

Preventing chaos in troubled Russia

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Visualize a country where: No one can use credit or debit cards, checks, or has access to his bank account; the government is trying to spend more than twice what it takes in from taxation, and no one will lend it money; regional governors increasingly engage in their own foreign and economic policies; Military personnel, out of desperation or greed, sell their weapons to the highest bidder; 20 percent of the population definitely say they would like to emigrate, and another 20 percent are considering it. There is such a country, and its name is Russia.

The current financial and political crisis in Russia is both different and potentially more serious than the other Russian "crises" of the last decade. It requires us to take action, not only out of humanitarian concern, but out of self-interest.

The payments crisis is a result of the inability of the Russian government to service its debt, which caused a collapse of the big banks who were major holders of this debt. Both Russian businesses and individuals are for the most part unable to clear transactions with each other (including electronic transfers, credit and debit card transactions, ATM transactions, and check clearing). Thus, otherwise solvent businesses are neither able to pay their bills nor receive payments. This in turn has led to an escalating spiral of layoffs and business shutdowns. Many workers in the financial industry have already lost jobs, and a large share of workers in the non-financial industries can now expect the same result in the coming weeks if nothing is done. The tragedy of the payments crisis is that parts of the real economy are being unnecessarily destroyed, and the group most severely impacted is the new Russian middle class.

The budget crisis results from the government allowing spending to get well ahead of its ability to obtain tax revenue and to borrow at reasonable rates of interest. In the first six months of 1998, Russian federal budget spending was about 14.7 percent of GDP. Tax revenues accounted for little more than 8 percent of GDP.

The difference was made up primarily from borrowing both domestically and abroad, and a small remainder came from user fees and state property sales. Debt service had grown from 12.1 percent of the budget in 1997 to 35.6 percent of the budget in the first six months of 1998.

With the beginning of the financial crisis in August, tax revenues fell drastically, to a third of their targeted level in September. It now appears that September tax revenues were no greater than 5 percent of GDP (and perhaps considerably less). The spending gap is now so wide that, even if the government fails to service any of its debt, tax revenues will cover less than half of government spending.

The present Russian tax system is unenforceable and needs to be totally revamped. If the government is to have any chance of getting tax revenues up to 10 percent of GDP, the tax system must be greatly simplified, with few collection points and severely reduced rates. (By way of contrast, the U.S. federal government collects and spends approximately 21 percent of the U.S. GDP.)

In the absence of massive Western help to close the budget gap, the government will have no choice but to increase the emission of rubles, ultimately leading to higher and higher rates of inflation. The increasing rate of inflation will reduce the value of the outstanding ruble debt, and other liabilities of the government. But, those dependent upon government payments, such as pensioners and the military, will see the value of their payments decline. Given that many of these recipients are already below a subsistence level, social tensions will rise.

Regional governors are taking actions that are the province of the central government in most countries (i.e., price controls, rationing, import restrictions, export taxes, as well as monetary and security policies).

The central government in Moscow is now so weak and fearful that it is increasingly unable or unwilling to effectively challenge the extralegal acts of regional authorities. This merely encourages the regional authorities to grab more

power, further weakening the center. The budget crisis makes it more difficult for the central government to make its required payments to the regional governments and the people in the regions.

This in turn has given the regional authorities more reason to withhold tax and other required payments to the central government - all of which accelerates the movement toward anarchy.

At some point in this process, effective control is also lost over the military and their nuclear, chemical, and biological weapons - and this is why the West needs to care and take action to prevent the total collapse of the remaining central government.

There are an increasing number of reports of unauthorized sales of Russian military equipment. For instance, on Oct. 7, Russia's Interfax news agency reported that "customs officials in the Russian Far East city of Khasan had intercepted an attempt to sell five MilMi-8T assault transport helicopters to North Korea. The helicopters bore identification numbers indicating they were the property of the Russian Army, and were still fitted with weapons and other military equipment." Most Russian soldiers have not been paid in months, and some are suffering from severe food shortages. Officers, having no choice, are finding ways to fend for themselves to take care of their troops, including selling weapons.

Fortunately, the Russian people have virtually all of their savings now in dollars "in the mattress." The total amount of dollar-denominated cash in private Russian savings is estimated by Russian economists to range from \$40 billion to well more than \$100 billion.

