANALYSIS
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Foreword

The memorandum reprinted on the following pages traces its origin to a request put to the International Institute for Applied Systems Analysis late in 1989 by Academician Stanislav Shatalin, then a leading member of the Soviet governmental economic reform apparatus. Recognizing IIASA's long history as an unbiased middle ground between East and West, Shatalin asked IIASA to create a venue that would facilitate Soviet reformers' consultations with leading Western economists. The result was the Project on Economic Reform and Integration, led by Yale University economist Merton J. Peck.

Working with IIASA and with Soviet advisers, Peck assembled a group of 36 eminent economists from the United States, Eastern and Western Europe, and Japan. During July and August, 1990, they met in Sopron, Hungary, for two weeks of discussions. Also participating were 13 Soviet advisers led by Eugeny Yasin, department chief of the USSR State Commission on Economic Reform.

One of the consequences of the meeting is this memorandum. It was drafted by Peck and seven other prominent members of the ERI Project during a two-day meeting in November, 1990, in New Haven, USA, in cooperation with Yasin and Petr Aven, a Soviet economist and IIASA scholar. While the memorandum was based primarily on discussions in the Sopron conference, it also took account of developments in the Soviet Union through the summer and fall of 1990. By mid-December the memorandum was in the hands of Soviet leaders.

Regardless of its subsequent impact on Soviet policy, it deserves study by anyone seeking the views of experts on the transition from central planning to a market economy. That process is now underway in many countries, and its outcome is of importance to us all. We at IIASA believe that this document represents an important contribution to the understanding of a difficult and historic transition.

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This memorandum was prepared by a 10-member study group convened under the auspices of the International Institute for Applied Systems Analysis. It was written by Merton J. Peck, study group Chairman (Yale University, USA, former member of the US Government's Council of Economic Advisers); Wil Albeda (MERIT, Netherlands, former Netherlands Minister of Labor); Barry Bosworth (Brookings Institution, USA, former Director of the US Government's Council on Wage-Price Stability); Richard Cooper (Harvard University, USA, former Undersecretary of State for Economic Affairs); Alfred Kahn (Cornell University, USA, former US Presidential Adviser on Inflation); William Nordhaus (Yale University, USA, former Member of the US Government's Council of Economic Advisers); Thomas Richardson (Yale University, USA); and Kimio Uno (Keio University, Japan); in cooperation with Eugeny Yasin (department chief of the USSR State Commission on Economic Reform) and Petr Aven (International Institute for Applied Systems Analysis).

Comments in the memorandum represent the views and opinions of its authors, and do not necessarily present the views and opinions of the institutions with which they are affiliated, the International Institute for Applied Systems Analysis or its National Member Organizations, or the organizations that provided financial support for the project.

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Contents

The Soviet Economic Crisis: Steps to Avert Collapse

The Soviet economy faces a worsening economic crisis that makes it essential to take steps immediately to complete market reforms, stabilize the budget and credit, and open the economy. This memorandum lays out the reforms that must be taken in the next few months if the Soviet economy is to arrest and reverse the economic collapse that is underway.

1. Introduction

1.1 The current situation

The symptoms of repressed inflation become more acute every day. The state shops have empty shelves, citizens and enterprises are hoarding goods and materials, trade within the Soviet Union deteriorates toward barter, and the ruble buys littie. The real gross national product has fallen sharply in 1990.

1.2 Creating a market economy

The question is, what is to be done? Reform measures have been frequent in the last five years but the result has been neither to create a market nor to improve the planning system. Any economic system needs a mechanism to coordinate and discipline its enterprise. No effective system now exists. Enterprises have been partially freed, but the incentives and competition necessary for an effective market have not been introduced. The banking system accommodates the demands of enterprises in a way that allows ballooning credit and no constraints on enterprise spending.

Prices at the procurement and wholesale level have been raised, but retail prices are still frozen. Such partial liberalization means that state subsidies have increased substantially. The increase in subsidies from freeing wholesale prices is likely to add 100 billion rubles or more to a government deficit that is already over 10 percent of the gross national product.

