

Economic Reform in the Soviet Union – the Need for Comprehensive Reform

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Abstract: This paper discusses the prospects for economic reform in the Soviet Union and summarizes the recommendations that were made in a «Joint Study» by the IMF, the World Bank, the OECD, and the EBRD. The paper starts with a review of recent economic trends and a discussion of political factors which condition the economic reform effort. The economic reform program recommended by the four international agencies is outlined under the headings of macroeconomic management, systemic reform, and transitional measures. Because of the close inter-relationships between the policies and institutional reforms proposed, emphasis is placed on the need for a comprehensive reform, i.e., simultaneous or nearly simultaneous action in many areas. This is followed with a summary of the recommendations regarding external assistance. The paper concludes with comments on the prospects for the future.

The Beginnings of Perestroika

The decision to initiate *Perestroika* or economic restructuring in the mid-1980s came after a period of declining growth rates and increasing dissatisfaction with the performance of the Soviet economy. Official statistics indicate that real NMP (net material product) increased at 8% in the second half of the 1960s, but that the rate had fallen to about 3% in the first half of the 1980s. These official figures probably underestimate inflation and hence overestimate real growth. Real output per capita was probably stagnant in the first half of the 1980s. Moreover, high levels of both investment and military spending restricted the levels of private consumption. The economy was inefficient; investment rates were high but growth rates were low. It was slow to introduce new technology or respond to changes in consumer demand; the quality of consumer goods was generally poor.

Perestroika, accompanied by *glasnost*, began in 1985. In the initial years there was a substantial increase in social expenditures, but little real reform of economic structures. This changed at the start of 1988 when the new Law of State Enterprises went into effect. This was a major change from the command economy. Mandatory output targets for enterprises were replaced by «state orders» and enterprises were given substantial freedom regarding the disposition of production in excess of what was called for by the

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state orders. The new law also gave enterprise managers considerable freedom in managerial decisions, particularly regarding wages and bonuses.

By 1990 it was clear to all that economic restructuring was not progressing well. Consumers, in particular, faced growing shortages, long lines, and empty shelves. These shortages were not caused by a decline in the supply of goods, but rather by large increases in monetary demand that were not accompanied by more than a very modest increase in the available supply of goods. This increase in monetary demand resulted partly from Gosbank's financing of greatly increased budgetary deficits and partly from the wage increases that followed the introduction of the Law of State Enterprises.

In almost any other country, the result of such an expansion of monetary demand would have been inflation. But in the Soviet Union, where prices were fixed by the government, the results of the supply-demand imbalance were shortages of goods and a growing monetary overhang. The secondary effects of the shortages were hoarding, barter, black markets, «dollarization» and restrictions on the internal movement of goods. These trends can be summarily described as the «barterization» of the Soviet economy. Barterization disrupted supply links for producers, making the economy still less efficient, and adding to the shortages. Thus the «vicious circle» between barterization and shortages continued.

At the Economic Summit in Houston in July 1990 the leaders of the G-7, with the agreement of President Gorbachev, asked four international organizations (the IMF, World Bank, OECD and EBRD) to undertake a study of the Soviet economy.* The objectives of this «Joint Study» were to make recommendations for the reform of the Soviet economy and establish the criteria under which Western economic assistance could effectively support such reforms.

In early September 1990, when the «Joint Study» was starting, there already existed two competing economic reform programs. They were the «Shatalin 500 day» program and the «Ryzhkov» program. When it came to economic reform, the proposals of the group headed by Academician Shatalin were both bolder and more specific than those of Prime Minister Ryzhkov. But what proved to be an at least equally important difference between them was that the Prime Minister's program emphasized a strong Union government while the «Shatalin» program proposed transferring major powers to the republics. For example, under the latter all powers of taxation would be vested in the Republican legislatures and the Union would have to make do with voluntary transfers from the republics.

In September 1990 an attempt was made to reach a compromise between the two programs. The hope was that the compromise would then be approved by the Supreme Soviet of the USSR and, following this, by each of the 15 republics. The uncertainty and drift on economic reform policies would thus be brought to an end. However, this effort at a compromise failed. The outcome was limited to the «Presidential Guidelines» for stabilization and economic reform which were approved by the Supreme Soviet on October 19. But they were never approved at the republican level. And these guidelines were more of an extended statement of objectives than they were a detailed program for reaching these objectives.

