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Inflation in Russia: 1989-Present

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Introduction

Russia suffers today from an unprecedented combination of economic ails: an industrial depression worse than the American Great Depression; rampant crime and corruption; widespread unemployment; falling productivity and standards of living; political instability; and a lack of resolve to address these problems. Of course, one of the biggest problems Russia faces is inflation. Prices rose more in Russia during the first week of 1994 than they did in the United States during 1993.¹

The primary purpose of this paper is to review the literature that analyzes Russia’s economic transition and the causes of the inflation. Next, the paper analyzes what role the inflation plays in the current process of reform of the Russian economy. Finally, drawing from the experiences of other nations with similar histories, previous and possible policy options to remedy the inflation are discussed.

Russian Inflation History

Nobel Laureate Milton Friedman, the major founder of the Monetarist School of thought in Economics, wrote that "inflation is always and everywhere a monetary phenomenon...produced only by a more rapid increase in the quantity of money than in output."²

¹“Indicators,” Kommersant”, February 22, 1994, no author, p. 3.
Russia is not exempt from this law: last year, while the Russian Central Bank pursued an irregularly loose monetary policy, consumer prices rose at a rate between ten and thirty percent every month.\(^3\) Table 1 (*Kommersant*, 1994) shows how credit levels (roughly equivalent to monetary aggregates) rose in relation to the Ruble/American Dollar exchange rate.

Because the Dollar is a relatively stable currency, this graph shows distinctly how inflation from loose monetary policy has eroded the value (ergo, purchasing power) of the ruble. The solution then, would seem simple: tighten monetary policy in order to reduce inflation. However, this is neither a satisfactory answer nor a

\(^3\) *Kommersant*: February 1, 1994, p.44. No title or author given.
complete solution for stabilization of the Russian economy.

Without a functioning economy, implementing selected and targeted policies has little effect. For example, implementing orthodox monetary policy before stabilizing political and economic expectations erodes living standards as well as public confidence in government. On the other hand, enacting sweeping fiscal reforms without corresponding monetary discipline is futile: any gains made in productivity or living standards are absorbed or overtaken by inflation.

In order to fully understand the inflation in Russia, so that solutions can be found, it is important to review underlying problems of the economy and the reasons why these problems exist. There are many underlying causes of the current inflation in Russia, ranging from economic to cultural in origin. Furthermore, these problems are often so intrinsically related that it is impossible to separate them from each other. Even so, it is necessary to isolate the major causes of inflation in Russia today.

The most important cause of the inflation in Russia is the legacy of the centrally-planned Soviet economy. It is common to refer to excess money in a certain type of inflationary economy as an 'overhang of money.' But, in this case, the 'hangover' is more than just a monetary metaphor. Because the Soviet Union indulged in unsustainable and irresponsible economic practices for most of its seventy-four years, Russia must now face not only spiraling inflation, but hungry citizens, dried-up production, angry
pensioners, corruption, and political headaches.

Central planning severely hinders the Russian economy. Industrial production in Russia declined more than fifty-percent since 1990. Economic, and therefore, fiscal recovery present substantial challenges. Poland, an economy Russia is often compared to, took nearly a decade to emerge from a central-planning induced depression.

Micro-economic relations, including domestic and inter-republican, have been severely limited by the dissolution of the Soviet Union and the economic transition. In this case an anecdote provides the best example: Because of the legacy of the old Soviet system, cigarette tobacco and rolling papers are produced in Russia. However, the glue to hold the cigarettes together is manufactured in another republic. Since the dissolution of the Soviet Union, coordinating the resources to collect all three raw materials became an impossible task, pushing up the prices for cigarettes.

Russian agricultural production is down 45 percent since 1990. Food industry productivity is down 35-40 percent.

7 “Happiness is not in Money, Even in its Quantity” Kommersant’, December 21, 1993, No author, p. 28.
Food production is key to the economy. Poland for example, was able to speed the transition to a market economy, in part, because nagging problems of food shortages didn't exist. Russia forcibly collectivized its agricultural system under the Soviets and depended more strongly on agricultural central planning than Poland.

All of these factors drive inflation by decreasing public confidence in the functioning of the economy. This results in behavior that accounts for inflation in advance, continuing the wage-price spiral. Food production for example, is critical to inflationary pressure. Since all people in an economy are affected by inflation of food prices, inefficiency in agriculture translates eventually into general consumer-price inflation.8

Political instability is another of the major reasons why

8 Meitel, Shlomo and Ben-Zion Milner, p. 42.
inflation is rampant in Russia today. Political instability produces apathy and neglect on the part of economic actors in a society. Because of this, increased precautions and undue reluctance on the part of industrialists and businesspersons results. Political instability also results in government paralysis and indecision. Both of these effects can lead to inflation. Because economic actors are unwilling to act without inflated prices to cover risk factors, economic production slows to a halt.

