Commentary: Monetary Policy and the Control of Inflation

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Governor Crow has given us an excellent summary of the issues and options in controlling inflation. I will focus my remarks on the application of the points that he made to the case of the Soviet Union, which I do in part because I've thought more about the Soviet Union than about the inflation problems elsewhere in Eastern Europe, but also because I think that perhaps it is in the Soviet Union that the problem of inflation is most critical at this time to the general subject of economic reform.

The potential inflationary pressures and the current pace of inflation in the Soviet Union are serious impediments to the more fundamental market reforms that are needed. The key reform in shifting to a market economy has to be price liberalization and an end to centralized planning and price setting. Free prices are the essence of a market system. But if prices were decontrolled now, Soviet economists and Western experts who look at the Soviet economy say that there would be an explosion of the Soviet price level because of the overhang of previously accumulated roubles. That rouble overhang is a reflection of the forced saving by the population of a monetized series of very large budget deficits over the last several years. In a market economy, those monetized budget deficits would have simply led to an increase in the price level, which kept the real value of those balances under control. But with prices frozen in the Soviet Union, the monetized deficits have created the dramatic shortages that we have all heard about and that some of us have seen and, at the same time, along with those shortages of goods on the shelves, have created the accumulation of substantial money balances.

The problem of dealing with this situation is certainly not just a central bank problem. And indeed, until the Soviet Union has created a government bond market at least, there are few instruments that could be used for central banking policy. I am not going to try to distinguish between what the central bank needs to do and what government policy needs to do more generally. Although the distinction is somewhat artificial, I think it is worth distinguishing between the problem of eliminating the current budget deficit—which at least until this year has been running at about 10 percent of GNP and, as I said, being essentially fully monetized—and the problem of dealing with the rouble overhang, the accumulation of past budget deficits.

Let me start with the notion of eliminating or reducing the deficit of the government budget. Essentially, as we all know in this country, that problem is so difficult not from a technical point of view but because of the politics that are inevitably involved in deficit reduction. And the increased democratization in the Soviet Union has made it that much more difficult for the Soviets to deal with deficit reduction. Any policy that reduces the budget deficit is going to hurt someone who feels it directly, while the advantages of reducing the budget deficit are more diffuse and benefit people indirectly.

What are the options for reducing the budget deficit? One obvious choice is an increase in taxes. Within the Soviet context, that may possibly be done in a way that is less painful than it often appears in the rest of world because of the system of pricing of Soviet goods. Certain consumer goods in the Soviet Union bring with them very large implicit taxes. And so shifting production into those goods that carry very large markups is a way of shrinking the budget deficit. In fact, it was the Soviet program of cutting production of heavily-taxed vodka that was one of the factors that led to the increase in the budget deficit. I'm not suggesting a new increase in vodka production in the Soviet Union, although I gather that's happening, but rather that there are other kinds of consumer goods the production of which would shrink the budget deficit.

A second option is reducing subsidies, an eventual necessity if the Soviet Union is to move to a system in which prices more accurately reflect costs of production, but again politically very difficult, as Prime Minister Ryzhkov discovered when his suggestions for increasing the price of bread were so soundly rejected.

A third, and I think most important, option is reducing the spending by the government on heavy investment and military acquisitions. After all, military spending in the Soviet Union is still about 15 percent of GNP and it is military spending and heavy capital goods that have a virtual monopoly on what I would call Westem-quality production in the Soviet Union. Shifting some of that production into consumer durables—television sets that work, refrigerators that work, and automobiles—has the potential for substantial implicit tax revenue for the Soviet government.

The more challenging problem, I think, is dealing with the rouble overhang. Gosbank Chairman Gerashchenko gave a very optimistic estimate of about a 100-billion rouble overhang, which is about 25 percent of annual trade and services. I've heard estimates from other economists, both Soviet and Western, of as much as 300 billion to 500 billion roubles. As long as the overhang remains, removing price controls has the risk of very substantial increases in price levels. So what can be done to deal with this problem of a pent-up rouble overhang?

There are basically two different approaches. The first approach is to eliminate the overhang of roubles by making the accumulated roubles worthless. This can be done either by a burst of hyperinflation which reduces the real value of roubles, in other words just taking off the price controls and letting the jump in the price level reduce the real value of existing roubles, or by an explicit currency reform in which new roubles are exchanged for old. The primary difference between those two is essentially distributional. An increase in the price level eliminates wealth proportionately for all nominal wealthholders, while a currency reform would be done presumably in a redistributional way as it was in the immediate postwar period in the Soviet Union.

