

# Market-oriented Economic Reforms in Russia and Its Impact on Russian-Japanese Relations

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## 1. The failure of a "Bolshevik" Approach in Radical Reforms and Liberalization Programs

We are living at a time when drastic changes are occurring in the overall geopolitical environment.

The Soviet Union does not exist any longer. The new Commonwealth of Independent States (CIS) formally includes 11 out of the 15 former Soviet republics, but it is, as yet, a newly-born baby, very weak, torn apart by serious controversies of a military, political, economic and ethnic nature.

Will it survive? At the moment, it is extremely doubtful that it will.

Member-states of the Commonwealth are still kept together by strong economic ties, but more and more, they are moving towards establishing separate currencies, separate banking systems, separate customs and, most importantly, separate armies.

Whatever happens to the Commonwealth, Russia remains a reality and, in the context of Asia-Pacific security and economic cooperation network, perhaps is the only reality inside the Commonwealth which counts.

For the most part the Russian Federation receives most of the world community's political attention. Only Russia is able to act as the real heir to the former Soviet Union being a nuclear power with a closely integrated scientific potential; only Russia is capable of assuming responsibility for all the Union's international obligations.

The Russian Federation, which is, perhaps, the only republic within the Commonwealth that has really started market-oriented reforms, is currently facing grave domestic economic, political and social difficulties. This poses a serious threat to President Yeltsin's leadership.

Theoretically, a large part of the economic

problems the "reformer government" will face in the first 12-18 months from the start of its stabilization program (January, 1992), are standard by nature and can be enumerated today. They are:

1. Price reform in conjunction with increased domestic and external competition;
2. Profound financial stabilization which implies reduced budget expenditures and a tough monetary and credit policy;
3. Ownership reform, involving the rapid privatization of retail trade and small enterprises as well as commercialization of large, state-owned enterprises;
4. Agricultural reform with the introduction of private ownership of land;
5. Full-scale program of military production conversion;
6. Substantial liberalization of foreign economic activities.

Other required measures include 1) completion of the legal framework for a market economy, 2) creation of a market system for banking and finance, 3) reconstruction of transport and communications infrastructure, 4) development of a system of labor relations and 5) programs to address social and environmental problems.

The former Soviet administration under Gorbachev spent much of the six years in power unsure of whether they really wanted to create a market economy. The economy was on a singular path to deterioration. Finally, incoherent and "wait-and-see" economic policy led to a full-scale crisis. The year of 1991 has shown the worst results of economic performance since the end of World War II, with a two-digit reduction of GNP and national income.

So, it is only natural that the new "reformer government" under Yeltsin was very much eager to speed-up market-oriented reforms so that they could be seen as an

irreversible break with the past and so that the process could gain an unstoppable momentum. Any delays or suggestions for a more cautious approach were ignored on the assumption that it would lead to an even greater and more prolonged decline in the Russian economy.

Undoubtedly, the Russian government should be duly appreciated for its strong desire to implement market reforms unhesitatingly. But to do so, the necessary prerequisites are as follows: a clear-cut program of action, proper sequence of market-oriented reforms, efficient mechanism of implementation, reliable statistics and, what is the most important, popular support. All this is lacking in present day Russia.

First of all, the conceptual framework of the transformation process to a market economy was designed under the strong influence of the classic recommendations of the International Monetary Fund (IMF). Contacts with the Russian Federation's government developed rapidly following the establishment of Special Association between the former USSR and the IMF, in October 1991, which authorized the IMF to extend the undertakings that the IMF had made toward Russia. These undertakings included the conduct of "reviews of the economy and economic policies...", and the readiness of IMF staff "to monitor the implementation of the economic reform program and to prepare related reports"<sup>11</sup>. But the advice of the IMF experts, undoubtedly the most well-intended, did not prove to be universally applicable, especially in a country like Russia with a deeply rooted anti-market psychology.

