Beyond a Bailout: Time to Face Reality About Russia's "Virtual Economy"

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The proximate causes of Russia's current financial crisis—the government's large budget deficit and the inability to service its debt, especially short-term dollar liabilities—are clear. The steps required to solve these short-term liquidity problems would seem to be equally straightforward and are being widely proposed. For its part, the Russian government is being called upon to reduce the budget deficit by collecting more taxes and cutting back on government spending. The international financial organizations and the Western nations, on the other hand, are being urged to craft an emergency loan package that would possibly include funds to stabilize the immediate financial situation but certainly a program to restructure Russia's debt for the longer term. These measures, it is argued, would allow the reformist government to get back to the business of market reform.

The idea that Russia's economic problems can be remedied by such measures is wrong. It is premised on a fundamental misunderstanding of the Russian economy, but one which is a near-consensus view. It goes something like this. Russia is a largely privatized economy whose early success in market reform has been slowed by widespread corruption, crime, and incompetence. The explosion of barter and non-payments is due to inept and immoral enterprise management. Poor tax collection has produced a weak state. Overcoming these obstacles is a formidable challenge. But if they can be surmounted, movement towards the market can continue.

In fact, most of the Russian economy has *not* been making progress toward the market, nor even marking time. It is actively moving *away* from the market. Over the past six years of "radical reform," Russian companies, especially those in the core manufacturing sectors, have indeed changed the way they operate. Only, they have not done so in order to join the market but rather to protect themselves against it. What has emerged in Russia is something that arguably qualifies as a new type of economic system with its own rules of behavior and criteria for success and failure.

We call the new system Russia's "Virtual Economy," because it is based on illusion, or pretense, about almost every important parameter of the economy: prices, sales, wages, taxes, and budgets. At its heart is the ultimate pretense that the Russian economy is larger than it really is. It is this pretense that allows for larger government, and larger expenditures, than Russia can afford. It is the cause of the web of non-payments and fiscal crisis from which Russia seemingly cannot emerge.

Below, we suggest the extent of the Virtual Economy and explain its roots. We also show how it helps explain some features of the current political process in Russia. The Virtual Economy, we argue, is robust, deep-rooted, and enjoys strong popular support. For those reasons, it has defined a new "reform" agenda for Russia that is already setting the tone for the current government. It will most certainly do so for a future one.

The Virtual Economy presents the West with difficult choices regarding continued support of Russian economic transition. The principal motivation for providing more emergency funds for Russia, a "bailout," seems to be a belief not only that more money is required to preserve social and political stability, but also that it can be given with strings that will induce more reform. We believe that the opposite is true: the inevitable outcome of a bailout will be to support the Virtual Economy, a system that is nonmarket in nature and whose inefficiency will ensure continued economic decline and future crises. At

best, a bailout will merely postpone the day of reckoning. When that day comes, the economic consequences and political backlash will be even stronger than they might be today.

REALITY AND PRETENSE

The widespread pretense regarding the Russian economy is apparent if one looks closely at economic statistics. The national statistics agency reported a growth in industrial output for 1997 (as it did a slight increase in GDP). After eight years of decline, industrial output was up by 1.9%. But it's very misleading to stop there. Real profits in industry were down by 5% last year. By now, the share of industrial enterprises that reported losses is almost half—47.3% to be exact—up from less than 27% two years ago.

Something else that reflects the economy's true state is the level of fixed capital formation. It dropped again last year, for the seventh year in a row (and continues to decline this year). In 1997, the overall level of capital investment in the economy's production sectors (industry, agriculture, transportation, and communications) was 17% of what it was in 1990. In the core manufacturing sector of metal-working and engineering products, the volume of real spending on plant and equipment in 1997 was no more than 5.3% of the 1990 level.

Very few negative signals are being sent about this state of affairs. Bankruptcy is still a rarity. There were more corporate bankruptcies in the U.S. in the past four weeks than the entire last year in Russia. It would thus appear that despite the obvious lack of success, nothing is changing in Russian industry. Yet, that is not true, either. The companies are not withering away, or are even merely moribund. They ended the year of 1997 with more workers than at the beginning.

On top of all this is the notorious "nonpayments" or "payments arrears" crisis. The way this story is reported is a familiar one: The enterprises don't pay their suppliers; they don't pay their workers; they don't pay their taxes. While the nonpayment of taxes and wages attracts media attention, it is in a sense not the real story. Payments *are* being made, just not in actual money. The share of barter in payments among all industrial enterprises in Russia is now above 50%. Last year, 40% of all taxes paid to the Russian federal government were in nonmonetary form. The degree of nonmonetization of local and regional budgets is even higher.

