

Evaluate the Positive and Negative Effects of Gaidar's "Shock Therapy" Reforms

In the early 1990s, the people of the former Soviet Union faced the second radical economic and social experiment of the twentieth century. The February Revolution of 1917 saw the autocratic tsarist regime, based upon a market economy, overthrown and the October Revolution saw the rise of the Bolsheviks and of a socialist command economy, fully regimented later under Joseph Stalin. In 1991, the world was stunned when the Soviet Union disintegrated. The Union had been struggling economically in the years prior to its collapse and made failed attempts such as *perestroika* and the '500 days' programme to reform its economy. The Soviet style command economy was obsolete; it may have struggled for a number of years, but in the long run it needed drastic reform. The new Russian Federation, under President Boris Yeltsin, was faced with the huge task of moving Russia forwards and reforming the economy. We can identify three clear options which the Federation could have taken: the Federation could have look backwards and emulated the tight control of the command economy under Stalin, however, this would necessitate a declaration of martial law and the state lacked the funds to achieve this style of command economy. Secondly, a gradualist approach also linked with an evolutionary or incrementalist approach. This approach would involve a hybrid of Soviet style market control with an incremental move towards free market institutions. Price-control signals and economic development would indicate the pace with which a transition to the free-market should take. Advocates of this approach were Joseph E. Stiglitz and to a certain extent the Russian politician Grigory Yavlinsky, who was the architect of the '500 days' reform programme (Stiglitz 1999; Sakwa 2008: 291). The third option was a 'big bang' approach to reform, more commonly known as 'shock therapy'. This was the approach taken and which we shall now explore in detail in this essay. We shall first look at why shock therapy was chosen and by who, then at the five elements of 'shock therapy' in Russia: the liberalization of prices, macroeconomic stabilization, privatization of state enterprises, abolition of the remaining elements of central allocation of resources and removal of barriers to free international trade and investment; and finally at the rise of the oligarchs. Throughout will be highlighted the positive and negative effects of shock therapy.

'Shock therapy' dictates a revolution of reform, both in its pace and its outcome. To expand on this, 'shock therapy' dictates that reform takes place at a rapid, almost immediate, pace and the goal of which is a radical change to the economic structure. This option was chosen and partly implemented under the auspices of the acting Prime Minister, Yegor Gaidar, who has since been described by supporters as a hero and the founder of market institutions in Russia, and by opponents as responsible for the cause of the misery suffered by millions of Russians in the 1990s; curiously, when he died in December 2009, the Parliament refused a one-minute silence.

Interestingly, the western advisors to the Russian Federation, including Professor Jeffrey Sachs, Anders Aslund and members of the 'Washington Consensus', advocated a policy of 'shock therapy' indicating the example in Poland. It is unclear entirely why the western advisors advocated a 'shock' approach, but it must be noted that the reforms effectively sealed the coffin on the communist past. There was indeed a fear that communist political elements may be able to return Russia to the Soviet days. It may be seen that the Western advisors were seeking to destroy the possibility of a continuance or a return to the communist command economy and the social implications that that entailed. Indeed, the Western advisors were perhaps attempting to destroy the 'evil institutions' associated with the Stalinist legacy. Joseph Stiglitz furthers this by proposing that the Western advisors were seeking a Blitzkrieg during the 'fog of transition' as part of Cold War triumphalism (Stiglitz 1999: 22). That is to say, they wanted to destroy the

institutions which were such an essential part of the 'evil empire', which most of the Western powers were at cold war with for much of the second half of the twentieth century, before the population could act to protect its previous vested interest. This style of approach encapsulates the thinking of the Bolshevik revolution and the Jacobin revolution in France. As Stiglitz points out 'it is almost as if many of the western advisors just thought the Bolsheviks had the wrong textbooks instead of the whole wrong approach' (Stiglitz 1999: 22). The advisors, with the correct textbooks, were then able to fly into Russia and 'use a peaceful version of Lenin's methods to make the opposite transition' (Stiglitz 1999: 22).

