"REVERSE GRADUALISM", INVESTMENT COLLAPSE AND MONETARY DEGRADATION IN RUSSIA IN THE 1990s

I. Introduction

In the 1990s The Russian transitional economy was characterized by many adverse economic processes, and this paper will focus on the two of these ones. The first one was the long and biggest fall in output and fixed capital investment. The second was monetary degradation (this term will be explained below). These phenomena (especially the first one) reflected clearly failure of economic reforms in Russia, because large negative economic growth implied nothing but fiasco. Why the Liberal Reforms of the 1990s were so unsuccessful?

The goal of this article is to give the answers to this and some other questions. I will show that roots of economic failure of Russia in the 1990s are in the type of the strategy of economic reforms. I called it "reverse gradualism"; indeed it is the newest label for the shock therapy strategy, as I will explain below. Such strategy generates the criminalization of the economy, which, in turn, does the adverse influence on investment, output and finance. The interaction between investment sector and monetary processes deepened crisis. The general outcomes are underdeveloped economy, technological backwardness and ineffective institutional environment. These ones can be considered as one of the roots of social and political processes started after reelection of Putin in 2012 in Russia.

The structure of the paper is the following. The Section 2 describes (in detail) the essence of gradualism and its important elements and also explains why shock therapy strategy – at least, in the case of Russia – is nothing but "reverse gradualism"; indeed it is the newest label for the shock therapy strategy, as I will explain below. The Section 3 illustrates the ideology of the Russian transitional reforms. The Section 4 describes both concrete carrying-out of reforms in Russia and how these reforms generated criminalization of the economy. The Section 5 describes the influence of criminalization on fall in fixed capital investment. The Section 6 contains the description of the influence of the same process on monetary degradation. Section 7 tells about the interaction between changes in fixed capital investment activity and financial development in the developed countries (including "new industrial countries") and in Russia. The Section 8 is the conclusion.

2. Gradualism versus Shock therapy or "Normal Gradualism" versus "Reverse Gradualism"

The problem of the gradualism/shock therapy choice is widely discussed among the economists who are concerned with the economics of transition (Dewatripont & Roland, 1995, 1997; Aslund, 1996 etc). It seems to me that, however, underestimation of the essence of gradualism takes place. Gradualism is the sequencing of reforms. Yes, of course, it is true. But this definition is not sufficient. It does not give the information about duration of each of these reforms. This point is very important.

What reforms constitute gradualist transition to the market economy? I think that it is necessary to mention the following ones.

a) The creation of the legal framework for the market economy. I mean such things as clear system of property rights, contract law, the definitions of rights and duties of private and state enterprises, the procedure of the bankruptcy, provision of the general coherence of laws (for example, coherence of instructions of the President with laws of legislative organs) etc (see Udovenko and Gurinovich (1994)).

b) The development of private sector.

c) Demonopolization and restructuring of the enterprises.

d) Privatization.

e) Price liberalization.

f) The departure of the government from the economy (in particular, from the sphere of the enterprises administration and management).

What especial feature of this list? Each successive reform takes less time than preceding one. The duration of price liberalization or of departure of the government from the business administration can be equal to one day. On the other hand, the creation of the good legal framework or the development of (even small) private sector can take a few years. More early reforms are longer (and also complicated).

It means that shock therapy policy is the immediate introduction of all reforms but is not immediate completion of all ones! If that policy takes place, logically later reforms are ended more early because of its extremely small relative duration! For example, imme-
diate introduction of both the development of private sector and the departure of the government from the business administration simply means that, as a (intermediate) result, many enterprises will remain without any administration (Raskov, 1995)! Or the attempts to create simultaneously privatized enterprises and legal framework will lead to the situation of the "game without rules". Both such situations took place in Russia in the 1990s.

I would like to note that the shock therapy policy ex ante has been transformed into the "reverse gradualism" ex post. Those reforms that must (from economic point of view) be implemented later, take place more early (it is the definition of the "reverse gradualism"). Such "bad" succession complicates the transition to the market economy and also generates chaos and increases the uncertainty of the future. But the main evil of the "reverse gradualism" is the creation of the prerequisites for criminalization of the economy. In other words, such policy gives the broad possibilities for the getting income by cheatings, plundering and other "black" (i.e. illegal) kinds of economic activity (I will show it in the Section 4).

