Credibility, the Monetary Regime, and Economic Reform in the Former Soviet Union

Peter J. Boettke

I find myself in substantial agreement with Kevin Dowd's (1993) discussion of money and markets in economic reform. His discussion of the network externality problem with the free banking alternative raises the pertinent theoretical question that advocates of free banking must address in order to make their policy solution more attractive to skeptics. On the other hand, his discussion of the failure of monetary growth rules to provide adequate institutional constraints against the public choice problems associated with government discretion logically point to a market-based monetary regime as the only viable solution. In addition, Dowd raises some very interesting questions concerning possible shortcomings of the currency board alternative for reforming the monetary system in the former socialist economies. In particular, Dowd points out that the currency board would have to develop safeguards "against the danger of political depredation." Historically, currency boards have always been an intermediate step on the way to a central banking system.

It is precisely this point, however, that I think Dowd could stress more forcefully. The issue of establishing a binding and credible commitment to sound monetary policy is not a footnote issue, but is perhaps the central issue in monetary reform.

The Failure of Perestroika

Perestroika as a policy of economic restructuring and renewal failed miserably.[1] The economic crisis that Mikhail Gorbachev inherited

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The author is Assistant Professor of Economics at New York University. He was a 1992–93 National Fellow at the Hoover Institution.

[1]See Boettke (1993) and Goldman (1991) for a general discussion of the failure of the reform effort from 1985 to 1991.

grew more acute and the political system simply fell apart. In large part, the official debacle of the Soviet system was a necessary precondition for fundamental reform to take place. But, understanding the debacle should still be a priority.

Perestroika failed because it was not attempted. From 1985 to 1991, Gorbachev introduced at least 10 major economic programs under the banner of perestroika, but not a single one was ever implemented. Moreover, even the policies that were introduced represented half-measures and incoherent policies. Most of the Gorbachev reforms were incentive incompatible with the development of the economic forces needed to resurrect the Soviet economy. Gorbachev's efforts, however, failed not only because of the incentive incompatibility of most of the reform decrees, but also because of the adverse reputational effect of constantly shifting and changing the status of reform policies. No one was sure whether a Gorbachev liberal zig today would not become a more repressive zag tomorrow, and as a result nobody had any incentive to invest in the official economy.

Nowhere was this felt as directly as in the monetary system itself. The Gorbachev era was characterized by a flight from the ruble. As the official economy sank deeper, individuals selected out of rubles to engage in exchange. Rubles, for a long time externally inconvertible, increasingly became domestically inconvertible as individuals found it more difficult to purchase goods and services with ruble notes at state stores.[2] Hard currency was sought in the black market to expand the array of choices available to consumers, and complicated barter arrangements emerged to coordinate the plans of economic actors. This unofficial exchange system came to dominate the economic landscape.[3] The competitive duality between the official sector and the unofficial sector allowed individuals within a desperate economy to survive—some even to prosper. But, it also convincingly demonstrated the extreme failure of the Gorbachev reform efforts. Individuals preferred to incur the costs associated with a complicated barter system rather than deal with the official monetary system that was no

[2]It was, of course, always the case that a ruble was not always a ruble. A ruble in the possession of a Communist Party official had a much higher purchasing power than a ruble in the possession of Ivan. Thus, despite the slight discrepancy in official income between high officials and average workers, there was quite a discrepancy in the real income distribution in the former Soviet Union. Moreover, in an administratively fixed-price economy it is conceptually difficult to talk about convertibility in a meaningful manner. But, the main point is that under Gorbachev the ruble became even less of an internally convertible currency then it was before.
[3]It was estimated that only 40 percent of food, for example, was obtained through the official distribution system by 1990 (see Peck and Richardson 1991, p. 24).

longer credible.[4] Without a well-functioning monetary system, though, systemic economic reform will continue to be absent.

Centrality of Money

In a monetary economy the generally accepted medium of exchange represents a link in all exchanges. Money, in other words, is one half of all exchanges; that is, it is the joint linking all transactions. This jointness aspect of money translates into the proposition that if policy alters the value of the monetary unit it also changes the pattern of exchanges throughout the economy, distorting the industrial structure and misleading economic actors.

The Bolsheviks knew from Marx that monetary exchange was at the heart of the commodity circulation system. The original Marxian aspiration was to abolish the commodity production system and with it monetary circulation. But, this project in Marxian economic rationalization led to the complete collapse of the economy of Soviet Russia by the spring of 1921, forcing the Bolsheviks to change course with the New Economic Policy (NEP).[5] During NEP, the Bolsheviks even tried to revert to a gold standard to renew faith in the monetary unit with the chervonets reform.