Another reason 'shock therapy' was chosen, other than a fear of the return of communism, was that a hybrid system with a gradualist approach to transition in Russia has been shown not to work, particularly evidenced by the failed efforts of 1985 – 91 (Kotz and Weir 2007: 155). However, economists such as Stiglitz and James R. Millar believe that a gradualist system was the only option Russia should have taken, and that the parties responsible for 'shock therapy' in Russia failed to understand firstly where they were when beginning the transition, that is they failed to understand Russia's peculiar social structures in the Soviet tradition, for example: paternalist factory bosses, instead of laying off redundant staff, continued to produce goods even though there was no demand for them, that is, they did not understand the principles of a free-market (Millar 2009: 48). Also, as Keynes' *The General Theory* promulgates, it is better to make modest reform with a high probability of success than a wide sweeping reform with a low probability of a favorable outcome (Keynes 1973). A gradualist approach would have allowed the society to adjust at a slower pace, instead of the huge shock of the approach chosen.

Shock therapy has been described by John Kenneth Galbraith as 'simplistic ideology', and he argues that the neo-liberal reliance on the market to the exclusion of any major role of the state was primitive economics (Galbraith 1990: 1 – 12). Indeed, a major element of 'shock therapy' adopted in Russia was the lack of state control in the process. A reason for this may be that those implementing the reforms saw clearly the damage caused by strict state control of the economy and may have succumb to the belief that the 'normal' or 'natural' state of an economy is a free market version, which fails to exist only when governments interfere and prevent it (Kotz and Weir 2007: 156). The government's role in the transition process, as dictated by the 'shock therapy' approach, is the following five measures, which we shall now discuss in detail: the liberalization of prices, macroeconomic stabilization, privatization of state enterprises, abolition of the remaining elements of central allocation of resources and removal of barriers to free international trade and investment.

Price Liberalization was aimed at freeing both retail and wholesale prices from state control. The value of amounts would then be determined by the supply and demand chain, a crucial part of a free market. Also, the value of the ruble was to be released from state control and allowed to 'float' against foreign currencies; its value would be determined by supply and demand in a free currency market. It was predicted that inflation would ensue, however, the rate of inflation that actually occurred was far above estimates with a massive rise of 2,500 percent in 1992 (Kotz and Weir 2007: 172). In June 1994, a kilogram of beef cost a massive 3,187 rubles, compared to 2 rubles in 1991. Russia's giant enterprises had huge monopolies so raised their prices without restraint. Instead of an increase in demand and supply, the opposite happened and the output of virtually all goods plummeted. Real wage was driven down by 28 percent in 1992 and most pensioners suffered even worse. Subsequently, most households could only purchase essential goods. Investment mainly went into assets that would keep their real value, like foreign currencies, real estate and minerals. Productive investment, such as building new plants or machinery, was seen as not so good an investment when compared to speculation in currencies and minerals. Accordingly, the rapid inflation produced by price liberalization pushed down household consumption and business

investment, the two components of total demand. A severe depression was thus unavoidable, unless the government spent enough to make up for shrinking private spending. (Sakwa 2008: 291 -293)

However, to curtail inflation shock therapy demanded the opposite of government spending. The government used macroeconomic stabilization, which consisted of two main elements: firstly, the reduction of government spending to achieve a balanced federal budget, which in the last days of the Soviet Union, was running at a large deficit. This needed to be quickly eliminated. Subsequently, large cuts were called for in large areas of public spending: military, social schemes, education, amongst others. Secondly, strict limits were placed on the growth of money and credit. Subsequently it was difficult for any parties to raise funds to invest in production. The tight monetary policies failed to prevent inflation, as the inflation of Russia in 1992 was just too strong to stop. However, the tight policies of the first three months in 1992 did see some result in controlling inflation but exerted an unbearable squeeze on industry. By the summer of 1992, enterprises working capital had fallen far behind the amount needed to stay in operation at the greatly increased prices. This meant that they did not have the funds to pay their workers or non-labor inputs, and due to the tight monetary policies, they were unable to borrow any money. In mid-July 1992, Georgy Matyushkin was replaced by Victor Gerashchenko, who was seen as more sympathetic to Russian industry, as central bank president. Following the change, monetary policy was eased. As monetary policy alternated between less and more tight during 1992 – 95, the inflation rate moved with it. The trend in this period was downward, but inflation had not been conquered by the end of 1995. Some believe that if monetary control had been tighter and more rigidly followed that in a small time frame inflation could have been brought under control, for example two years. However this would have meant unbearable pressure on industry and society as a whole. Tight monetary control also prevented Russian industry to modernize. This meant that products were of a low standard and could not compete on the global market. Cuts in government spending also put back the modernization and improvement of communication, travel and power infrastructures, which affected the long-term economic welfare of Russia. Scientific development, one of the major achievements in the Soviet epoch, had its budget cut and so technological development was put back. Cuts in healthcare and education had a huge impact on society. According to one recent study, the death rate in the former Soviet Union increased by 13 percent (Cited in Schneiderman: 2009).