Broadly speaking, the above reasoning implies that the ("normal") gradualism is the only effective strategy for the transition to the market economy. Privatization and price liberalization can be successful only if these reforms are based on clear legal framework and are realized under the existence of private sector. It means that the time period between the initial decision to create the market economy and fully desired liberalization must be long. But then that transition will be very effective, as experience of China (country which was gradualist very consistently) shows. Quick reforms in the spirit of shock therapy approach, on the other hand, can lead to the sharp economic slump and to many social problems.

So there is effectiveness/duration trade-off. More effective reforms are more long and vice versa. The effective policy a la ("normal") gradualism is slow. The quickest shock therapy measures (the "reverse gradualism") are harmful for the macroeconomic performance and financial development.

But the political constrains also take place. Many economists believe that high costs of reversal are disadvantage of shock therapy policy (Dewatripont & Roland, 1997). But if there are both extreme political instability and the threat of the seizure of power by the reactionary forces, then transitional reforms must be quick and irreversible in order to make the market economy rising inevitable. In that case high costs of reversal are the advantage of shock therapy policy (Aslund, 1996) because in such politically adverse situation rapidity is more useful "good" than effectiveness and macroeconomic performance (it is the point of view of many extreme liberal reformists). It is such circumstances that took place in Russia, when the Russian government made the decision to create the market economy.

3. The Ideology of Transitional Reforms in Russia

In order to understand special features of the Russian economic reforms, it is necessary to ascertain its ideology. According to my opinion, this ideology was characterized by the following points.

a) The idea of the "jump into the market". Many economists said: "the main is to jump into the market, all the rest does not matter". In other words, for many Russians the market economy was not the means but the goal. The market became the idol. "Towards the Market at any cost". I think that it is the reflection of the essential features of the psychology of the Russians. "All or nothing" is the principle of many Russian people. For such people the "cost/benefit" thinking (which is so typical for the Americans) is not characteristic.

b) The Hayekian idea of the "spontaneous rising of the market institutions". This idea occupied the brains of Gaidar and many other reformists. According to this principle, the creation of the market economy must not be concerned with the government actions. The government should depart from the economy and open the way for the rising of the market institutions. The emergence of such institutions is the effect of the chaotic interactions between many atomized individuals. The government must not disturb the "mystery" of spontaneous rising of the market economy.

c) The above-mentioned fear of the seizure of power by the reactionary forces, i.e. of the revenge of the communists. "If we will make reforms very quickly, the return (to the power) of the communist forces cannot deteriorate situation, because the transition to the market will become irreversible". It is the way of thinking of many Russian reformists. "The main thing is to make the reforms as quick as possible".

These fundamental principles had laid the foundation of the Russian transitional reforms. The analysis of these principles shows that such reforms were extremely quick and completely "unreasoned" and "unstructured". The implementation of these reforms generated big chaos and increased the uncertainty of the future in Russia.

4. "Reverse Gradualism" and Criminalization of the Economy in Russia

By the 1991 in Russia the state organs of the enterprises administration were abolished. In the January of 1992 price liberalization took place. In 1992 - 1994 the main part of privatization took place. But these reforms were executed in conditions of the absence of such important elements of the healthy market economy as a clear legal framework, private sector and competitive environment. In other words, economic agents got large possibilities to "make money" by illegal means. The main such means was the "nomenklaturna-
It took place when managers of state enterprises created false firms and transmitted resources of these enterprises into such firms. These and similar actions (together with famous "rent-seeking activity") displaced "usual" productive and investment activity. The point is that because of the government departure the property which belonged to the state became belonging to nobody. It led to massive redistribution of incomes and criminal formation of capital of many economic agents. More exactly, the most part of the Russian private capital was created because of such "reverse gradualism" by criminal and semi-criminal methods, that is, by "nomenklaturaja privatizacija", speculation, theft, rent-seeking activity and so on. These phenomena became possible owing to the absence of clear property rights and other "rules of game". Such institutions are the necessary condition for domination of the motive of profit maximization on the base of productive and investment activity. In the transitional economy these institutions must be created in the first phase of "normal" gradualist reform and make the base for the subsequent measures (see the Section 2). In Russia in the 1990s this base was not satisfactory. That is why as in the beginning of the transition as in the end of the 1990s, speculations, cheatings and transactions with rights, privileges and licenses generated more benefit to economic agents than "normal" productive and investment activity.