Western efforts to help Russia move to a market economy have been dominated by American economists and consequently "too much stress is placed on the effectiveness of market forces"<sup>12</sup>. It is quite understandable that since the breakdown of the communist system in the former Soviet empire the widespread "rejection symptoms" were commonly seen among people who have tended to think that everything socialistic is bad.

The Russian government has run now into another extreme, which is best described by professor Tsuneaki Sato of Nihon University (Tokyo) as a kind of reversal of a "Bolshevik"<sup>13</sup> approach to radical reforms as

if they were trying to build a capitalist market economy as quickly as possible, just as the Bolsheviks had tried to build socialism in a short span of time regardless of the consequences involved<sup>4</sup>.

The experiences gained during half a year of initial efforts seem to have clearly shown the negative consequences of this "Bolshevik" approach under which too much weight has been placed on monetarist "shock therapy", financial stabilization coupled with restricting macro-demand, while paying too little attention to the "real economy" aspect which is an indispensable element for any stabilization policy.

The introduction of a tough deflationary policy package aimed at stabilizing the monetary system under the real conditions of continued recession was inevitably followed by an exceptionally sharp fall in the production and living standard.

Russia has no reliable statistical data at this time. Figures published by State Statistical Committee, Statistical Service of the Parliament and numerous independent survey agencies differ greatly. Nevertheless, we still can determine general trend.

According to the governmental (official) figures, the decrease in industrial output in the first half of 1992 was about 17-18%, while the speaker of the Russian Parliament R. Khasbulatov considers it to be not less than 30-32%, and estimates it may well reach some 50% by the end of 1992 as compared with the previous year. What is more important, the sharp fall in production has spread to the daily necessities with a 28% decrease in food production, including 34% in production of meat and milk<sup>5</sup>.

The liberalization of prices which took place in January 1992, was inevitably followed by their sharp rise. In Russia there is still no large private sector in production able to quickly increase supply and bear high prices. Most of the production and distribution is monopolized by big government factories and business organizations who, taking advantage of shortages in the economy, have increased prices by 10 to 15 times on the average in one month only, while wages and salaries have only doubled. As a result, the population at large has become impoverished, nearly 90% of it is below the subsistence, or



poverty level.

Economic "genocide" of the population was followed by an artificially imposed crisis of cash money, which resulted in further destruction of horizontal ties between enterprises. Their mutual indebtedness reached 2.5 trillion rubles (as of July 1, 1992)<sup>6)</sup>. Delays in payment of wages and pensions became a wide-spread phenomenon. Only in May of this year such delays amounted to 78.5 billion rubles out of 272.3 billion rubles due for payment. Well-known Russian economist academician N. Petrakov rightfully describes it as the most uncivilized and illegal form of freezing incomes of the population<sup>7)</sup>.

The macroeconomic consequences of the "Bolshevik" attack on financial stabilization proved to be totally bleak: industrial stoppages, falling business discipline, low labor moral, sharp contraction of industrial supplies from abroad and politically unstable regions inside Russia, conscious and unconscious destructive actions taken by many local authorities (for example, introduction of their own surrogate money or refusal to transfer taxes to the central budget), an explosion of various crimes, heavy slowdown of investment in machinery and equipment, and sky-rocketing inflation—this is the real present-day picture of Russia. The situation is expected to deteriorate further along with the anticipated growth of unemployment up to 2 million by the end of this year and 5 million people in 1993<sup>8)</sup>.

## 2. Growing Social and Political Tension.

Under such economic and living conditions the discontent of the population is strong and widespread, there is a general loss of confidence in the "reformer government".

Frankly speaking, politically Russia is now extremely unstable. In spite of his remaining popularity (35% in June ratings) Yeltsin's position inside the country is not very strong. The ratings of his "reformer government" are much worse, less than 10%. Of course, Yeltsin now has Western support as Gorbachev did. But Western support did not help Gorbachev retain his power.