Privatization called for immediately turning small enterprises into private businesses. The Russian government used a voucher scheme in the first phase of privatization, where it gave all citizens a voucher to invest in shares of previously state controlled enterprises. The problem with this was that no money was actually being injected into enterprises. While it was recognized that middle to large firms could not be privatized as quickly, 'shock therapy' called for immediate 'commercialization' of the smaller firms. This meant a conversion from state owned property into joint-stock corporations and from plan-fulfillment into profit-seeking. The state's shares in companies were to be privatized as soon as possible, thus completing the privatization procedure. Banking, excluding the central bank, was to be included in privatization. Indeed, the Russian government succeeded in privatizing much of Russia's enterprises. It took several years for the larger enterprises to be privatized. However, as everybody knew that the larger enterprises would soon be in private hands, and nobody knew whose hands, the incentive to invest for the future waned. Another driving factor of the collapse of investment. Some analysts believe that rapid privatization was needed and that restructuring Russian enterprises was a better policy (Amsden 1994: Ch. 1 and 5). Indeed, in many industrialized capitalist countries, a sizeable portion of enterprise is state-owned, for example in France, Canada and Germany. Also, the government appointed managers of these enterprises are able to respond to price signals in an effective manner, this being one of the reasons for rapid Russian state enterprise privatization. Of course, transferring businesses to private hands does not necessarily mean that they will be run more

efficiently. The advocates of 'shock therapy' insisted on privatization, when the real importance was transforming the external economic environment in which the companies operated. As there was no pre-existing class that could buy large business, large enterprises naturally fell into the hands of the old elite, which in the eyes of the population gave privatization illegitimacy.

Privatization, taken with the other elements of 'shock therapy', was a major factor in the rise of organized crime and corruption. The so-called 'mafias' were in a strong place to acquire firms as they had the finance and the ability to use illicit means to strong-arm their will. In 1994, a report for President Yeltsin found that 70 to 80 percent of private banks and businesses had to pay 10 to 20 percent of their revenues to organized crime (Kotz and Weir 2007: 178). The 'mafia' became very visible in society, and very violent. Gang-style executions were common, 120 bank employees, including 15 directors, were killed and 780 arson attacks were made on banks in 1993. At least two members of Parliament were killed in 1994 – 95, organized crime being the likely culprit. Crime groups also murdered residents in well-placed recently privatized Moscow apartments. The power of the mob is clearly identified by the fact that Police wore masks when apprehending crime figures, apparently fearing retribution, clearly, crime groups were taking control in Russia¹.

Price liberalization impoverished a huge section of society, including the government employees responsible for managing privatization. Even those with high morals soon found that they had to accept bribes to survive. Law and order was drastically weakened by huge public spending cutbacks, and officers, whose wages were also hugely cut, were also open to bribes.

The abolition of the central planning system had begun in 1991, but elements remained; most important was the system of state orders. This required companies to produce to set numbers allocated by the state. With this removed in 1992, market forces were the sole mechanism of coordination for the economy, and enterprises had to struggle to create new supply and marketing relations amidst the economic chaos.