The «Presidential Guidelines» did, however, include a description of the state of the economy and the society in October 1990:

«The position of the economy continues to deteriorate. The volume of production is declining. Economic links are being broken. Separatism is on the increase. The consumer market is in dire straits. The budget deficit and the solvency of the government are now at critical levels. Antisocial behavior and crime are increasing. People are finding life more and more difficult and are losing their interest in work and their belief in the future. The economy is in very great danger. The old administrative system of management has been destroyed but the impetus to work under a market system is lacking».

The situation, accurately described in this quotation, called for a strong economic program. But, despite a worsening economic situation, it has so far proved impossible to reach a consensus on what this program should be.

Late in 1990 there was a «conservative» or «right wing» reaction to the deteriorating situation. A number of important economic reformers left their high governmental posts. Factors contributing to this reaction no doubt included (i) some discrediting of the economic reform effort from the apparent failure

* The conclusions of the «Joint Study» are summarized in *The Economy of the USSR — Summary and Recommendations*, published in December 1990 by the World Bank on behalf of the four organizations. The collected background papers prepared as part of the study are contained in the three volume report, *A Study of the Soviet Economy*, published by the OECD on behalf of the four organizations.

of the earlier partial reforms, (ii) growing concerns regarding ethnic conflicts and the possible fragmentation of the USSR, (iii) the proposed cuts in the military budget, which would seriously affect the defense industries, and (iv) a not surprising fear of loss of power by those in the traditionally powerful state and party organs. On the last point, however, it should also be noted that a substantial number of the traditional Communist Party *nomenklatura* are choosing to join in the reform and are becoming entrepreneurs in the expected new order.

Reacting to both the serious developments in the Baltics and the failure to make progress with a serious economic reform effort, by the end of January 1991 the major Western industrial countries were putting their plans for both food aid and technical assistance «on the back burner». During the first half of 1991 the economy continued to deteriorate. Reported industrial production fell by 11% from the levels of the previous year. This was due to a variety of causes; they include the collapse of exports to Central and Eastern Europe, declines in arms production, strikes and ethnic disputes, and added difficulties in obtaining needed inputs as a result of the worsening balance of payments situation. The continuing decline in petroleum production and exports, and substantial debt service obligations combined with a reluctance of Western bankers to extend new credits, contributed to the balance of payments problems. However, in recent months the prospects for economic reform have improved. In April food subsidies were drastically reduced, a necessary if not sufficient step to get the budget deficit under control, and the first draft of an «Anti-Crisis Program» was circulated by Prime Minister Pavlov. On April 23 the «9+1 agreement» took place; in this agreement nine of the republics agreed to work with the Union government to complete an acceptable anti-crisis economic reform program and a new Union Treaty. The six republics not participating in the «9+1 agreement» account for less than 10% of the population and economic activity of the present Soviet Union.

In May a group of Soviet economists began work with several Harvard and Massachusetts Institute of Technology professors in an effort to come up with a reform program, covering political as well as economic changes, that they hoped would be acceptable to both the republics of the USSR and the major Western nations. The Soviet team was led by Grigory Yavlinsky, who had been Chairman of the Commission on Economic Reform of the Russian Federation as well as a major contributor to the «Shatalin 500 day» program. Their proposal, titled «Window of Opportunity: Joint Program for Western Cooperation in the Soviet Transformation to Democracy and the Market Economy», became better known as the «Grand Bargain» because of its emphasis upon large scale economic assistance from the West.

In July President Gorbachev met in London with the G-7 heads of state at the conclusion of their annual Economic Summit. The Soviet leader emphasized his country's determination to establish a market economy that would be integrated in the world economy. Although the London meeting did not result in any agreements on financial assistance, there were both supportive words and promises of technical assistance (to be facilitated by a special relationship with the IMF and World Bank). The expressions of support from the G-7 were also backed up by plans for continuing discussions of Soviet economic reform efforts.