In 1992 and 1993 the amount of criminal appropriation by private agents was equal to 75-80% of GDP; in 1996 (when law framework became already a little more clear) it was equal to 12-15% of GDP (Shmeljov, 1997, p. 32).

As a result in the Russian economy in the 1990s there was rising of informal rules of game created by criminal groups. Criminalization of the economy was self-intensifying. It did the adverse influence on the investment and financial sector, as I will show in the next two sections.

5. Criminalization of the Economy and Collapse of Fixed Capital Investment in Russia

It is known that fixed capital investments are the moving force of macroeconomic dynamics. Such investments increase the level of aggregate demand, expand productive possibilities of the economy (Lavoie, 2006, ch. 5) and are the channel of innovations' diffusion. Without fixed capital investment there are no economic growth and technical progress. The consequences of the slack capital investment activity are stagnation and technological degradation. The long decrease in such investment leads to the heavy slump.

But fixed capital investment activity is concerned with the long-run estimates and expectations of the future. The necessary condition for the carrying-out of fixed capital investment projects is (more or less) stable socio-economic environment. In other words, fixed capital investment is the decreasing function of the (high) uncertainty of the future, economic and political instability, "non-clear" legal framework, the absence of certain guarantees from the government etc (Rozmainsky, 2013).

It is stupidly clear that conditions which are favorable for fixed capital investment and ones which are favorable for criminalization of the economy are opposed each other. Criminal and semi-criminal kinds of activity - stealing, illegal speculations, "games" with rights and licenses - are the "fishing in troubled waters". Criminalization needs chaos, instability and uncertainty. Time horizon of the representatives of criminal groups is extremely short-term. The goal of such economic agents is to make money as quickly as possible ("while waters are still troubled"). Such agents are characterized by investor myopia which means that agents evaluate consequences of their decisions only over short-time horizon (Rozmainsky, 2013). Criminal actions are inconsistent with any long-run activity. In short, the uncertainty of the future, socio-economic instability and helter-skelter with legal framework both increased the uncertainty of the future and created prerequisites for the success of criminal activity.

On the other hand, investment activity needs the "calm waters". Time horizon of "fixed capital investors" is very long (5-40 years). The goal of such agents is to earn maximal profit during a very prolonged time period. Any uncertainty, instability and chaos are extremely disturbing the fixed capital investment activity.

So if in the economy the most profitable activity becomes short-term and extreme short-term one, that it means unattractiveness of fixed capital investment. Such investments are impossible in the system of short-term horizon economic agents. At the same time in this system criminal activity can be gainful.

Two of the most harmful effects of the Russian "reverse gradualism" were "troubling of waters" and forming of short-term orientation of economic agents. These effects are interactive. "Troubled waters" were ideal for criminal activity; such activity, in turn, "troubles waters" in a more degree. So "reverse gradualism" in Russia generated catastrophic effects to fixed capital investment activity. The main channel of influence of these effects was criminalization of the economy. The profitability of criminal and semi-criminal actions implied non-profitability of fixed capital investment because of sharp distinctions in accompanying conditions (short/long time horizon, non-clear/clear legal framework, high/low level of uncertainty of the future etc).

But criminalization was harmful for fixed capital investment activity not only because of these listed forces (of "troubled/calm waters"). The second fundamental reason was the criminal origin of new private capital. Many Russian reformists believed in the Marx's theory of "primitive accumulation of capital". "Let them accumulate as they (new entrepreneurs)
like". According to the point of many Russian reformists, criminally formed private capital was much better than absence of private one. Reformists believed that new entrepreneurs will invest own criminal capitals in the Russian economy and, therefore, help both to transit to the market system and to begin economic growth. And then rich criminals will become honest (fixed capital) investors (Davydov, 1997).

It turned out that this conception is not true. Criminal origin of capital induced owner of such capital to invest outside the country where this capital was formed because that owner wants to conceal his (or her) crime from authorities of this country. This "law" is the main reason for the huge capital outflow form Russia during the transition to the market system. Annual capital outflow (in the 1990s) equaled about $ 50 billions. Foreign financial and productive assets were the main (and very strong) competitor to Russian fixed capital for Russian investors. The glaring blunder of Russian reformists was creation of favorable conditions for the concentration of capital at criminal groups; for example, in 1997 in Russia domestic and foreign criminals possessed 55 per cent of capital and 80 per cent of voting stocks (Davydov, 1997, P. 116). As a result, those who wanted to invest in fixed capital, had no money, and those who had money (these people were criminals), did not want to make it.