This dollar-denominated cash savings is widely distributed among the Russian people, particularly the middle class. The poorer people in the regions already exist largely outside the money economy (dollar or ruble). They grow much of their own food and have developed an elaborate barter system (which is largely untaxable and unregulatable by the state).

Unfortunately, this year there was a widespread drought in much of Southern Russia, which severely reduced the potato and cabbage harvests that many Russians depend upon to get through the winter. This past week, the Russians requested food aid from the European Union, and press reports indicate they will also make a similar request to the United States. On humanitarian grounds, some aid is clearly warranted, but it should be disbursed to those regions where the need is greatest, and with adequate controls to prevent theft.

Russia also is suffering from a flight of human capital. Many of Russia's most highly trained and productive citizens have already moved to other countries. Without hope of a better future in Russia, legal and illegal emigration will accelerate. The human flight will further destabilize Russia and increase social tensions in some of the countries receiving far more Russians than they can quickly and easily absorb. For this reason alone, the West has a vested interest in the economic stability and prosperity of Russia.

The Russian government could immediately solve much of its payments crisis by allowing its citizens and businesses to legally open bank accounts anywhere in the world and to allow non-Russian banks to operate on the soil of Russia. This could be set up as a temporary measure, until the Russian banking system is functional again.

Opponents to the measure in Russia will argue that it will increase capital flight. In truth, it is likely to do just the opposite, because most of the capital that people wanted to get out of the country has already gone.

There is no better signal that there is sufficient faith in the future of the country by the leadership than to allow the free mobility of capital. If you now tell people they can legally take their capital out of the country, it will help to restore the faith of the people in the financial system.

The remaining mobile capital is primarily U.S. dollars in mattresses. Dollar bills hidden at home are not productive capital, and do Russia no good "in the mattress." The people should be given a chance to put their money to work with safety.

Any future aid by the International Monetary Fund or the United States or any other Western government should be conditioned on the immediate removal of restrictions on the use of foreign currencies for transactions and the use of foreign banks. (Prices of many goods are already expressed in "units," with a unit being equal to one U.S. dollar, so the ruble-only restriction is both unenforceable and serves no useful purpose.) Given that the government is going to reliquify the banking system to some extent, it should concentrate on those midsized banks that were beginning to

operate as real banks. They could be the future of a new domestic payments system, as well as the foundation of a real banking system.

In order to prevent a total breakdown of the Russian central government, the United States and others should provide financial aid, but this aid should be highly restrictive and conditional both in amount and form (no more large, untargeted IMF-style loans to the central government, which at times merely fueled corruption and fiscal irresponsibility). Any loans to the government to support general government spending should be made conditional on the establishment of free banking (as described above); a new fully backed currency based upon gold and other real assets, including foreign exchange reserves, administered by a truly independent central bank; and a new simple, low-rate, enforceable tax system.

In addition, the U.S. should insist that loans be fully collateralized by real Russian assets, such as oil and gas reserves, proven gold deposits, etc. Additional monetary aid could be given to help stabilize the Russian military by increasing Western purchases of obsolete weapons (nuclear, chemical, and biological) so they would be less likely to be sold to undesirable potential customers - such as Saddam Hussein, Moammar Gadhafi, etc. - or be involved in a major accident. Officials of the Russian government and the Duma have signaled that such an arrangement could be negotiated. Obviously, our support would need to be firmly tied to restrictions on Russian exports of weapons to rogue states.

Finally, it would be in the interest of the West to increase funds for the clean-up of the most hazardous environmental sites in Russia. This would employ many Russian workers and professionals, giving them real income for making not only Russia, but the planet, safer.

Russian officials and their Western supporters (including the IMF) have made many mistakes in the economic and political transition. There is still too much corruption and too little rule of law. But there has been considerable progress toward a free market democratic Russia. Abandoning the patient halfway through the treatment -because the patient didn't take all of the medicine - is not in our own self-interest. The United States spent something on the order of \$3 trillion to win the Cold War. If some Russian chemical, biological or nuclear weapons leak into the wrong hands because we were not willing to spend a few billion more, to see the transition through, then much of what was spent over the past 50 years will indeed have been wasted.

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