Some Political Background

Before considering the economic reform recommendations of the «Joint Study», we should remind ourselves of some of the political factors that condition the prospects for economic reform in the USSR. Foremost is the strong revival of ethnic and national aspirations in the USSR — which is a federation of republics with different cultures, languages, and economic levels. Many of the republics (and particularly the large Russian Federation) are themselves far from ethnically homogenous, so there are tensions within as well as between the republics.

Following the reduction in controls by Moscow, the country has been going through a period of ethnic euphoria. It is not yet clear whether this initial euphoria is now diminishing. Some believe it is. But others think that the pendulum is still swinging towards republican independence. They believe that it may be several years before it will be possible to bring the republics back into a «common market» or «single economic space» (perhaps along the lines of the European Community in 1992). The challenge facing both Union and republican leaders is how to combine political diversity with economic unity.

Many forces in the republics seek economic as well as political independence. But economic independence, or autarky, would prove costly in terms of economic well-being. The various republics are in fact heavily interdependent. In addition to comparative advantage based upon natural and human resources, Soviet industrial planners added to this interdependence by concentrating production of particular ma-

nufactured goods in a relatively few large plants. In these circumstances trade barriers between republics would be costly to all concerned. Indeed, the restrictions on the internal movement of goods that are part of the present «barterization» of the economy, are adding significantly to the present disruption of the economy.

The «9+1 agreement» of April 23 and subsequent progress towards a new Union Treaty offer some basis for hope. However, in July the Russian Federation approved the draft Union Treaty only after entering reservations which would leave the individual republics responsible for foreign trade and leave the Union government without powers of taxation. At the same time the Ukraine simply postponed consideration of the treaty for two months, although agreement on a new Union Treaty is clearly a matter of urgency since a political understanding, probably in the form of a new Union Treaty, is a prerequisite for economic reform.

Some of the contentious issues include (i) the allocation of tax powers and expenditure responsibilities between the Union and the republics, (ii) ownership of natural resources and state owned enterprises, (iii) measures necessary to maintain common fiscal, monetary and foreign exchange policies, and (iv) an agreement to prohibit interrepublican trade barriers. The reform is proceeding on the basis that the republics are in fact sovereign, but that those participating in the new Union Treaty thereby delegate certain powers to the center which will, among other things, be adequate to maintain a single economic space.

It remains to be seen whether this will prove possible. There is substantial verbal support for maintaining a «single economic space», but there seems to be a lack of understanding regarding the economic institutions and policies required. Republics already have their own central banks which they do not want to be totally subservient to the USSR's Gosbank; some of them want the power of emission, and at present an effort is being made to get them to settle for the authority to set their own reserve requirements. The currently highly overvalued commercial exchange rate (which is about 1/15 of the official rate offered to tourists) results in a situation where «foreign exchange retention» is demanded by republics as well as wanted by exporting firms; it is uncertain whether these pressures can be overcome by anything less than a unified exchange rate responsive to market forces combined with current account convertibility. There continues to be strong opposition to giving the Union government any taxation powers; even the Prime Minister's draft «Anti-Crisis Program» has the Union at least partly dependent upon voluntary upward revenue transfers from the republics. The restrictions on interrepublican trade are in fact increasing (as republics respond to shortages by prohibiting «exports» to neighboring republics). Moreover, the tendency for vertical integration in Soviet enterprises has its parallel in the desires of some individual republics to minimize dependence upon «imports» from other republics that are considered unreliable sources of supply.

Comprehensive Economic Reform

Much of the debate over economic reform programs in Eastern and Central Europe, as well as in the Soviet Union, has been in terms of the choice between «shock therapy» or the «big bang» on one hand and «gradualism» on the other. The «Joint Study» outlines an economic reform program for the USSR which it describes as «radical», but which perhaps is better described as «comprehensive». While it is certainly not a «gradualistic» approach, it isn't really a «big bang» or «shock therapy» either. Some of the reforms are necessarily going to take substantial time to implement; reform of the banking and legal systems are examples. Moreover, the recommendations include a number of transitional measures designed to soften the initial shocks of reform. «Comprehensive» is perhaps the best simple descriptor since the recommended program clearly calls for simultaneous, or nearly simultaneous, actions in a great many areas.