The solution lies in abandoning the search for halfway houses, in abandoning the dream of a regulated market economy: It is crucial to move quickly to an effective market system. The need for a market system is widely recognized in all the reform plans considered in the last year. What has not been recognized is that it takes a few bold but simple steps to make it effective. Otherwise a market system cannot deliver the benefits that the economic texts promise and the Western economies have achieved.

The Soviet Union now has a large market with a common currency and almost 300 million people within its boundaries. Thus it already has the unified market that has been so successful in America and has taken Western Europe decades to achieve. The forces of separatism, now so pervasive, threaten to destroy it. Trade barriers would be particularly costly for the Soviet Union because its plants and facilities have been built on the basis of geographic specialization and exchange across the unified market. All of the republics have a large fraction of their economic activity dedicated to inter-republic trade.

1.3 Proposals for economic reform

Economic reforms must be adopted quickly if the current economic crisis is to end. The policies must be simple and effective; they must provide at least the minimum essentials for an effective market system.

One of the characteristics of a market economy is its interdependence. What happens in one sector feeds back to other sectors. The failure to recognize this interdependence doomed earlier partial reforms.

The minimum measures are five:

(1) Liberalize prices.
(2) Corporatize enterprises.
(3) Stabilize government spending and restrict credit.
(4) Moderate the social costs of unemployment.
(5) Open the economy to competition, both internally and internationally.

The five measures must be taken simultaneously and, in view of the present crisis, as soon as possible. That is, early in 1991. The time for careful sequencing of reform plans is past. Furthermore, as discussed below, each of the five measures reinforces the others. If adopted together, the five can be successful; if adopted only singly or over time, they are doomed to failure.

2. Liberalize Prices

2.1 Definitions

To "liberalize" means freeing prices so that sellers can set whatever prices they choose. Sellers will then set prices at "market-clearing" levels – that is, prices will equate the demand of buyers with the supply of sellers. Thus freeing prices means goods in the shops, albeit at higher prices. It also means sellers will set prices that will cover their costs, so that they will no longer require state subsidies to operate.

The Soviet Union has already freed many prices. As of November 15, 1990, retail prices are free of central control on such items as television sets, higher quality furniture, and such luxury items as jewelry. On January 1, 1991, all wholesale prices are to be freed of central control, along with prices at which enterprises sell to one another.

Retail prices, however, remain controlled for more than 80 percent of total retail sales. With retail prices fixed below market-clearing levels, the government must provide subsidies for the difference between wholesale and retail prices. In 1991, such subsidies will greatly add to the already excessive government deficit. The deficit is financed with new money, so the consequence of freeing wholesale prices without freeing retail prices is that even more rubles will be chasing the goods in the shops.

2.2 The failure of administrative reform

To equate supply and demand without ever-increasing government deficits, retail prices must be increased in the near future. But that change can occur effectively only if prices are set free, rather than by administrative decree.

This is true for several reasons. First, administrative reforms typically fail to raise prices to market-clearing levels. As a result, consumers are not compensated for increased prices by goods becoming plentiful on the shelves.

Second, it is simply impossible to calculate the correct set of relative prices for several thousand commodities; economic conditions change too often in unpredictable ways for a correct administrative reform to be possible.

Third, administrative reform results in a succession of price jumps; before each jump, which will be much discussed in parliament and the media, consumers will anticipate the price increases by hoarding. The result will be periodic shortages that will further strain the public's patience. In contrast, freeing market prices will result in thousands of frequent and small price adjustments that consumers and producers will not anticipate with extensive hoarding.

2.3 The impact of price liberalization

The freeing of all retail and wholesale prices will lead to immediate price increases for most goods, threatening to trigger inflation, and possibly lowering the real income of many households.

There are a number of ways to estimate the increase in prices. One technique examines the increase in household money balances, and produces an estimate that prices are likely to rise by about 50 percent after they are freed. Some estimates suggest a rise of 150 percent, while other estimates are based on prices in free markets, which in mid-1990 were around three times the official prices. Much depends on the amount by which wages are allowed to rise in step with prices. If they increase fully as much as do prices, an explosion is possible. While there is no way of choosing definitively among these estimates, there is no doubt that liberalization will result in a price increase of serious proportions.