The phenomena described above are most prevalent in the large enterprise sector. A Russian government commission last year reported that the country's largest companies conducted 73% of all their business in the form of barter and other nonmonetary forms of settlement. Even more remarkable was the way these large enterprises dealt with the tax authorities. To the federal budget they remitted 80% of the taxes they owed—not a terribly bad figure—but the proportion paid in cash was only 8%.

The following sentences from the report sum up the commission's own conclusions about the current Russian economy:

> An economy is emerging where prices are charged which no one pays in cash; where no one pays anything on time; where huge mutual debts are created that also can't be paid off in reasonable periods of time; where wages are declared and not paid; and so on. [...] [This creates] illusory, or **virtual** earnings, which in turn lead to unpaid, or **virtual** fiscal obligations, [with business conducted at] nonmarket, or **virtual** prices.[1]

In short, what has emerged is a "Virtual Economy."

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[1]Report of the Inter-Agency Balance-Sheet Commission, P. A. Karpov, chairman, Moscow, December 1997 [emphasis added].

THE ROOTS OF THE VIRTUAL ECONOMY

The roots of the Virtual Economy lay in the largely unreformed industrial sector inherited from the Soviet period. At the heart of the phenomenon are the large number of enterprises that still produce goods but destroy value. This is a sector of the economy that has survived six years of market reform. The reasons are complex, but the most important is that in Russia today enterprises can operate without paying their bills. This is possible because value is redistributed to them from other sectors of the economy. One way this is done is through tax arrears, which are in effect the continuation of budget subsidies in a different form. More important, however, is direct redistribution of value to value-subtractors from the value-producing sectors of the economy, primarily the resources sector.

It is important to understand the continuity with the past that is involved here. The Soviet economy appeared to be a large industrial economy. In fact, industry in the Soviet economy was subsidized by under-priced raw materials and insufficient charges for capital. The economy appeared to have a large manufacturing sector that produced value; in fact, manufacturing destroyed value, but this was masked by arbitrary pricing. The roots of the Virtual Economy lie in the maintenance of this pretense.

A SIMPLE ACCOUNTING MODEL

The simplest way to understand today's Russian economy is to imagine that it consists of only four sectors.[2] First, there is the household sector. It supplies labor. Second, there is a government, or budget, sector that transfers tax receipts to the households. Third, there is a value-adding production sector (we call it "Gazprom" for short). We designate these three, respectively, "H" (for households), "B" (for budgets), and "G" (for Gazprom). Finally, there is a fourth sector, a value-subtracting manufacturing sector, "M", that encompasses all the rest of the economy (speaking somewhat loosely—but not very).

Think of M as a single plant that takes 100 rubles of labor from H and 100 rubles of gas from G and makes a product worth 100 rubles. It subtracts, or destroys 100 rubles worth of value. But it pretends that it is a value-adder. To do that, it overprices its output. It claims it is worth not 100, but 300. And everyone else accepts that pretense. They do so because they can use the overpriced output in barter trade with one another (where prices have no meaning) or to pay their own taxes.

M pays G for the gas by giving it one-third of its final product, claiming it is worth 100 rubles. (In market terms, it is worth only 33 1/3.) That is fine with G, since it merely passes the product on to B in fulfillment of its tax obligation. (We assume a 100% tax rate on value-added.) M, of course, pays its own taxes—100 rubles—in kind as well.

Problems begin to arise only in respect to the households. H expects to be paid 100 for its labor, but cannot accept in-kind payment. It needs (at least some) cash. But the cash value of M's remaining product is only 33 1/3. Hence, "wage arrears."

This model of course is highly stylized. But despite its simplistic nature, it is remarkable how much of the contemporary Russian economy it manages to capture. Beginning with the scheme outlined above and making a few additional assumptions, the model generates nearly the entire Virtual Economy: not only the wage arrears, but also the unrealistic budget, the pension arrears, and the apparent increased output.

Equally important, the four-sector accounting model immediately suggests the utility or futility of various policy measures. Take, for instance, the IMF-dictated tax collection crackdown. The Russian government has been under pressure to increase the amount of cash to the budget and is therefore

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[2]The following section is based on Clifford G. Gaddy and Barry W. Ickes, "A Simple Four-Sector Model of Russia's 'Virtual Economy'," Center for Social and Economic Dynamics, The Brookings Institution, May 1998.

demanding that enterprises settle their tax debts in cash, not in kind. The model makes it clear that such an approach can only mean shifting a given amount of value—too small already to satisfy claims by both budgets (taxes) and workers (wages)—from one recipient to the other. One's gain is the other's loss. If taxes are paid, wages won't be.

That is what has happened at regular intervals in recent years, including in the first quarter of this year. In January through March, Russia's tax service increased its intake of cash by slightly over five billion rubles (after accounting for inflation). During that same period, enterprises' debts to their workers for overdue wages rose by almost exactly ... five billion rubles.