Such a comprehensive reform program is both politically and administratively difficult. The close relationships between the various components, however, make a comprehensive approach essential. Many of the USSR's recent economic problems result from the fact that the reforms of the past three years have been partial and therefore inconsistent. Thus Soviet experience with *Perestroika* supports that proposition that the results of partial reform can be worse than those of no reform at all. As was stated in last October's Presidential Guidelines, the old system of economic management has been largely destroyed, but a new one has not yet been put in place.

The elements in the economic reform program outlined in the «Joint Study» can be classified under three headings:

- (1) strengthened macroeconomic management,
- (2) systemic reform, and
- (3) transitional measures (to soften «shocks»)

The elements of macroeconomic management are the conventional ones, although in the case of the Soviet Union they involve structural reforms as well as policy changes. In the fiscal area it is not simply a matter of adequate fiscal discipline, but of restructuring intergovernmental fiscal relations and of basic reforms in the tax system. In the monetary area, it is not simply a matter of tighter monetary policy, but of establishing an effective central bank with adequate tools for monetary management. Regarding incomes policy, there is a need to maintain reasonable floors and ceilings on real wages; there is also a need to develop collective bargaining procedures, and to adjust nominal wages and wage differentials as subsidies are eliminated and greater attention is paid to differences in productivity.

In the Soviet Union macroeconomic stabilization will not be simply a matter of tightening policies with the usual existing policy instruments. By and large, the necessary instruments and institutional arrangements have yet to be put in place. There are important political aspects to this process. Indeed, in 1991 fiscal management has been seriously compromised because some republics have been holding back, and using for their own purposes, tax collections which previously had been transferred to the Union to meet expenses of the center. The result is a much larger than expected consolidated state budget deficit in the first half of the year — although no one seems to know exactly how large, because some republics have not provided the financial data necessary to fully evaluate the situation.

The «Joint Study» discusses six elements of systemic reform. They are:

(1) *Price liberalization*. As well as ending most administered prices this involves (a) using market clearing prices (rather than orders from state planners) to allocate available supplies of goods and to signal producers regarding what the market wants, and also (b) progressively bringing Soviet prices in line with world prices.

(2) *Enterprise reform*. This includes (a) privatization, beginning with retail trade and services, wholesale distribution and smaller manufacturing plants; (b) «commercialization» of those government enterprises which it may not be possible or convenient to privatize in the short run; and (c) the encouragement of new private sector activities.

(3) *Financial sector reform*. New financial institutions are needed to mobilize saving and to replace central planners in allocating savings among various investment possibilities. Initially the emphasis will be upon the establishment of a commercial banking system, but other types of financial intermediaries and markets also need to be developed. The creation of a commercial banking system involves training «commercial bankers» and establishing the needed system of prudential regulation and supervision.

(4) *«International economic relations»*. Included in this general heading are reforms of trade, exchange rate and foreign investment institutions and policies. Trade should be liberalized and a unified exchange rate, responsive to market forces, and current account convertibility should be established as rapidly as feasible. Foreign investment needs to be encouraged (although here it should be recognized that what matters is not just specific legislation on foreign investment, but also the general investment climate and the overall legal framework).

(5) *The social safety net*. The most immediate issues are an adequate system of unemployment compensation and assistance to the unemployed with retraining and job placement. But the safety net also requires improving social protection for vulnerable groups, reform of the pension system, disability insurance, and other aspects of social security.

(6) *The legal framework*. The creation of a legal framework for a market economy includes establishing a commercial code and a judicial system to enforce contracts, the clarification of property rights, and the elimination of laws clearly inconsistent with a market economy. (For example, until recently the law on «economic speculation» made it a criminal offense to buy something with the intention of selling it at a profit). Of fundamental importance is bringing to an end the «war of laws» between the Union and the republics (during which each has claimed that its own legislation would be binding in the event of conflicts between Union and republican law).