NEP failed because the government backed out of its policy commitment to economic liberalization domestically and internationally. Discretionary action by the Soviet government undermined the monetary system and destroyed any incentive that peasants may have had to market their wares. By the end of the 1920s, the "market" was simply not a secure outlet for economic actors.

The Soviet experience with economic policy provides many important insights, but perhaps none as important as the central role a stable and credible currency plays in economic development. Without such a currency, development of the productive forces of society are thwarted. Recognizing the centrality of the monetary unit in any economic system forces economists to pay particular attention to systemic questions concerning the monetary regime itself and the rules under which it operates as opposed to particular pro- or counter-cyclical policies that are suggested by advocates of either demand-side or supply-side management of the economy.

[4]See Peck and Richardson (1991, pp. 2–3; 29–33; 55; 89) for a discussion of the economic crisis in the former Soviet Union near the end of the Gorbachev period.

[5]See the discussion of the original Bolshevik project in Boettke (1990) and Roberts (1991).

The Credibility Problem

Only if a reforming regime can convince the populace that it will honor its promise to respect their rights and create a stable environment for economic activity, will the economic liberalization reforms ever get off the ground. Conveying such a commitment, however, is the major problem in establishing a workable constitution of economic policy.

One of the major difficulties facing any reforming regime is somehow signaling to its citizens that it will honor its promise of reform and not renege. There are two strategic problems confronting the reforming regime. First, a strategic incentive game is generated by reform proposals. A policy or promise announced at one time may bring forth a response that in the next time period provides one player with a greater opportunity for personal gain by reneging rather than honoring the promise. When I am having trouble falling asleep, for example, I may attempt to solicit my wife to rub my back with the promise, "I'll rub your back, if you rub mine." However, if her soothing back rub produces the intended result, then I will be much better off by reneging than honoring my promise—since I will now be asleep. My wife, of course, knows that I will renege on the promise, and therefore, except for the kindness of her heart, will refuse to believe the promise and not rub my back.

A similar situation faces the government and its citizens when formulating public policy. Without a binding commitment to honor its promise, citizens will realize that the government may gain in future periods by reneging on the policy, and thus will not trust the policy announcements of the government unless the government can establish a binding and credible commitment to the policy.

This problem is compounded when we realize that the situation is not limited to the strategic incentives, but also includes an informational problem that may be even more difficult to overcome. Faced with a reforming government, citizens do not really know who they are playing with. The citizens' only prior knowledge of the regime was the "old way" of doing things. Reform signals a break from the past, but why should citizens believe the regime? Without citizen participation, though, the reforms will stall.

The regime's problem, then, is not simply limited to the difficult problem of solving the basic paradox in establishing constraints on its activities that do not deter its positive ability to govern. In order to get economic liberalization off the ground, the rulers have to simultaneously establish binding constraints on their behavior and signal a sincere commitment to reform to the citizenry. During war, for example, if his troops crossed over a large river to do battle with opposing forces, the commanding officer may order the bridge burned—thus precommitting his troops to the battle ahead by eliminating the only possible escape. At the same time, however, opposing troops witnessing the smoke have received a signal that the other side will fight a hard battle. The reforming regime must do something similar to the commanding officer's burning of the bridge to establish trust and bind itself to the liberalization policy. If it does not, then neither domestic citizens nor foreigners will have much of an incentive to invest in the economic future of the region.[6]

Monetary Regimes and Credibility

Economic liberalization demands a convertible currency. One of the main problems of the transition of the former Soviet economy to a market economy lies in the inconvertibility of the currency. A market economy requires a widely accepted medium of exchange that can purchase goods and services on the domestic market (internal convertibility), and that is easily converted into foreign currency (external convertibility) at free-market rates. The reality of the Soviet economy under Gorbachev was that the ruble was neither internally nor externally convertible. Despite the wide variety of proposals for ruble convertibility, most have in common the reliance of a central banking system to institute the reform.

Successful monetary reform, however, can be nothing short of complete depolitization of the monetary system. The reasons for depolitization of the monetary system are straightforward. Depolitization of the monetary system eliminates the inflationary ability of the government and forces government to either borrow in the capital market or raise revenues through taxation to finance its affairs.