It is important to recognize, however, that these are estimates of the increase in official prices. By contrast, grey- or black-market prices are already at market-clearing levels, and they are likely to fall with liberalization while official retail prices increase sharply. Hence for consumers the price increase will be on only a portion of their purchases. Consumers who currently buy only in the state shops will, of course, experience the entire burden of the rise in official prices.

It is true that rationing by price means that consumers will face a reduction in their real wages. But they will also benefit from reduced time spent in lines, as the current system of rationing by queues requires. The ruble will buy less but it will buy *something.*

The serious threat to the Soviet economy is not the one-time price jump but the possibility that this jump would set off a wage-price spiral in which price increases lead to wage increases that in turn lead to further price increases. A price-wage spiral can turn into hyperinflation, as prices and wages chase one another at an accelerating rate. Only with tough macroeconomic stabilization measures can the government keep the one-time price jump following upon price liberalization from turning into hyperinflation.

The price increases will lower the incomes and reduce the real value of the savings of some households. A measure that could moderate the social costs of price changes would be to have some basic necessities guaranteed to low-income households and pensioners at prices they can afford to pay. This can be accomplished through the distribution of coupons for specific minimum quantities of selected items, or by controlling the prices of a few items such as bread, milk, and cheap meat. It is important, however, to keep the fraction of items subject to price controls few; otherwise the required subsidies will vastly increase the budget deficit and cause inflation to soar. In view of the geographic diversity of the Soviet Union, such controls might be best administered by the Republics or localities.

2.4 The benefits of liberalization

First and foremost, by freeing prices to equate supply and demand, liberalization means that people will be able to buy things with their rubles. Currently that is not so. Goods are disappearing from shelves, and Republics and localities are driven to ration basic goods like soap, meat, bread, and cigarettes. The ruble is less and less convertible *internally* by Soviet residents into Soviet goods and services. Free prices will make the ruble once again convertible into domestic goods.

One advantage of the Soviet economy is that it has a common currency used in all the fifteen Republics. But that advantage becomes a liability when the common currency is no longer acceptable because prices are severely distorted. When the ruble not freely convertible into goods internally, trade between enterprises and localities has shifted to a complex and inefficient barter system.

By bringing goods back onto the shelves of the shops, the decontrol of prices eliminates the long lines waiting to make purchases. It brings goods from the back of the shop, where they are sold illegally for high prices to a select few, to the front, available to all willing to pay the now higher prices. Under the pressure of low official prices that do not equate demand and supply, alternative distribution channels have developed. A recent study found that only 40 percent of the food is currently distributed in state stores, with the balance distributed in enterprise stores, farm markets and special stores serving veterans, invalids, and pensioners. Such a breakdown of the normal distribution channels is a clear sign of repressed inflation and unrealistic official prices.

Second, liberalization makes an important contribution to stabilization. Stabilization requires reducing the growth of money incomes. That requires first reducing the government deficit that is financed by printing more rubles. Price liberalization eliminates or reduces the need for subsidies for enterprises which now make up a large part of government expenditures.

Finally, price liberalization sets the stage for greater economic efficiency, by giving enterprises the incentive to serve the consumers, on whom they will now be totally dependent. They will no longer need to obey the Ministries who provide their subsidies, and who pay for whatever they produce, however poor the quality.

Competition among enterprises will begin to develop, leading to improved productivity. Though the process will take time, it will be a major benefit of moving to a market economy, and the only possible basis for improving the standard of living of the people of the Soviet Union.

3. Corporatize State Enterprises

To be most effective, liberalization of prices requires that enterprises be converted into independent, self-financing, and profit-maximizing organizations. The most important step, which we call *corporatization*, immediately establishes enterprises as independent and financially autonomous entities; once corporatized, enterprises must no longer be under the direction of the Ministries or dependent on the government budget for subsidies and investment funds. This step is distinct from privatization, which will require more time.

The two key elements of corporatization are independence and self-financing for all the enterprises. *Independence* means the directors of an enterprise must have the authority to set prices, output, and wages, as well as determine inputs and financing. Corporatization would ensure the legal and actual separation of the enterprise from the state.