The «Joint Report» discusses a number of transitional measures that could be taken to reduce the declines in household real incomes and the losses in output and employment which must be expected as part of any major stabilization and restructuring program. The report proposes one for households and another for enterprises. Regarding households, it was recommended that the prices of urban transport, and of other natural monopolies, continue under administrative controls while gradually being adjusted to realistic levels. Housing rents are also a special case, where adjustments should come slowly and as part of an overall reform including the financing and construction of housing. In addition, the report suggested that, as a way of protecting vulnerable groups, a strictly rationed amount of some basic consumption goods might continue to be subsidized. Any quantities consumed beyond the ration would have to be bought at market clearing prices. The total subsidy involved, of course would have to be held to a level consistent with satisfactory fiscal management.

Regarding enterprises, it was recommended that — for oil and gas plus some other primary product exports, and also for a limited number of imports — transitional export and import taxes might be imposed to slow the move to world market prices. The future move to world market prices would be clear, but enterprises would be given some time to adjust to the new situation (e.g., a 3-year transition period). The use of export and import taxes, rather than price controls, would mean that the allocation of the resources involved could be done by the market rather than requiring administrative interventions.

Another transitional measure for enterprises would be a program to assist in the physical, financial, and managerial restructuring of state enterprises. Intervention in these areas by the state is often questioned, partly because of the fear that it would become a continuing subsidy for inefficient firms, and partly because of doubts about the capacity of any public sector administrators to make the necessary decisions. On balance, however, such intervention seems essential if the transitional losses in output and employment are to be held to acceptable levels. There are major issues regarding the conversion of the defense industries and the down sizing of heavy industries where administrative intervention is desirable. Also, there are many potentially viable firms that have inherited heavy debt-equity ratios and which, for this reason alone, probably could not survive the tightening of credit that would accompany the reform effort. There is a danger of a hiatus in credit availabilities while the banking system is being restructured (as well as a question on whether the newly created commercial banks should be asked to undertake the risks involved in all industrial restructuring activities). Restructuring can also serve other important objectives; in particular, some state enterprises will need to be «demonopolized» (by dividing them into a number of competing firms) before they can be privatized. It would be a mistake to leave all of these restructuring problems to be solved by quite imperfect markets. Some kind of state restructuring agency, which can provide both technical and financial assistance, seems necessary.

It was previously noted that the case for comprehensive reform rests on the interrelationships between the many different aspects of macroeconomic and systemic reform. For example, it is widely accepted that one cannot successfully carry out systemic reforms, particularly where price policy is a key element, in a seriously inflationary environment. In the Soviet Union the reverse of this proposition is equally clear, i.e., the fiscal and monetary situation cannot be brought under control without undertaking systemic changes — particularly those related to enterprise reform and pricing policy. In addition to drastic reductions in subsidies, a «hard budget constraint» must be placed on state enterprises — i.e., there must be an end to the covering of enterprise deficits by budget transfers or readily available bank loans. This means making state enterprises financially and managerially independent — either by privatization or «commercialization».

However, if state enterprises are going to be privatized or commercialized, their manager must have the authority to raise prices and dismiss unnecessary workers. This requires both substantial price liberalization and the establishment of an adequate unemployment compensation system. Especially in the Soviet Union, where production of manufactured goods tends to be concentrated in a relatively few firms, one can hardly liberalize prices without simultaneously taking steps to encourage a competitive environment. For retail trade, rapid privatization will help create the necessary competitive environment; at the wholesale level it will be necessary to encourage the formation of competing channels of distribution. For tradeable goods, much could be accomplished by a combination of import liberalization (accompanied by current account convertibility), «demonopolization» as part of the industrial restructuring, and the ending of «profile restrictions» where they seriously inhibit firms from changing their product lines.

Whether accomplished by the privatization and commercialization of existing state enterprises or by the growth of new private sector activities, the financial and managerial autonomy of enterprises will have to be accompanied by financial sector reform. The central planners' allocations of capital for new investments need to be replaced by banking and other financial market decisions. Reform of the legal system is equally necessary. Although it will take some time to complete the legal reform, the evolving market system will not work satisfactorily in the absence of a suitable legal framework. There are other relationships which must also be taken into account. For example, the authorities are under pressure to distribute the state's assets while keeping its liabilities. Insofar as this is allowed to happen, future macroeconomic management will become even more difficult. Thus, when approaches to the privatization and commercialization of state enterprises are considered, it will be necessary to keep in mind not only the need to reform ownership and management, but also the need to mobilize financial resources. These resources will be needed to recapitalize the commercial banks (many of which have very weak portfolios), to help finance industrial restructuring and unemployment compensation expenditures related to the reform program, and also to capitalize the pensions funds.