Those who advocate one of these two approaches say that much of the accumulated balances in the Soviet Union are the result of illegal activities. These activities are not just illegal in the Soviet sense, in which virtually any kind of market activity until recently was illegal, but illegal also in the Western sense that they reflect theft, extortion, and other things. I'm certainly in no position to judge the truth of that. Opponents, though, of that kind of involuntary elimination of the rouble overhang argue that the criminal component in the accumulation of wealth was really quite small and that eliminating the overhang would certainly be unfair to those who have saved. After all, financial assets are the only kinds of assets that Soviet citizens have been able to accumulate in the past. Consequently, an inflationary increase would wipe out all of their wealth. And, as Governor Crow said, either of these approaches would weaken confidence in the monetary system and, indeed, in capitalism itself. My own sense is that those should be regarded as options of last resort and that it would be far better to try to deal with the rouble overhang without confiscating previous accumulations.

What are the alternatives that I would put under the category of the voluntary absorption of the rouble overhang? The first is to increase the demand for financial assets by making them more attractive. As Mr. Gerashchenko said, Soviet citizens do not currently have a real store of value. They get an interest rate of 2 to 3 percent in an economy in which the inflation rate estimates run from the official 7½ percent to more casual private estimates of significant double-digit inflation. The key, therefore, is to increase the interest rate so that holding roubles becomes attractive. Until now, there has been strong ideological opposition to doing so. I was encouraged by Mr. Gerashchenko's statements that an interest rate increase is now an option that is being considered more seriously. I think it would be very desirable to move toward offering state bonds and longer term time deposits based on a floating interest rate tied to inflation. However, that can only be done after the Soviets have inflation statistics in which the public has some confidence.

But, and this is I think a critical point, if a high enough interest rate could be offered so that financial assets were sufficiently attractive to induce households to hold voluntarily the entire previously accumulated balances, prices could then be decontrolled without any increase in the price level. After that had been accomplished—once the public saw that there were stable decontrolled prices—then the level of interest rates required to sustain those holdings of monetary balances could be reduced. If that could be done, it would certainly be the best approach, and I think it certainly deserves to be a central part of the Soviet strategy.

A second option within this voluntary approach is the sale of government assets, to which both Governor Crow and Mr. Gerashchenko referred. But as Mr. Gerashchenko rightly pointed out, the only way that one can make the sale of apartments attractive is to begin by a radical change in the rents currently being charged for Soviet apartments. I am not very optimistic about either that or the notion of selling shares in Soviet companies. It is not clear what "shares in a company" means to Soviet citizens. How reliable is the notion that they will ever be worth anything? It seems to me the right place to start, if we are going to go down that road at all, is by selling some kind of convertible bond that has a fixed promise to pay, perhaps tied to inflation, with the notion that they might eventually convert into some form of equity ownership.

Finally, there is the option of using foreign resources to absorb the rouble overhang. Those foreign resources could be the result of foreign aid of the sort that the Germans have been providing, or loans from foreign governments, or the receipts from sales of Soviet assets to foreign owners. Those foreign revenues could be used to soak up the existing rouble overhang in two basic ways. One way would be to use foreign revenues to import consumer goods that could be sold at very high rouble prices to Soviet citizens to soak up some of the rouble overhang. Remember, roubles exchange for dollars on the street at roughly 10 or 15 roubles to the dollar so that the total overhang, if Mr. Gerashchenko's 100-billion rouble number is correct, is equivalent to only about $10 'billion. Eliminating that overhang would then permit the freeing up of prices and the moving ahead with economic reform. In addition, if individual entrepreneurial activity in the Soviet Union is now to be legalized, the Soviet government could also permit those small private entrepreneurs to import equipment and machinery for their private businesses. And that too could absorb substantial amounts of the rouble overhang.

I asked myself, perhaps a little facetiously, what is it that we in the United States produce that has the highest potential value in the Soviet Union relative to our costs of production? What would be the ideal good for making available to the Soviet Union as part of a package of loans or financial assistance to help absorb the overhang? I think the answer to that question is currency—$10 bills. A loan to the Soviet government of $5 billion or a sale by the Soviets of $5 billion worth of assets would permit them to absorb 50 billion to 75 billion roubles. Some of that currency would, of course, be converted by the public into goods and would, therefore, have a real economic cost to the provider—the U.S. or other foreign governments. But much of it would be held as a store of value by the Soviets, withdrawing the equivalent amount of rouble overhang with no real cost to the provider.

Let me conclude by emphasizing that although the fundamental problem in the Soviet economy is a microeconomic problem of creating markets and incentives, a prerequisite to that kind of market reform is a sound monetary and fiscal policy to eliminate the budget deficit and to absorb the rouble overhang.