Self-financing, or financial autonomy, means the enterprise can obtain money to pay its workers, build plants, buy equipment, and to pay its suppliers from only three sources: sales of its products, borrowing from banks at realistic rates of interest, or by the sale of its assets. The objective of self-finance is to impose hard budget constraints on all enterprises. An enterprise operating under a hard budget constraint must accept the fact that it cannot turn to the Union, the Republics, localities, or banks for subsidies or unlimited credit. The enterprise must know that unprofitability ultimately means bankruptcy for the firm and economic ruin for the managers. The possibility of bankruptcy provides a market system with the stick that makes enterprises efficient.

A market system also needs a carrot; enterprises must retain a portion of their profits for bonuses to managers and to expand and to improve their facilities. While a tax on corporate profits is consistent with a market system, the rate must be uniform across enterprises, non-negotiable with the tax authorities, and must be set at levels that still leave a significant reward for success.

3.1 Preconditions for corporatization

Corporatization requires the government to create certain additional conditions:

(1) The government must enact and enforce laws of property. There must be clear rules for ownership transfer and a system of contract enforcement to encourage longer-term agreements and the development of capital markets. Creditors must have the right to seize quickly the assets of debtors who are unwilling or unable to meet their obligations.
(2) Banks must refuse to issue credit to enterprises that have poor economic prospects. (This issue is discussed further under stabilization below.)
(3) There must be rules of bankruptcy and liquidation to govern what happens when the claims on an enterprise exceed its liquidation value.

3.2 The steps in corporatization of large state enterprises

The joint stock company is the best organizational form for making large state enterprises independent and self-financing. The existing management could serve as the initial directors.

As the initial owners of the capital stock, governments should create Property Management Agencies (PMA) of the Union, Republics, and localities. The appropriate governmental level would depend in part on the type of company and in part on a political decision as to the distribution of ownership among the present levels of government.

The PMA will hold all the stock and collect the dividends. It should have an interest in seeing that its corporations maximize profits. The PMA will have important duties, which basically are to behave as a traditional stockholder. It must select directors on the basis of their competence; it must provide as much protection as possible against abuses of managerial discretion while avoiding interference in day-to-day operations; it must resist political interference with the firm; it must not seek subsidies for its failing corporations. This asks much of governmental property agencies, but fulfilling these responsibilities is essential to a market economy, and will help produce the benefits it alone is capable of providing.

An enterprise so transformed into a joint-stock company, with its stock initially assigned to the PMA, will have the ability to decide on prices, production, and product mix; on the inputs of labor, materials, and capital, as well as the prices it will offer for these inputs; and on the level and financing of investment. It will have the right to enter freely into contracts with the government, other enterprises, and foreign entities. It will have the right to hire and fire workers. All these rights will, of course, be subject to the laws of the land, but those laws must not preclude the kinds of discretion and behavior generally provided businesses in market economies.

At the outset, enterprises would be government-owned corporations. While corporatization is an imperfect substitute for private ownership, it is a crucial and useful first step. Corporatization can be done quickly – in a month, if necessary – once the division of ownership between various levels of government has been resolved and the property to be assigned to each enterprise has been established. Privatization should be the ultimate goal, but privatization takes time. To wait for privatization would delay the reforms which are so urgent. In the short run, corporatization is a necessary compromise that will bring a measure of independence and self-financing.

3.3 The monopoly problem

Many of the state enterprise are monopolies. By freeing them from government restraint, the combination of corporatization and price decontrol will create the possibility of monopolistic behavior and monopoly profits. Yet reform should not be postponed until effective competition is established. Nor should most monopolies be subject to special price controls at the time of liberalization.

In a market system high profits attract the entry of new rivals, and thereby sow the seeds of destruction of the monopoly power that made them possible. The retention of price controls for these enterprises would interfere with that healthy competitive process, and preserve all the distortions created by the present ubiquitous administrative price controls. The best remedy, therefore, is encouragement of competition itself.