Thus, we see that starting with one element in the reform program, bringing the fiscal and monetary situation under control, leads us to the need to simultaneously undertake reform in the other areas as well. Thus the general answer to questions about the timing and sequencing of reform measures seems to be that postponing any of these major elements in the reform program is likely to create more problems than it will solve. While enterprise reform and price reform are both *sine qua non*, they must be supported by strengthened macroeconomic management, by the other elements of systemic reform, and by transitional measures that cushion the inevitable shocks from restructuring.

The area where «gradualism» is most often proposed is that of price liberalization. It is argued that, while prices should be adjusted, they should also be kept under administrative controls — because of the problems of monopoly power and the time needed to strengthen market infrastructure and institutions. Indeed, many of those participating in the «Joint Study» began with this point of view. But, in the course of the study, they became convinced that a widespread price liberalization was the best and perhaps the only way to end the present disruption of the economy from hoarding, barterization, and barriers to internal trade. Thus the recommendation of widespread price liberalization is not made with the expectation that it will result in the «efficiency prices» discussed in books on the theory of perfect competition. Instead, it is a recommendation to adopt market clearing prices in order to move the economy from what is becoming a barter economy to an exchange economy.

Price liberalization would no doubt result in some further inflation, since changes in relative prices can hardly be accomplished without an increase in the general level of prices. Price liberalization would, of course, have to be supported by fairly tight monetary and fiscal policies, or it would indeed contribute to a dangerous inflationary spiral. But price liberalization, in the sense of moving to market clearing prices, seems to be the best if not the only way to restore the value of the ruble — in the simple sense that the ruble would again be a medium of exchange for buying and selling goods and services. This would go a long way toward reversing the recent declines in production which have resulted from the difficulties in maintaining supply relationships in an increasingly barterized economy.

External Assistance

The report recommends that the Western nations provide economic assistance to support the Soviet Union's reform efforts, but suggests that a two-stage approach be taken. At present, and until a comprehensive reform program is under implementation, it is proposed that aid be limited to three kinds. These are (1) food and other humanitarian assistance, (2) technical assistance, and (3) loans for projects in a few special areas. The areas recommended for project lending are energy, environment, and perhaps help in removing some infrastructure bottlenecks such as telecommunications.

Once a comprehensive economic reform program was introduced and under implementation, external lenders would have greater confidence that both a higher level of assistance and other forms of economic assistance would be used effectively. With the exception of technical assistance, economic assistance to the Soviet Union is expected to take the form of loans on normal commercial terms. If such borrowing on commercial terms were not used effectively, the borrower as well as the lender would suffer, because it would leave the borrower with a higher debt burden, but without the increase in productive capacity and exports that are needed to service the increased indebtedness. Thus both the borrower and the lender should be concerned that any large scale external assistance contributes to improving economic efficiency and output.

Concurrent with the implementation of a comprehensive reform program, it would be desirable to support that program with balance of payments assistance and with project assistance in additional areas. Although a unified exchange rate would have to be responsive to market forces, balance of payments assistance through a stabilization fund could be helpful in providing initial support for the current account convertibility of the ruble. Also, at the outset of price liberalization it would be useful to provide balance of payments assistance to help assure adequate supplies of many goods whose prices were being liberalized. At such times there is a tendency for exchange rates and prices to move erratically and to «overshoot», but these tendencies can be kept under control if a stabilization fund and additional supplies of imported goods are available.

The inflow of direct private investment should be expected to increase once a comprehensive reform program was under implementation. However, expectations seem exaggerated regarding both the likely level of private foreign investment and the extent to which it offers a solution to the economic problems of the Soviet Union. Particularly important for potential foreign investors will be the clarity of the legal fra-

mework. Indeed, except for the ability to remit profits and establishment of reasonable procedures for the settlement of investment disputes, the most important factors to encourage foreign direct investments are the same ones that encourage domestic private investments. The most important role of foreign direct investment will be as a source of ideas and information on organization, technology, and access to foreign markets. Insofar as getting foreign exchange is the main objective, foreign direct investment is in fact a relatively expensive form of financing.