Because many industrialists still retain strong ties to the government leaders of the old Soviet Union, cheap credits are often demanded from the Central Bank. Such credits are different from normal currency issues from a central bank. These are direct, subsidized loans to individual industries. Often they are targeted toward factories and sectors that employ large numbers of people. Rather than invest these credits in restructuring and renovation, they are used to further fund inefficient production and labor practices. They also serve as a substitute for money, continuing the inflationary spiral. Although Central Bank Chairman Victor Gerashchenko has accomplished a considerable lessening of credit extension since December 1993, these subsidized loans continue the inflation problem in Russia today.

Banking problems, lack of enforceable property laws, crime, and bureaucracy are examples of other factors that continue the current inflation in Russia. Furthermore, all of these factors contribute to an unbreakable circle: none of the problems can be solved without the others being simultaneously addressed. However,
no one has the political ability to address all of the problems concurrently.

There is general disagreement about the original causes of the inflation. On a governmental level, this paralyzes the process of establishing fiscal responsibility. Because of this, outside agencies, such as the IMF and World Bank, are reluctant to offer assistance. Before analyzing possible policy solutions, it is instructive to review the origins of the inflation.

Is the inflation now cost-push or demand pull?

One of the major reasons inflation in Russia is such a serious problem is the fact that aggregate demand exceeded aggregate supply. For years, the inefficient Soviet economy\(^9\) produced an insufficient quantity of goods to fulfill the needs and wants of the Soviet people. That which was produced was sold at regulated prices, or even rationed out. Everyone, except those unfortunate enough to be part of the huge prison/labor camp system, was paid wages and benefits, regardless of their productivity. Therefore, most goods and services during the Soviet period were immediately purchasable; inflation was evident only in non-price factors, such as lines, shortages, and black markets.

This inequality manifested itself as price inflation only during the late 1980s and early 1990s. During this time, Soviet

\(^9\)While the Russian economy is not the only successor to the Soviet economy, the only predecessor to the Russian economy is the Soviet economy. Unless otherwise stated, all further references in this paper to the Soviet Union will therefore assume only the Soviet Economy as it relates to present-day Russia.
leader Mikhail S. Gorbachev began his economic reforms, known as Perestroika. Among other actions, Gorbachev brought regulated prices closer to the actual costs of producing them. Later, Russian President Boris Yeltsin, and his Prime Minister/Advisor, Yegor Gaidar, freed most prices. With large amounts of savings available, consumers and producers drove up prices. Simply put, Russia has suffered in part, from a hangover of rubles. These points support the hypothesis that inflation in Russia is demand-pull inflation.

In order for an inflationary spiral to exist, cost-push inflation must follow demand-pull inflation. There are many arguments that support a hypothesis that cost-push inflation is a factor in the Russian economy.

The first argument that supports this hypothesis, is that there is not enough money left in the economy to continue demand-pull inflation. Savings were virtually wiped out in the Summer of 1993, when the government issued an edict that issued new currency, and invalidated old monies. This edict allowed only several thousand rubles to be returned in cash, the rest was forced into inaccessible savings accounts. Without available cash savings to spend on goods and services, demand-pull inflation could not continue.

The second, and most powerful argument that the inflation in

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10 Brigitte Granville. “Price and Currency Reform in Russia and in the CIS,” Russian and East European Finance and Trade, Vol. 29 #1, p. 6.
Russia is not demand-pull inflation, is that productivity in Russia right now is low in all sectors of the economy. Demand pull inflation can really only occur when the economy is producing goods and services that people can purchase with their earnings or excess savings. Therefore, cost-push inflation must play some role in the current inflation.

Another reason why cost-push inflation may be an underlying cause of inflation, is that the restrictions of the Soviet period ignored the normal increasing of costs in an economy. It can be argued that this repressed cost-inflation has not yet been fully recurred. Therefore, industries continue to increase their costs to meet world price levels.

Continued inflation has forced inflationary expectations, leading to a third kind of inflation: hyperinflation. While the traditional (Cagan) definition of hyperinflation -- 50% inflation per month -- has not been reached statistically in Russia, the evidence indicates that superinflation (galloping inflation) is occurring. Evidence for this can be seen in the fact that, even during the strictest monetary and fiscal periods during the Yel'tsin/Gaidar administration, inflation continued at a level of several percent per month.11

Impacts of Inflation

Inflation has many pernicious effects on any economy. First,

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11 See Kommersant' issues from Fall and Winter months of 1993. See especially "Economic Indicators Covering Two Years of Reform," December 21, 1993, p. 15, No author.
continuous inflation often leads to a decline in output. "Severe inflation encourages a diversion of effort toward speculative, and away from productive activity." For evidence of this effect in Russia, Maital and Milner write:

"The streets of Moscow are lined with makeshift stalls, where everything imaginable is hawked. Many of those stalls are at curbside [sic] in front of abandoned stores; privatizing those stores is painfully slow, so they sit idle and empty. All over Moscow, there are huge open markets that rival any 'suk' (open marketplace) in the Middle East.

"It looks, for all the world, like an explosion of entrepreneurial activity. Apparently, many Russians get the idea. Under capitalism, they have learned, you make your living by selling things other people want -- especially when there is no alternative way to make a living."