The most crucial element of such a policy is to ensure legally free entry of enterprises into whatever markets they wish to enter. Opening the economy to the competition of imports will further effectively limit monopoly power, and it will do so promptly. In addition, laws can be enacted, like the American antitrust laws, prohibiting enterprises from combining or agreeing among themselves to limit competition.

The one exception to this general principle would be the natural monopolies, such as the railroads, some communications services, or the local distribution of electricity, water, or gas. In these cases, either the technological advantages of large scale or the existence of monopoly bottlenecks give a single firm a cost advantage over all possible rivals. For such natural monopolies, and for them only, the kinds of price regulation practiced in most market economies would continue to be necessary in the Soviet Union as well.

The Soviet economy is unlikely to become consistently and pervasively competitive overnight. A successful demonopolization effort will take time. That is one of the most important reasons why we emphasize the necessity for opening the economy to international trade at the earliest possible moment. It is also one possible reason to delay ultimate privatization, since private owners may successfully resist demonopolization. Still, we think that thorough conversion of the Soviet economy into a competitive one cannot be considered an essential precondition for the reforms recommended here. They cannot be delayed.

3.4 Small business and agriculture

Corporatization applies to large state enterprises. A different approach can apply to small businesses. Retailing, services, and small-scale manufacturing are activities that can be quickly privatized by sale or leasing. This denationalization can probably best be done by local governments. Improving retailing and services by introducing competition is a step that can improve consumer welfare quickly at little cost in resources.

Entry of new enterprises is likely in these activities. All requirements to enter new markets or activities should be abolished except the minimum necessary to protect public health and safety (e.g., sanitary standards for restaurants and food stores).

Agriculture is a special case in which a mix of corporatization and small-scale individual ownership may prove most appropriate. Individual farmers should have the opportunity to own or lease land to engage in small-scale farming – mainly in fruit, vegetables, meat, and dairy production. Large-scale agricultural organizations are likely to be most efficient in grain production, and such units should be converted to joint stock companies along the lines discussed above.

4. Stabilize Government Spending and Restrict Credit

4.1 The problem today

In addition to the microeconomic issues of pricing, the Soviet Union today faces a huge and growing government budget deficit, money incomes that are rising much more rapidly than output, worsening open and repressed inflation, and a flight from the ruble.

In a free market, rising incomes and stagnant production would result in a rise in prices – inflation – sufficient to ration out the increased demand. Since most retail prices are fixed in the Soviet Union, the increased demand manifests itself in barer and barer shelves in state stores and lines that get longer and longer. The few goods left in the state stores are rusty tins and rotten cabbages. Free-market or black-market prices rise sharply, and the street price of hard currency diverges even more from the official rate.

Once shortages appear, the dynamics of hoarding take over as people begin to worry about the value of their rubles and begin to use goods as a store of value. Republics are driven to ration basic goods like soap, meat, cigarettes, and sugar. Overvalued rubles drive out undervalued goods. In other words, the ruble is less and less convertible *internally* by Soviet residents into Soviet goods and services.

4.2 Diagnosis

All of these are the familiar symptoms of *severe repressed inflation*. It is a syndrome that has been seen in many countries over the twentieth century. In understanding the issue, we separate the causes into three categories:

- *Ruble overhang*. The "ruble overhang" signifies that households have excess spending power in currency and savings accounts. This is the result of past budget deficits.
- *Budget deficit*. The current budget deficit adds continuously to the ruble overhang. The official budget deficit (expenditures less receipts) is

on the order of 10 percent of GNP. This deficit will explode in 1991 if retail prices are not raised when wholesale prices are liberalized. Because of the structure of the Soviet financial system, budget deficits are effectively monetized immediately; they are turned automatically into cash or savings accounts.

- *Hoarding*. As people come to expect price increases, there occurs an outbreak of hoarding and attempts to flee the ruble. Particularly after the announcement of future price increases in May 1990, the shelves in state stores were cleaned out of goods. The black-market exchange rate of the ruble has fallen in 1990, another indication of price disequilibrium and widespread hoarding. More recently, there has been considerable "dollarization", or use of foreign currencies inside the Soviet Union – a further indication of a deteriorating confidence in the ruble and of a repressed inflation.