The «Joint Study» concludes with the following: «...we must stress that balance of payments assistance should accompany the introduction of a major and comprehensive reform program. Without such a reform, additional financial resources would be of little or no lasting value. With it, assistance could provide important support during a time of difficult transition to integration of the economy of the USSR into the world economy, with benefits for all partners».

The Prospects for the Future

There is little likelihood that the present economic disruption can be brought to an end, and output restored to more normal levels, in the short run, i.e., in the next twelve or eighteen months. Even if a comprehensive reform program is adopted, one must anticipate further declines in output and employment during the initial period of transition and industrial restructuring. However, if such a reform program is not adopted, the problems are likely to be even more severe as the economy would continue its present downward course. An added source of concern is agricultural production in 1991; there was a large decline in the area planted in the spring, so the fall harvest could be seriously reduced. Another complicating factor is the fiscal deterioration in the first half of 1991 and the resulting increase in the monetary overhang.

There are two favorable aspects of the restructuring process that should be noted. One is that a substantial part of the decline in output is falling upon the military industries. While this affects employment and incomes, it does not reduce the total level of goods and services available to meet private consumption needs. Indeed, the latter will be increased insofar as the military industries can be converted to the production of civilian goods. The second favorable aspect is the improvement in supply links, and consequently in economic efficiency and output, that can be expected as a result of introducing market clearing prices and moving from the present «barterization» to an exchange economy. However, these two favorable factors will not be sufficient to offset the transitional costs that are inevitable as the Soviet economy establishes a market system and becomes increasingly integrated with the world economy.

The experience in other countries suggests that economists, both the foreign advisers and those in the countries concerned, have been overly optimistic about the ease and speed of the transition from a centrally planned to a market economy. There is also a tendency by some to turn «the free market» into a new ideology, rather than to see it as a practical way of organizing affairs that solves many problems, but certainly not all of them. There are problems of «market failure» just as there are problems of «government failure». The state needs to play an important positive role during the transition and beyond. Even in the most market oriented economies, the state has responsibilities in regulating economic activity, in providing economic and social infrastructure, and in maintaining acceptable minimum welfare levels. Maintaining the appropriate role of the state can be difficult in a society where the state has in many respects discredited itself as a result of its past behavior and failures. It will be even more difficult in the Soviet Union where there are additional reasons for strong centrifugal forces.

Essentially political issues, particularly ethnic tensions, clearly make it difficult to get the necessary consensus on an economic reform program. Moreover, in the republics many are more interested in the decentralization of power from than in economic reform. They are anxious to see the power to make economic decisions move from Moscow to the capital of their republic or to its major municipalities. But they are less interested in having this power move to enterprise managers whose actions would be guided and disciplined by market forces. The problem is illustrated by the remarks of one official who announced that «state orders» to enterprises would be ended — and be replaced by republican and municipal orders. This is not only a desire to exercise power. After over seventy years of a command economy, many simply do not understand what is involved in moving the Soviet Union to a market economy that is integrated in the world economy.

Just as it was not possible to reach a compromise between the «Shatalin» and «Ryzhkov» proposals for economic reform in the Fall of 1990, it was not possible to reach a compromise between the «Grand Bargain» and the «Anti-Crisis» programs prior to the G-7 meeting in the Summer of 1991. Indeed, it is far from clear if the republics (even nine of them) are willing to give the central government the degree of

economic authority that will be necessary to maintain a single economic space for these republics. A possible scenario is a relatively prolonged and difficult «learning period» during which many economic policies are likely to be inconsistent and inadequate. Getting safely through such a period would be a test of both Union and republican leadership. Despite the uncertain near-term outlook, there is reason to hope that in the longer run movement towards a market economy integrated into the world economy will prove irreversible. No one should be surprised if, at times, progress is interrupted (as it was for some months beginning late in 1990). While external financial assistance at appropriate points may ease the transition, the fundamental and most difficult problems can be solved only by the Soviet people.

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