In 1999 investment in Russian fixed capital was equal less than 25 per cent of its level in 1990 (and during the transition period R&D expenditures, according to the studies of Shmeljov (1996), fell by ten times). That collapse was much more awful that the American Great Depression. Such collapse, as I showed, was the effect of failed "reverse gradualism" which led to the "troubled waters" (high uncertainty, absence of clear legal framework, "short-termisation" etc) and concentration of capital at criminal groups.

6. Criminalization of the Economy and Monetary degradation in Russia

In developed countries (including new industrial ones) financial evolution takes place. This term means rising and spreading of new kinds of money (and quasi-money) and new financial practices. I mean liability management, securitization, off-balance sheet activities etc. As I will show in the Section 7, there is a positive interaction between financial evolution and economic growth. The former facilitates fixed capital investment activity, which, in turn, is the reason for the further development of financial system.

In Russia during the transition period there was monetary degradation. I use this term as a reflection of increase of primitive mediums of exchange and means of payment - cash, inter-enterprise arrears ("non-payments") and barter - and (relative and absolute) decrease of "advanced" kinds of money. The negative influence of such degradation on investment activity will also be shown in the Section 7. In this Section I will describe criminal roots of monetary degradation in Russia.

The point is that criminalization needs "adequate" financing. Financing is "adequate" for criminal activity, if it allows to conceal outcomes of (criminal) transactions and make more difficult of all calculation and accounting. In other words, such financing creates conditions for above-mentioned "fishing in troubled waters". Bank money is not good for it. But any new, "advanced" kinds of money and quasi-money (certificates on deposit, repurchase agreements etc) are bank money or are created by the financial institutions’ activity. Therefore, to some extent, financial evolution disturbs criminal activity, because it makes all transactions "transparent" for the statistical services and tax authorities.

On the other hand, primitive kinds of mediums of exchange can help criminal groups to hide its actions.

a) Cash. Black cash ("chjornyj nal") is cash inflows and outflows which are not reflected in ("official") enterprises accounting. Such kind of financing is the simplest way to hide income from taxation. In Russia in the 1990s so-called "black cash" was widespread. The share of cash in the total Russian money supply increased in the 1990s (for example, in December of 1991 cash/M2 ratio was equal to 0.18, in December of 1993 it was equal to 0.36, and in October of 1998 it was more than 0.38). It is reflection of criminalization of the economy (Nesterov & Vakurin, 1995).

b) Barter. Barter is ideal means to conceal incomes. Under barter pricing is very muddle, and material things flows are reflected in accounting only partly (or not reflected at all). Multi-stage barter exchanges are based on "word of honor" and personal connections between enterprises top managers and very often unknowable for the other workers. (Makarov and Kleyn, 1997). So barter allows to hide from tax authorities and police enormous amount of wealth. The cases were known when managers of some Russian enterprises bought "Mersedeses", and at the same time "simple" workers could not get wage during the months. In 1996 in Russia barter financed 34-50 per cent of turnover of manufacturing enterprises, 70-80 per cent of transactions with raw, and 75 per cent of turnover of small businesses producing nonconsumption goods (Makarov and Kleyner, 1997, p.26). According to sociological interrogatories, in 1996 Russian firms financed 35-38 per cent of its transactions by barter (and only 17-23 per cent by bank money and 9-12 per cent by cash); the share of transactions financed by barter had risen in this year by 15 per cent (Klepach, 1997, p.45, 54).

c) Inter-enterprise arrears ("non-payments"). Arrears did the influence on criminalization through three channels. In the first place, mutual arrears between firms are not but specific kind of barter. In the second place, "non-payments" allowed enterprise-creditor to
Delay tax payments. In the third place, rising of "bad" arrears induced firm-creditor to ask criminals to take debt principal and interest away from firm-debtor. In other words, in this last case, incentives to cooperation between firms and criminal groups appeared. Only in 1996 annual increase of inter-enterprise arrears was equal to 16 per cent (Klepač, 1997, p.54). In January of 1997 "mismatured" inter-enterprise arrears were more than 23 per cent of Russian GDP (Shmeljov, 1997, p 26).