[6]Dani Rodrik (1989) has addressed the issue of commitment signaling with regard to policy reform in a game-theoretic framework. As he sums up his argument: "At the outset of any reform, the public will typically be unable to fathom the true motivations of the government undertaking the reform. Since the distorting policies in question have been put in place by those in power to begin with, what reason is there to believe that the authorities now 'see the light'? . . . Signalling via policy-overshooting can then help reduce the confusion. . . . The more severe are the credibility problem and its consequences, the more likely it is that a sharp break with the past will be viewed as attractive" (p. 771). Therefore, if the credibility gap is particularly important, as it was in the Soviet situation, all notions of gradualism must be put aside for the appropriate signal to be conveyed. Policy overshooting can distinguish a sincere reform government from its insincere counterpart. Thus, policy overshooting will have the effect of rendering the policy reform more credible than it otherwise would be, and alleviate the problems associated with lack of credibility.

The logic of the depolitization of money is also fairly straightforward.[7] The market for monetary services is no different than the market for other commodities. There is no need for government to "manage" money. Rather than a regulated banking system based on central bank monopoly note issue, a more viable alternative can be found in an unregulated banking system of competitive note issue.

The fundamental problem with central banking, however, is not the problem of political manipulation of the monetary unit. The real problem is that central banking presupposes the capability of state authorities to access information that is neither in their interest nor ability to gather.[8] For central banking authorities to manage the supply of money accurately, they would have to possess knowledge of the conditions of supply and demand that is not available to any one mind or group of minds. Both the political and economic problems of central banking are inherent in the institution itself.

Competitive note issue will set in motion an entrepreneurial process that will adjust supply decisions of bank managers to meet the public's demand for monetary notes. The clearing mechanism under free banking will ensure that managers will receive the appropriate signals for effective resource allocation. The clearing mechanism provides signals concerning debit and credit that follow from the bank's under- or overissue of notes. This information will cause bank managers to adjust their liabilities accordingly. Moreover, in a free banking system of competitive note issue, the return of notes and checks for redemption in base money will also provide incentives and information that is vital for the proper administration of the money supply. Monopoly note issue by a central bank simply cannot generate the incentives or information required to adequately manage the money supply. Central banks are not well equipped to know whether an adjustment in the supply of money is needed; nor are they well equipped to assess changes in the demand for notes.

Competition in note issue, however, promises all the same benefits that competition in any other commodity does. The availability of

[7]See the discussion of free banking theory in White (1989) and Selgin (1988). For a historical discussion of the operation of a free banking system, see White (1984). A key episode in White's discussion of the Scottish system is how the banking system handled the Ayr Bank failure of 1772. As White points out, the Ayr Bank, which was in operation from 1769 to 1772, engaged in reckless management and extended a great deal of bad credit through note issue. The bank's failure also led to the failure of eight other private bankers, but it did not threaten the financial system as a whole. The note exchange system that emerged in the Scottish system served as an important check against overissuance by a single bank and provided market incentives to discipline those that attempted to engage in overissue of its notes through the law of reflux (White 1984, pp. 30–32, 126–28).

[8]For a discussion of this problem with central banking, see Selgin (1988, pp. 89–107).

substitutes will force bank managers to act prudently in forming their business decisions. Brand names will be important in the competitive process as some bank notes will become more respected than others. But as long as freedom of competition persists, then an effective administration of the money supply will result.

In the current situation of the former Soviet Union, the ruble has become basically worthless. The Russian Republic is running its printing presses 24 hours a day. Free banking offers an alternative to this monetary chaos.

Banks could offer notes backed by hard currency or some bundle of commodities or gold.[9] The banks would offer deals on ruble exchanges to attract customers. Individuals would gravitate to bank notes that were most widely accepted for market transactions. Central bank rubles would disappear, as would the institutional organs of central banking, but monetary order would emerge and the money supply would be free of the manipulation of the political process.

One final note: free banking offers an answer to the policy dilemma highlighted above concerning commitment conveyance. Eliminating government control over the money supply not only precommits the regime, it also signals to market participants that the government is sincere in establishing restraints on government's leading role in the economy. It will take such a drastic step—policy overshooting—that signals binding constraints on government action to get economic liberalization policies on the right track. Allowing competitive note issue under a regime of free banking offers the best chance for achieving the simultaneity required for conveying and establishing a credible precommitment to liberal economic reform.

Conclusion

Liberalization requires a transformation of the previous institutions and practices of the "old regime." The monetary system is central to any economic system, and, therefore, represents the most fundamental focal point of economic policy. Depolitization of the monetary system offers the best chance for the emerging market economies of Eastern Europe. Competition in note issue is not only a theoretically viable system; it represents a practical solution to the problem of precommitment and signaling that government's discretionary role in the economy has been constrained in a credible manner.

[9]A private currency board, therefore, could represent a viable alternative. But, a government-run currency board possesses severe theoretical and practical shortcomings.

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