Another of the effects of inflation is the redistributive effect of inflation. Inflation acts as a tax on those who hold long-term investments, and on those who live on fixed incomes, such as pensioners. These effects are readily visible in Russia today, although inflationary wage-indexing and COLA's are increasingly common. While these safeguards may protect people in the short-term, they are extremely inflationary, and consequently, ineffective in the medium- and long-terms.

Finally, inflation is disruptive to normal economic relations, and to economic planning. Without reasonable knowledge about the future of prices for inputs, it is impossible for managers to plan output. Similarly, Federal and local governments, attempting to protect the living standards of their constituencies, capriciously

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13 Ibid, p.175.
raise the benefits for the electorate.

Other Experiences with Inflation

Argentina and Brazil have had long battles with inflation. Neither country has yet recovered from their inflationary cycle. Similar to Russia, their inflation is rooted in an excess of aggregate demand, brought on by generations of a command economy. While many of their attempts at heterodox inflation strategies have reduced inflation temporarily, none has been successful in eradicating the causes of the inflation.14

Similar to Russia, Poland has had inflationary difficulties during its transition from a command economy. However, the public is fortunate, in that the recession associated with restructuring of the economy occurred under a strict political regime. Price increases have been restricted, as have increases in wages. Although this is a painful approach to economic restructuring, the 'shock-therapy' approach had more success than Russia's current mixed approach.

Previous Attempts at Policy solutions.

While the Russian government has not yet achieved success in its restructuring, some of the policies that have been implemented are noteworthy. The first of these, ironically, is the issuance of new currency in Russia in the summer of 1993. While this policy destabilized the public's confidence in government, it did serve to

14 Moskoff and Nazmi, p. 7.
reduce inflation.  

The second of the government initiatives is internal convertibility of the ruble. This action allows for foreign businesses to exchange currency within the borders of Russia. While this action does not allow profits to leave the country, it does allow more freedom for foreign investment. However, there have been many conflicting policies during the last year. The former Parliament, in an effort to undermine Yeltsin, limited the freedom in how these monies could be converted.

Tight monetary policy has been used several times in recent months to lessen inflation. This is the most effective, and most direct, method to reign in inflation. However, tight monetary policy makes standards of living fall in relation to previous expectations. This is a pernicious effect of inflation: once the cycle begins, it is very difficult to stop politically. In fact, Yegor Gaidar lost his position as Prime Minister largely because he implemented the fiscally conservative measures necessary for tight monetary policy.

In the December 1993, the new Russian Constitution passed. Modeled after the French Fifth Republic, the Constitutions establishes a legal basis for property rights and laws. This, combined with the general price liberalization and commitment to

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15 While statistical correlations are not available to conclude this premise, *Kommersant* graphs from the period indicate that inflation slowed during the period. See especially February 1, 1994, p. 44, Graph #2, "The Relationship of Credit Levels and Inflation." No author.
privatization the Yeltsin administration has demonstrated, serve to encourage productive investment, which makes the economy stronger, thus reducing inflationary pressures. Privatization by vouchers -- shares 'given back' to the general public for ownership in formerly government property -- has continued since 1992. A program continued by Yeltsin, these vouchers are freely tradable on several exchanges in Russia.

Possible Policy Options:

The first action the Russian government can take to end inflation is to make the ruble totally and freely convertible. Making the ruble convertible allows investment money to freely enter Russia. This would spur an influx of investment into Russia. Continued enforcement of property laws in Russia would further this effort.

Another possible policy to mitigate inflation in Russia is to restructure the Russian agricultural system. The United Nations is in a good position to offer technical assistance in this vein. Because agriculture is the linchpin for consumer prices, this is especially important. Such a policy would help consumer confidence, as well.

The Russian government should encourage long-term growth in production in Russia, by giving companies incentives to assist in the tricky transition to privatization. There are many positive

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signs that the economy can work. First, profitable enterprises exist in Russia. While they are rare, and much of the activity is speculative, they prove that opportunities do exist. Second, Russia can return from hyperinflation: as a monetary and political phenomenon, the inflation can be reduced to levels that reflect only the structural problems in the economy.

Russia is also in a unique position to encourage intra-republic trade. This is true for both the states of the former Soviet Union and for Russia's own Federal states. This could further regional stability and would serve to reunite old producers and suppliers. Environmental cleanup and oil production are areas in which these new nations could cooperate profitably. While a single currency might aid in developing this cooperation, it is not absolutely necessary.

Finally, the International Monetary Fund (IMF) should loosen its requirements for fiscal constraints. While the IMF should not abandon its role of guaranteeing that fiscal responsibility is enforced, shock-therapies of the nature that the IMF advocates are inherently politically destabilizing.

17 Ibid, p. 45.
Conclusion:

This paper reviewed the underlying problems with Russia's economy, and how they relate to inflation. I have concluded that inflation is now basically cost-push, but I believe that some evidence remains to support the idea that demand still pulls inflation to an extent in Russia. However, expectations of inflation play the largest role in continuing inflation in Russia today. Therefore, I feel that a combination of strict monetary policy and some heterodox methods should be combined to conquer inflation in Russia. This should be a long-term effort, combined with continuation of tight monetary policies, and further economic and political reforms.
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