Degradation of monetary system was both cause and consequence of criminalization of the Russian economy in the 1990s; the former was the reaction of financial sector on development of criminal tendencies; but such degradation, in turn, created conditions for intensification of these tendencies.

Monetary degradation (and especially barterization) was harmful for economic development and technical progress. It increased transaction costs - because the carrying-out of exchanges becomes more difficult - and reduced allocative efficiency (Makarov & Kleyner, 1997, p.33; Malahov, 1997, p.86). But, possibly, the main evil of monetary degradation was negative influence on fixed capital investment.

7. Fixed Capital Investment and Financial Development: Very Important Interaction

In orthodox macroeconomics the problem of financing fixed capital investment and economic growth is, unfortunately, not studied. Only some representatives of Post Keynesian Economics explored this question (Minsky, 1977, 1985, 1986; Carvalho, 1992; Pollin, 1994; see also Rozmainsky, 1995, 1996).

On the one hand, permanent expansion of investment possibilities increases enterprises demand for finance and induces banks and other financial institutions to search new ways to satisfy this demand. In these circumstances financial institutions try to escape from the central bank (reserve) control; to make it, these institutions create new kinds of money and financial practices (already mentioned liability management, securitization, use of credit lines etc). So banks and other financial institutions get the possibility to create money independently on central bank policies. Money supply becomes endogenous (Chick, 1992; Chick & Dow, 1988; Niggle, 1990, 1991; Rozmainsky, 1995; Nozdran and Berezin, 1993).

On the other hand, such financial evolution expands opportunities for financing expensive and long-term fixed capital investment. The financial barriers to investment projects weaken. The increase in the productive possibilities becomes quicker. The economy grows more rapidly. All this is the essence of mentioned interaction between economic growth and financial development.

The above-described story is about positive tendencies in economic and financial development. But negative tendencies can also take place. It is case of Russia in the 1990s. I showed already how criminalization (induced by "reverse gradualism") generated both collapse of fixed capital investment and degradation of monetary system. The problem is that now even under the successful struggle with criminal tendencies investment fall and monetary degradation can interact and deepen each other. On the one hand, fall in investment will decrease demand for finance and, therefore, do not stimulate financial development. On the other hand, decrease in real (deflated) amount of financial sources (because of monetary degradation) will narrow possibilities for financing investment expenditures and, consequently, economic growth. Growth is impossible without sufficient financial resources, without separation of finance (financial sources of investment) from savings (Carvalho, 1992; Pollin, 1994) because otherwise for increase of investment it is necessary at first to increase savings; but owing to famous the "paradox of thrift" such increase will lead to output fall.

I mentioned already the data about a level of investment fall in Russia and about a monetary degradation measured by increase of share of cash in the total money supply. Now I would like to note that during the period of 1992-1995 the price level rose by 8,500 times, money supply (including cash) rose by 230 times (and cash rise was more than increase in the total money supply). The M2/GDP ratio was equal to 0.7 in 1991 (this figure is typical for industrial countries) and 0.1 in 1996 (Shmeljov, 1997, P.26). According to Shmeljov, the total money supply was less than aggre-gate money demand of the economy by 15-20 times. The quasi-money/total money supply ratio was equal to about 0.01-0.03 during all the transition period in the 1990s (in the developed countries now this ratio is equal to about 2/3). In other words, in Russia M2 and M3 were not created. Nozdran and Berezin (1993, P.39) believe that the reason for it is the investment collapse. I agree with this point of view. So we can see that combination of investment collapse and decrease of real (deflated) money supply (especially "advanced" kinds of money) was the reality in Russia in the 1990s.

During this period there was threat for Russia to get into dangerous "trap of absence of financial sources of growth". This trap is the part of or even the reason for the "trap of equilibrium at low level of income" described by Kornai (1994). Moreover, during all 1990s gross domestic output and investment fall in spite of the government's promises of "stabilization".