Russia is no longer a country dominated and ruled by the Communist Party, whose activity is currently prohibited by Presidential Decree. It is difficult to place the country

into any definite socio-political category, as yet. There is practically no discussion nowadays about the ultimate goal of transition, namely about the economic system to be created as a result of the transformation.

President Yeltsin's administration is clearly not yet democratic, but should be characterized rather as a bureaucratic autocracy. It is largely ruled by former communist bosses and former Soviet bureaucrats who have shed their communist ideology and are rapidly integrating into a system of perverted state capitalism. This new elite, as a rule, is extremely corrupt but, what is more important, at the level of local authorities there is no clear understanding of how a market-oriented and democratic system operates. It is making the country a continuous mess. In the near future the Yeltsin's administration will probably evolve towards even more autocratic forms of government.

President Yeltsin faces strong opposition to his regime. The opposition comes from different quarters:

- The left-wing, represented by a number of newly formed parties, Communist and Social-Democratic, whose main concern is to preserve what remains of socialism and prevent a complete capitalist transformation;

- The nationalist, or "Russian Patriotic" parties and groups whose main purpose is to retain as much of the former Soviet Union as possible, and to prevent the further disintegration of Russia as a great power;

- The military, represented by a large number of generals and top officers, whose main aim is to preserve a strong military force that is able to maintain order and Russian power in most of the Commonwealth.

In the eyes of the opposition, Yeltsin's current policies are contrary to these aims. He is giving away too much, including territory, to the other republics. He is not standing firm on preserving the interests of the army. He is about to cede territory to foreign powers. In short, the opposition sees Yeltsin as continuing in the same "destructive policies" of his predecessor, Gorbachev.

Prospects for President Yeltsin's leading position in domestic political scene will crucially depend on the development of the economic situation in Russia. It is now clear that the short and medium-term outlook for

the Russian economic recovery is rather pessimistic. In any case the Russian Federation will not be able to avoid further deep cuts in production for the coming 1-2 years.

I maintain that the stabilization of the Russian economy is an attainable objective. But sober reconsideration is required concerning some aspects of the initial concept and strategy of the transition. Obviously, it is a long, long way to go to build a workable market infrastructure. Taking into account Russia's specific economic background, I believe that a big portion of the public sector should be retained on which an effective macro-economic regulation is exercised with due attention to socio-economic values and priorities.

Recently (July 30), the Russian government adopted "The Program of deepening of economic reforms", which recognizes that the year 1992 will be the most difficult for the economy. This medium-term Program proceeds from the assumption that in 1992-1993 the monthly rate of inflation will be reduced to 3%, 30% of industrial assets will be privatized and the ruble will become a stable legal tender which is indispensable for moving on towards a market economy. The ultimate goal of the Program is the "revival of the economy", which is considered to be the achievement of no less than 60% of its privatization by the 1996<sup>9)</sup>.

In view of the failure to achieve the major objective of the first stage of reforms, namely financial stabilization, experts have come to the conclusion that this second stage actually means a change in economic policy: tough monetarism is replaced by inflationary stimulation of production.

Despite rather pessimistic or even dramatic short-run prospects for the Russian economy, there are some long-term positive elements emerging. The move towards market relations and economic liberalism, in fact, has already begun, though the weakness of executive power and the absence of a detailed program of action, which could be accepted by all major political and economic forces, make this process disorderly and painful.

### **3. Moscow and Tokyo : Is Reconciliation Possible ?**

The domestic economic and socio-political

situation influences Russian-Japanese relations in many ways. Unhappy with the results of the Tokyo summit in April 1991, at which Gorbachev merely left the door open for future talks, Tokyo officialdom is wary of Moscow's possible end run around the issue of territorial settlement.

Irrespective of any new trend in Soviet or Russian foreign policy since 1985 relations with Japan traditionally prove to be a most hard case for Moscow. April 1991 turned out to be the first and unique diplomatic fiasco of Mikhail Gorbachev. After the aborted putsch in August changing Russian attitudes toward Japan raised certain expectations for normalization between Moscow and Tokyo, but a lack of a visible progress at bilateral consultations since October has cooled down initial enthusiasm. Now Russia hopes to reverse the trend through the visit by President Boris Yeltsin in September and does not conceal her calculations to arrange a historic turning point in Russian-Japanese relations.