4.3 Stabilization policies in the short run

As late as last summer, it might have been possible to stabilize the economy – bringing total demand in line with total supply by monetary and fiscal measures – prior to taking some of the other steps. This is no longer possible; the crisis is too severe, and stabilization now requires the support of the other measures.

The immediate threat is that the deterioration of economic activity and the disruption of the distribution system will get worse: fewer goods in state stores, more dollarization, greater divergence between official and black-market prices, and spiraling inflation. In response to the breakdown of the price system, Republics and localities will turn increasingly to rationing, coupons, substitute currencies, border controls, and restrictions on movement of goods. The major goal of stabilization policy should be to restrain the growth of money incomes. The primary tools for accomplishing this are through reducing the budget deficit, tightening credit, and liberalizing prices.

Given the existing budget policies and the "ruble overhang," it will be difficult to avoid a major increase in the average price level in the period ahead. If liberalization of prices is postponed, the flight from the ruble will intensify, inflation will accelerate, and hyperinflation will become a real possibility. the best hope for avoiding this kind of total breakdown is price liberalization and a tough curb on budget and credit policies. The sooner prices are liberalized, the smaller will be the price jump and the less will be the risk of hyperinflation.

The following steps will help stabilize the economy and prevent runaway inflation:

(1) The first priority is to reduce the budget deficit. A balanced budget would effectively control the growth of incomes. If the budget is not controlled, incomes will continue to rise, and an uncontrolled price-wage-price spiral may begin.

The priorities for reducing the budget deficit are, in every country, subject to controversy and political debate, but we have a few concrete recommendations. The most important action in the short run would be to liberalize prices and remove subsidies; without such a measure, the budget deficit will rise by at least 100 billion rubles. Liberalization today is an essential step toward stabilization.

More generally, we recommend focusing on spending reductions rather than tax increases. There is clear room for reduction of subsidies to unprofitable industries; this is in any event essential to establish market discipline. Central investments are thought to be highly inefficient and can be cut. The allocation of hard currency might be immediately reformed, say by hard-currency auctions; this would reduce the budget deficit substantially.

(2) We believe that a substantial tightening of credit is essential to subject enterprises to hard budget constraints. It is neither possible nor necessary in the short run to privatize the banking system in order to have tough credit policies. In the longer run, however, creating a private banking system will help ensure that result.

In the near term, Gosbank must make enterprises financially independent by extending credit only to firms that can repay it; this implies curbing credits to unprofitable enterprises. In addition, the banking system must place overall credit limits on the enterprise sector, much as western central banks do today. We envision that banks will charge high interest rates to enterprises under a regime of tight credit. In the period surrounding liberalization, real interest rates (equal to money interest rates less the rate of inflation) must be positive; this implies that money interest rates must be well above today's level. After inflation has stabilized, interest rates can be reduced to levels prevailing in market economies.

(3) We believe that the current structure of taxes is on the whole viable for the immediate future. However, one major point is vitally important: all "specific" turnover or other taxes (i.e., taxes denominated in ruble terms per unit) must be replaced with percentage or "ad valorem" taxes (i.e., taxes set as a percent of the product price). This step will prevent the erosion of real taxes as prices rise. We understand this proposal is under consideration and endorse it strongly. More generally, government expenditures should be budgeted in rubles rather than in real terms so as to prevent the development of an inflationary psychology and to slow any inflationary spiral.

Some economists advocate a monetary reform to solve the stabilization problem. For example, existing rubles might be exchanged for new rubles at, say 2-to-1 or 3-to-1; other suggestions are "parallel rubles" or "gold rubles". We believe these approaches should be avoided unless budget and monetary stability are *absolutely* guaranteed. If a monetary reform fails, as it surely will in the absence of strict fiscal and monetary discipline, the government will lose most of its remaining credibility. On the other hand, if monetary stability is achieved, then monetary reform is likely to be unnecessary.