8. Conclusion

In this paper I tried to describe the essence and some negative consequences of shock therapy policy of transition to the market system. I called this policy "reverse gradualism" because in fact all reforms cannot be completed immediately (as the "philosophy" of shock therapy postulates); there is full realization of reforms with less duration; it is these reforms that should from economic point of view be last. For exam-
ple, privatization must be implemented only after creation of clear legal framework; and attempts to make both reforms simultaneously lead to situation when state enterprises are privatized without clear system of law.

So "reverse gradualism" increased uncertainty, instability and creates law chaos. All these phenomena generated profitability of short-term kinds of economic activity, first of all, criminal and semi-criminal "operations": stealing (for example, "appropriation" of state property by managers of state enterprises without state administration), illegal speculations, transactions with rights, privileges and licenses etc. Economic agents tried to "fish in troubled waters". Criminalization of the economy took place.

This process, in turn, had two adverse effects. In the first place, criminalization was inconsistent with long-term fixed capital investment activity. Criminalization "troubled waters" in a more degree; at the same time fixed capital investment projects can be executed only in the "calm waters" (clear legal framework, including clear property rights and duties of government; low uncertainty of the future; socio-economic stability etc). Many agents started to behave in the manner described by the concept of investor myopia. Furthermore, owners of criminal capital did not want to invest it inside the country where they formed this capital (in order to hide crimes from police and tax authorities). Such criminalization generated huge capital outflow.

In the second place, criminalization required "adequate" financing, that is, financing which allows to conceal value of transactions from the government agencies (tax authorities etc). Such financing was provided by monetary degradation, i.e. spreading of primitive kinds of means of exchange - cash, barter and inter-enterprise arrears ("non-payments").

But fall in fixed capital investment and degradation of monetary system interacted and deepened each other. This interaction pushed the economy into the "trap of absence of financial sources of growth". The backwardness of such transitional economy from the developed industrial economies increased. That is why collapse in Russia in the 1990s was so huge. It was, to a large extent, a consequence of "unreasoned" "reverse gradualist" reforms in Russia in the 1990s.

And the echoes of these processes are beyond the 1990s! Let me give one example. The average age of equipment in the USSR and the US was equal in 1970 to 8.4 and 6.4 years respectively, in 1990 10.8 and 7.1. In 2004 the same variable was equal to 6 years in the US and 21 years in Russia (Fedotov, 2005). So, the resulted technological and financial backwardness together with higher uncertainty is perhaps one of the roots of adverse political and economic processes in Russia after reelection of Putin in 2012.

References

В 1990-е годы российская переходная экономика характеризовалась множеством неблагоприятных экономических процессов, но самыми важными были два из них. Первый — длительный и громадный спад производства и инвестиций в основной капитал. Второй — денежная деградация, представлявшая собой увеличение роли примитивных средств обмена и средств платежа — наличности, неплатежей и бартера — вкупе с относительным и абсолютным уменьшением роли «продвинутых» видов денег. Цель этой статьи заключается в объяснении взаимосвязей между этими процессами. Основная идея состоит в том, что эти феномены были генерированы политикой шоковой терапии, которая оказалась чем-то вроде «обратного градуализма». Последнее означает, что политика шоковой терапии является мгновенным внедрением всех реформ, но не их мгновенным завершением. Если такая политика осуществляется, то те реформы, которые логически должны были быть проведены позже, реализуются раньше из-за их чрезвычайно малой относительной длительности. Это и происходило в России в 1990-е годы.

Ключевые слова: градуализм; инвестиции; денежная деградация; переходная экономика; экономическая теория перехода; российская экономика.

Розмайнский И. В. "Reverse Gradualism", Investment Collapse and Monetary Degradation in Russia in the 1990s

In the 1990s The Russian transitional economy was characterized by many adverse economic processes, but the very important are two of these ones. The first one was the long and biggest fall in output and fixed capital investment. The second was monetary degradation which is increase of primitive mediums of exchange and means of payment — cash, inter-enterprise arrears ("non-payments") and barter and (relative and absolute) decrease of "advanced" kinds of money. The goal of this article is to explain interconnections between these processes. The main idea is that these phenomena were generated by shock therapy policy which is turned to be a something like "reverse gradualism". It means that shock therapy policy is the immediate introduction of all reforms but is not immediate completion of all ones. If that policy takes place, logically later reforms are ended more early because of its extremely small relative duration! That was a case of Russia in the 1990s.

Keywords: gradualism; investment; monetary degradation; transitional economies; economics of transition; russian economy.