There is no doubt that the Russian democratic revolution has created better conditions for the debate on Japanese claims. Unlike Mr. Gorbachev, who was unwilling to even discuss the problem, Mr. Yeltsin was one of the senior Soviet politicians to propose any option to settle the dispute. Though his five stage plan announced in January 1990, is too vague in its final details, and has not impressed either Moscow or Tokyo authorities, it remains the only option proposed by a Russian opinion leader, and till now any new idea of making a deal with Japan is presented in Moscow as an alteration or adaptation of the Yeltsin plan for new political conditions.

After August 1991 the diplomacy of the Yeltsin administration scored another point with an open address on the issue of Northern territories declaring a chance to accelerate implementation of the five stage plan and a solution of the territorial dispute on principles of "justice and international law", though the meaning of the formula was not officially revealed. Certainly this initiative was a great step forward replacing Gorbachev's mistaken tactics to use nonexistent Japanese economic interests in Siberia to shelve the territorial dispute.

The new Russian leadership, including the Ministry of foreign affairs, seems to take the



position that the territorial issue should be settled relatively soon. Negotiations have started. They will not be easy. President Yeltsin is scheduled to come to Japan this September. Will the territorial issue be prepared for solution by that time? It is hard to answer that question definitely. Both sides have lost a lot of time since Gorbachev's visit to Japan. The time could have been used for more productive mutual discussions through normal diplomatic channels.

Evidently, the new Russian approach could have been accepted only as an indication of some substantial changes taking place, but it absolutely is not enough to ensure the success of the September visit. After the initial euphoria in September-October 1991, the Japanese foreign ministry has already begun to display their displeasure with the hollow results of any Russian-Japanese diplomatic meetings since October.

What may be a solution for the time being is the "Kunadze line", ideas advocated by Russian deputy foreign minister George Kunadze responsible for Asia-Pacific policy. His proposals elaborated when he was a senior Japanese expert in Moscow think tank of the IMEMO (Institute of World Economy and International Relations), provide for recognition of the 1956 Soviet-Japanese Joint Declaration including the clause on transfer to Japan of Shikotan and Habomai after a Peace treaty is signed, and initiation of talks over Kunashiri and Etorofu with a deadline clearly set. In case Russia and Japan fail to reach agreement during negotiations, the issue is to be submitted to the International Court in the Hague with both nations accepting any resolution passed. In both Tokyo and Moscow the proposal is known as the "two plus alpha" notion.

The "Kunadze line" is *de facto* accepted by the Russian foreign ministry as a guideline and seems to be adopted as a basic idea in preparations for Yeltsin's visit. In that case minor discrepancies with the Japanese approach remain.

Though Tokyo recently softened its demand for immediate return of all four islands under dispute and is ready to consider a stage-by-stage scenario including implementation of the 1956 declaration as an initial step, it insists on Russian recognition of

Japanese residual sovereignty over all the claimed area<sup>10</sup>). Therefore, for Japan, a subject for further discussion should be determined as terms and conditions for physical acquirement of islands, while Dr. Kunadze still puts Japanese sovereignty over Etorofu and Kunashiri under question.

Meanwhile, larger political uncertainties still exist. Yeltsin's stand on the Southern Kurils may not be viewed as consistent. As soon as he rose to power in Russia in 1990 he irritated Japan on his trip to the Kurils, stating that the islands under claim are Russian territory, and he does not plan to give them up. In the middle of preparations for his trip to Tokyo he said in Barnaul city (South-East Siberia) in May: "I never said we'll give up the Kurils. The problem may be settled in twenty years".

A combination of factors may explain the inconsistency by Mr. Yeltsin.

In Russia there is still a strong popular opposition to returning the four islands in dispute to Japan. It is supported by the patriotic parties who are contesting Yeltsin on a wide range of political and economic issues.