A major question is whether it is desirable, by indexing, to compensate various groups for price increases. We recommend minimizing the amount of automatic indexation. There is no way to index the entire economy. Indexation cannot produce goods; it simply redistributes real resources from one group to another. The more the system is indexed, the greater is the threat of hyperinflation. Many countries have indexed their economies and have lived to regret it; indeed, in the country with the greatest price stability, the Federal Republic Germany, wage indexation is illegal.

The only exception we would recommend is for transfer payments to low-income households, like pensioners, who must be protected against the hardships of a severe inflation. Indexation of wages should be altogether avoided if at all possible.

What about the possibility of "incomes policies", designed to control wages and prices directly? We believe that tight fiscal and credit policies are the crucial ingredients for the containment of inflation. The only certain way to check inflation is the threat of unemployment and bankruptcy that prevents firms from raising prices; for this, tight budget and credit policies are essential. Incomes policies may help, but they must not be used as a substitute for fiscal and monetary discipline.

5. Moderate the Social Costs of Unemployment

Perhaps the most serious adverse consequence of the essential reforms we identify here will be sharp increase in open unemployment. The weaning of State enterprises from government subsidies and easy credit, the authority and incentives managers will and must have to reduce costs and increase efficiency, the introduction of competition both domestic and foreign and the elimination of inflation, will all inevitably mean the displacement of large numbers of workers from their current employments.

In a dynamic economy, the resources released in this way will be absorbed in the expansion of output, the springing into existence of new enterprises, the opening up of opportunities for exports, and in the increase in effective consumer demand and real income that improvements in productivity make possible. And that kind of economic progress is impossible if every worker is instead given a one hundred percent guarantee of retaining his or her job in its present location.

Unemployment compensation is the only possible way of reconciling this requirement of reversing the present disintegration and stagnation of the Soviet economy with the prevention of severe hardships for workers in the transition. Such a system will provide workers who are laid off with temporary support. However, that support must be substantially below the wages of those who continue to work and should decrease with the length of unemployment, in order to preserve incentives for workers to relocate, retrain, and accept alternative employment.

Given the geographical diversity in the Soviet Union in terms of wage levels and the cost of living, it would be desirable to have the unemployment compensation system administered by the Republics and localities. Of course, these levels of government must have the tax revenues necessary to meet the costs of an unemployment compensation system.

6. Open the Economy Internationally

In a sense, the several steps we have recommended to this point are all steps to create an open, competitive market economy *within* the Soviet Union. These also require avoiding the imposition of trade barriers among the several republics.

In addition, as the Soviet Union liberalizes and stabilizes its economy, opening the economy internationally can play a critical role. We recommend moving to a convertible currency and removing import and export restrictions very quickly. Opening the economy will provide consumer goods, will speed the introduction of foreign technology, will ensure that prices reflect competitive world market prices, and will restrain monopolistic forces inside the Soviet Union.

We recommend that the ruble be made freely convertible for all imports and exports, with limitations only on "capital-account" transactions. In addition, we recommend that all quantitative restrictions be replaced by low and uniform tariffs, in the neighborhood of 10 percent.

6.1 Reasons for opening the economy

There are several reasons for opening the economy very quickly. the principal reason is that it would expose the Soviet Union to the competitive world marketplace. The Soviet economy must make the transition to new lines of production and more efficient productive techniques. History shows that the quickest way to achieve an efficient pattern of production is to allow the price signals of the market to get transmitted to domestic enterprises. By removing quantitative restrictions on imports and allowing ruble convertibility, Soviet enterprises will have a price and quality standard that they must match in order to sell at home or abroad.

Second, currency convertibility will ensure that Soviet prices will move to market-clearing levels. Foreign firms are adept at finding the combination of prices, quantity, and quality appropriate to each country; they will force the newly corporatized Soviet firms to align internal prices with the world prices of tradable goods, adjusted for quality differences. The sooner convertibility is introduced, the quicker will be this alignment.

Third, opening the economy will provide goods to Soviet workers whose incentive to produce is at present severely undetermined by shortages and the unavailability of domestic and foreign goods and services. Opening the economy will offer a wide array of new goods, albeit at high prices; ironically, however, these prices are likely to be lower than the ones prevailing in today's black markets.