International trade was to be encouraged by the removal of high tariffs and quantitative restrictions, meaning a move towards free trade and capital movement. Foreign investment was to be encouraged and foreigners were to be encouraged to invest in Russia. The ruble was made fully convertible, that is anyone holding them would be free to exchange them; this would encourage free trade and investment. However, the primary effect of western involvement was the displacement of many domestic products with foreign products as the multinational corporations moved in with their superior marketing and financial muscle. The idea was for Russian industry to gain the incentive to produce more efficiently, however, this view failed to take into account the peculiar Russian market. Those who could afford the foreign products, the new rich and new middle classes, did not object to the high prices. However the average Russian, with low spending power, could afford to buy little of the foreign import, and so were largely dependent on domestic produce. Accordingly, the new foreign goods provided less of a competitive pressure for the improvement or reduction in cost of products than had been forecast. Subsequently, Russian goods failed to compete with imports and making the import market relatively free and open was perhaps not the best policy. Trade protectionism was indeed used in the earlier phases of industrial nations such as the USA, Japan and Germany. Foreign investment was slow to arrive in Russia, except for some investment in oil and other raw materials, continuing legal and bureaucratic obstacles being an unmistakable factor in this. However, even with these problems

¹ Moscow Times, 4th June, 1994, displayed a photograph of masked Interior Ministry police arresting suspected crime leaders in the Radisson Slavyanskaya Hotel.

solved, 'shock therapy' made Russia an unattractive place for investment; rapid inflation, falling production, declining real incomes and expanding crime and corruption created an environment that was dangerously unstable, economically and politically. Of course, long-term investors would place their money in places where stability would maximize a good return. In fact the opposite of capital inflow occurred; capital outflow. Those who gained from privatization using somewhat questionable means were eager for capital to be stored safely abroad in case a future government decided to take it off them.

By the mid 1990s, Russia had a market economy, but amounts of financial resources were still controlled by the state. The capitalist transition was still incomplete, and so the state continued to play a major role in the economy. The business class, which had emerged under 'shock therapy', realized the importance of close relationships with officials, and some were able to amass huge economical and political power. These are the so called oligarchs, who originally included Vladimir Gusinsky (the Most group), Alexander Smolensky (the Stolichny bank), Mikhail Khodorkovsky (Menatep-Bank), Vladimir Potanin (ONEXIM-Bank), Boris Berezovsky (the Logovaz group), Mikhail Fridman (Alfa-Bank), and Vladimir Vinogradov (Inkombank). The oligarchs gained more power in the 'loans for shares' auctions, where highly lucrative state enterprises were loaned to the oligarchs at very low prices in auctions which could be attended only by those close to the government. The stipulation was that if the government did not pay the loans back by a certain date, then the shares would become permanent property of those who had provided the loans. The government had no intention of paying back the money, so the shares were transferred. The effects of oligarchy have been much debated. Anatoly Chubais believes that 'oligarchs are a big private Russian business with both positive and negative features they bring to Russia' (Padma 2006: 90). Indeed, according to Chubais, they started capital investment and began attracting foreign investment. They battled for increasing economic competence. So economically, there are many positives to oligarchy, however following the Yeltsin election victory of 1996, which they bankrolled, they 'thought they could rule the world and could do everything' (Chubais in Padma 2006: 90). The oligarchs tried to place themselves above officialdom, putting democracy at stake and they sought to retain economic superiority, thus putting free market development at stake as well. Interestingly, when Putin came to power, he did seek to destroy the oligarchs, but he removed the most threatening to his power, including Boris Berezovsky and Vladimir Gusinsky and Vladimir Khodorkovsky, but has not done away entirely with oligarchy, having recognized the obvious benefits. However, the remaining oligarchs must play to his rules and not get involved in politics.

In this essay, we have explored many negative effects of 'shock therapy' particularly in the short term; decrease in real wages, life expectancy and economic output; the outflow of capital, without the inflow in the opposite direction. The rise of organized crime and corruption, and the rise of the oligarchs as a political power. However, in the long term, shock therapy may be said to have more positive effects. Russia is now rising again as a world economic power. If a gradualist approach had been used, then most definitely the suffering of millions could have been somewhat avoided, however it would have taken much longer for the economy to grow again. In short, 'shock therapy' was not ideal, but the economic situation in early 1990s Russia was not an ideal situation and called for radical solutions. 'Shock therapy' was certainly radical and in the long term has been beneficial to Russia.

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