On one hand Yeltsin desperately needs Japanese economic assistance and her participation in Western joint efforts to support Russian democracy.

These days Russian envoys are trying to convince the Western powers and Japan that it is indeed in their interest to rescue the drowning Russian economy.

Considerations that should encourage developed countries to enter into such interaction are far from being philanthropic. We are now facing a historic opportunity to seal the end of the Cold War and to establish more firmly the new international order. The leading western states should proceed from the assumption that only through transformations aimed at creation of a market economy and a democratic political system would Russia be able to become an equal and stable party to the international community, that serves the strategic interests of the West itself to provide reliable security.

The problem of economic assistance to the former Soviet Union has already revealed some sources of tension among the coalition partners in the mighty G-7. In the US and Europe today the question of substantial

Russian aid seems to be not so much whether, but how. In the Munich summit there was a spectacular change in basic US strategy since the previous summit a year ago. Bush finally started to commit himself fully to Yeltsin's struggle, fearing that the lack of Western-bloc aid will lead to another failure in Moscow's reform plan<sup>11</sup>.

Although Tokyo no longer sticks to outright opposition, it remains very cautious in providing economic aid to Russia.

At present, it seems that Japan may risk international isolation in facing this challenge to assist market-oriented economic reforms in Russia. Now even Japanese specialists admit that on aid to Russia, Japan faces isolation, largely because the US increasingly supports giving money to help achieve president Boris Yeltsin's reform plans<sup>12</sup>.

The dilemma for Japan is that foot dragging on Russian economic aid will look like another act of national indecision and selfish unwillingness to share the burdens of international security. On the other hand, Japan is obviously reluctant to weaken its hand in bilateral negotiations with Russia by surrendering its strongest economic cards.

The dilemma for Russia is that the development of Russian Siberia and the Far East requires abundant capital, advanced technology and skilled labor. These are not available in the Russian Far East, nor can the central government afford them. In the process of market economic reforms now underway in Russia, local authorities are encouraged to meet their respective local economic needs.

On whom then can the Russian Far East count? It is not likely to be the central government. More likely it will be its economically prosperous neighbors, first of all Japan, South Korea and Taiwan.

In view of this economic reality, the Russian leadership seems to realize that the only viable way to develop Siberia and the Far East is to make the best use of the economic dynamism of the Asia-Pacific region. It is widely acknowledged now that the development of natural resources and upgrading of industrial structure of Siberia and the Far East in an environmentally sustainable manner will depend crucially on the economic assistance and direct participation of Japan,

ROK and other Asia-Pacific countries.

There is also a strong domestic political aspect to impart a dynamism to international cooperation of the Far Eastern economic region. If it fails to attract financial resources, advanced technology and managerial skills of the Asia-Pacific countries, there will be a real danger of bolstering a separatism movement in the Russian Far Eastern region with already existing proposals to create an independent Far Eastern Republic and other independent provinces. This would be a completely new "ball game", which could only complicate and destabilize the whole international situation in the region.

But much in Russian domestic politics stands against reaching any territorial compromise. Similar to the Gorbachev era, pro-Western actions of Russian diplomacy like sanctions against Libya and Yugoslavia become objects of increasing attacks from conservative opposition. Bearing in mind that a territorial deal with Japan is strongly opposed not by conservative communists and nationalists, but by centrist factions and some democrats, fears of Russian foreign policy being rejected by a majority of the domestic political sector is an important factor to pay attention to.

Once again it was shown at a special hearings in the Russian Parliament (July 28, 1992), devoted to the problems of Russian-Japanese relations with particular emphasis on the territorial issue. I was invited to this hearing as an expert and received a strong impression that they were designed by still influential "nomenclature of the Cold War" with the aim of holloing out the forthcoming visit of President Yeltsin to Japan and to prevent him from making any territorial concession. As before Gorbachev's official visit to Japan, they aggressively speculate that a concession to Japan would open up a Pandora's box of territorial claims from other countries (including the successor states to the USSR) and from within the Russian Federation itself<sup>13</sup>.