Finally, as noted earlier, corporatization and price liberalization will allow some Soviet enterprises to charge high prices. Introduction of foreign competition will be the most effective and immediately available method of restraining the exercise of monopoly power for tradable goods. Easy entry by foreign firms into the Soviet market will provide some check on non-tradable sectors as well.

These are compelling reasons to place opening the economy near the top of any serious move to a market economy. We propose taking these steps as soon as possible, either simultaneously with or very quickly after most prices are liberalized.

6.2 Concrete steps

(1) The ruble should become freely convertible into other currencies for all "current" transactions. Current account convertibility means that Soviet enterprises and individuals have free access to foreign exchange for the purchase of foreign goods and services, and that foreigners have free access to sell in the Soviet market. All Soviet and foreign enterprises will be allowed to buy and sell rubles and foreign currencies for the purposes of export and import of goods and services. Foreign firms should be allowed to hold ruble accounts and to repatriate their profits. We propose an initial limitation on "capital" transactions, however. Soviet residents would not be permitted to hold foreign securities or large quantities of foreign currencies.

(2) In the long run, it would be desirable to have a fixed exchange rate for Western currencies. In the near term, this will not be feasible, because of the prospect of severe inflation. It is therefore recommended that the ruble be allowed to float, although the government will probably want to intervene to prevent excessive short-term exchange-rate fluctuations.

A freely-floating ruble will initially move to a level between the official rate and the black-market rate. Thus, depreciation upon floating is both inevitable and desirable. A lower exchange rate will balance supply and demand for foreign exchange, will ensure that enterprises can buy foreign goods when that is most efficient, and will provide a wider variety of goods and services to consumers.

We are against an overvalued exchange rate. It would be better to have the ruble priced too low than too high. An undervalued ruble ensures that doing business in the Soviet Union would become a bargain, and foreign firms and technology would be attracted to set up production there.

(3) We recommend replacement of all quantitative restrictions on imports with a uniform tariff on all imports in the neighborhood of 10 percent. Tariffs are more even-handed than quotas as a way of protecting domestic industry, and they avoid the administrative system that currently dominates and distorts Soviet foreign trade. In addition, tariffs can provide

a source of valuable government revenues. It may be desirable to subsidize importation as well as domestic production of some food products, such as bread and vegetable oils, which are exceptionally important to households. Energy exports, particularly oil and gas, may need to have a temporary export tax to cushion domestic consumers from large price increases, although permitting domestic energy prices eventually to increase to world levels – which we strongly recommend – will free resources for exports and generate an important source of export earnings.

6.3 Economic union

One of the critical issues facing Soviet policy makers is the economic relationship between the Union and the Republics. From an economic point of view, maintaining free trade among the different regions would contribute to an efficient division of labor and use of resources. In many ways, the existence of the United States as a continentally free trade zone has contributed to the success of the American economy, and the European community is moving toward a free-trade region.

The centrifugal forces leading Republics and localities to seize control and demand autonomy arise from the breakdown of the current administrative system. When administrative prices deviate so far from realistic prices, nobody wants to sell and everybody wants to keep goods at home. It is futile to try to negotiate agreements between the Union and the Republics in a world where the terms of trade – the prices – are so distorted, where trade is involuntary, and where everyone feels exploited.

There are powerful gains from maintaining a free-trade zone when the price mechanism is functioning effectively. However, only when prices are freed and reflect genuine scarcities and costs, and the ruble regains value and stability, will be economic conditions be propitious for forging a political consensus about the shape of the new Soviet Union.

7. Conclusion

To succeed, these measures must be explained to the parliament, to the media, and to the people. Successful adoption will require a firm, wholehearted, and consistent commitment by Soviet leaders and the reaching of an accord with the leaders of the Republics.

We recognize that the proposals will be painful and controversial. They impose major social costs in the short run as the Soviet society makes the transition from a centralized administrative approach to the decentralized direction of individuals through markets. Moreover, it is not possible to provide an ironclad guarantee that these measures will cure the nation's ailments. But we can say with confidence that history shows again and again that allowing markets to direct an economy offers the best hope for resuscitating a sick economy and for raising living standards toward those in Western Europe and the United States.

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