The issue of Russian public opinion allegedly opposing any territorial transfer is much exaggerated by politicians in Moscow, but recent trends in this field are not so helpful for a rational choice. Data of a poll organized in May by the Center of comparative social studies in Moscow suggests that the Russian



public is more afraid of a possible domestic political destabilization if the Southern Kurils are returned to Japan, rather than opposing such an option per se. Simultaneously, the public option makes a distinct linkage of territorial solution with economic benefits for Russia, and chances for the latter are assessed as very low under any scenario. Therefore, improvement of Russian-Japanese relations is regarded as having little to do with economic needs, and thus an object for an affordable sacrifice to keep territorial card for the future. These attitudes certainly are not an obstacle to finding solutions, but indicate that Mr. Yeltsin may not hope to improve his deteriorating domestic image through making a deal with Japan.

On the other hand he shares Gorbachev's legacy in having Japan as the only major Western nation with which neither have yet scored any important diplomatic results after radical improvement in relations with the West, and Yeltsin's possible failure in September may add much to his image of a politician rapidly repeating Gorbachev's pattern of political inefficiency.

So far preparations for the presidential visit to Tokyo were guided by a "two islands plus alpha" notion, but a final decision by Mr. Yeltsin has not yet been announced. With all the pros and cons a possibility of elaborating new orientations a few days before leaving for Japan may not be ruled out. The issue is pending on Yeltsin's personal decision affecting much more than islands under dispute. Once more it is an issue of choosing domestic political alliances.

Regardless, a Peace treaty providing for the return of four disputed islands has no prospects of being ratified by today's parliament, making the most hopeful achievement in Tokyo limited by provisions of the 1956 Soviet-Japanese joint declaration asserting return of the two minor islands, as it is already ratified by the Soviet Supreme Soviet.

But one should not deceive oneself. The worse the economic situation in Russia becomes, the greater the probability of a

social explosion, reducing the chances that Yeltsin would risk returning the islands to Japan. A wise new initiative may involve first giving a strong helping hand to Yeltsin.

We believe that Japan will play a leading role in forming the new world order, due to the magnitude of its economic potential and its large external surplus which, in the long- and medium-term is a source of major influence on global economic dynamics.

To do the right thing, the Japanese government must now reassess its traditional position that the reversion of sovereignty over the Northern territories is a prerequisite for any large-scale economic assistance. There may be other ways for walking through the door left open after the 1991 Tokyo summit.

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#### Notes

- 1) *Economic Review : Russian Federation*. International Monetary Fund, Washington D. C., 1992, p. 1.
- 2) *The Nikkei Weekly*, Week Ending June 20, 1992, p. 3.
- 3) "Bolsheviks" is the name for hard-line communists who dominated the former USSR since the October Revolution, 1917.
- 4) Tsuneaki Sato. "The Role of "Public Factor" in the Transformation Process to a Market Economy in Central-Eastern European Countries and CIS : A Reconsideration from a Japanese Perspective". Based on the lecture the author gave in Praha, Bratislava, Budapest, Sophia and Moscow, March-May, 1992.
- 5) *Moscow News*, N 28, July 12, 1992, p. 16.
- 6) *Commersant*, N 27, June 29-July 6, 1992, p. 2.
- 7) *Moscow News*, N 28, July 12, 1992, p. 16.
- 8) *Commersant*, N 27, June 29-July 6, 1992, p. 24.
- 9) *Ibid.*
- 10) *The Japan Times*, July 17, 1992, p. 1.
- 11) *The Nikkei Weekly*, Week Ending July 4, 1992, p. 23.
- 12) *Ibid.*, p. 1.
- 13) Peggy Levine Falkenheim. "Moscow and Tokyo : Slow Thaw in Northeast Asia". *World Policy Journal*, New York, Winter 1990-1991, p. 167.