WHY THE RUSSIANS PREFER IT

Obviously, the kind of system described above could not exist, or at least could not long persist, in a market economy. But it does exist in Russia, and seems to be getting stronger each day. To understand why the Virtual Economy is so robust, let us again turn to the stylized four-sector model to see what would happen if it were to be terminated. We can compare the apparent outcome of the Virtual Economy to what is really happening beneath the pretense. All that is necessary is to assume that no one, including the value-subtracting manufacturer, pretends that its final product is worth anything other than the 100 it actually is.

The first result is that M would have to report a loss of 100 instead of a profit of 100. It therefore would have no tax obligation. But with sales revenue of only 100, M could not pay both G (to whom it owes 100 for gas) and H (to whom it owes wages of 100). It would have to apportion the 100 it does have between them. Assume it pays an equal amount to each: 50 to H and 50 to G. M thus has wage arrears of 50 and inter-enterprise arrears of 50. (In fact, these arrears numbers are arbitrary. The sum will equal 100, but it can be divided in different proportions between G and H.)

G in turn remits to B its only earnings, the 50 it receives from M. This leaves G with tax arrears of 50. B's only revenues are what it receives from G, since M has no value added. B then transfers to H the 50 it received from G. This still leaves budget arrears (pension arrears, say) of 50.

COMPARING THE MACRO INDICATORS, VIRTUAL AND REAL

This exercise could be pursued in greater detail, but the picture is starting to become clear. It is useful to summarize the results in the form of a set of imaginary national accounts. Table 1 compares how it *appears* that the economy is performing in the Virtual Economy regime with how it is *actually* performing. On all counts, the Virtual Economy's aggregate performance indicators (sales, profits, GDP, output) look better than the real variant's.

Table 1. Comparative Indicators for the Virtual Economy and the Underlying Real Economy.

	VIRTUAL	***REAL***
Total sales	400	200
Total profits	200	0
Profit rate	50%	0%
Total value-added (=GDP)	300	100
Industrial output	400	200
Budget size		
Planned	200	100
As implemented	67	50
Household income		
Accrued	300	200
Actual	100	100
Arrears		
Wage	67	50
Inter-enterprise	None	50
Tax	None	50
Budget	133	50

The item in Table 1 on the size of the budget deserves special comment. The planned budget is equal to the total taxes due and total spending based on those expected revenues. In the real variant it is only half as large as in the virtual variant. What does that mean? If we assume, for instance, that the budget transfers to households represent pensions, then this means that nominal pensions are cut by 50%. In reality, of course, nothing changes. In fact, the government fulfills its promises to a greater degree in the real variant (it promised 100 and delivered 50, as opposed to promising 200 and delivering 67.) Nevertheless, the perception will be that pensions have been cut in half! And it is the pretense that counts.

The arrears picture differs as well. Total arrears are the same in this numerical example. But note that two new types of arrears arise when the Virtual Economy's pretense is eliminated. Now, G has a tax debt, and M has inter-enterprise arrears to G. The web of mutual indebtedness has become even more entangled than in the original case.

Perhaps more important than any aggregate indicator, however, is how elimination of the Virtual Economy would affect the individual enterprise, M. The Virtual Economy masks the non-viability of the value-subtracting manufacturer. In the Virtual Economy, M appears to add value of 100. In the real variant, M is a clear loss-maker.

In sum, none of the participants in the Virtual Economy gain by its elimination. Any attempt to shift from the pretend virtual world to the honest real world would be unpopular, to put it mildly. It would mean slashing pensions, irritating Gazprom by branding it as a tax delinquent and demanding more taxes from it, and threatening the bankruptcy of the manufacturing enterprise and complete loss of jobs and wages for the population.

This in turn emphasizes the key point brought out by the model. The Virtual Economy arises because of the combination of two fundamental facts: (1) most of the Russian economy (especially its manufacturing sector) is value-subtracting, while (2) most participants in the economy pretend that it is

not. Barter, tax arrears, and other non-monetary modes of payment turn out to be the main mechanism used to sustain the pretense. The pretense is what causes all the nonpayment difficulties. There is less value produced than there are claims on it and commitments to it.

DESPERATE FOR CASH

The relationship between the non-cash Virtual Economy and the cash-based market economy is a curious one. To some extent, the system described above is driven by an active effort to avoid cash. Cash transactions expose the pretense. There are other reasons to avoid cash. Cash is costly to earn and costly to keep. The presence of a lot of cash in an enterprise might make it more likely that the tax authorities would refuse to accept noncash offsets. Cash is also liable to be "taxed" by the ubiquitous protection rackets in Russia. Nevertheless, the effort to avoid cash earnings only kicks in at a certain point, once a certain level of cash is obtained. That minimum level is called the cash constraint. Until that level is reached, cash is needed inside the system, and it is needed desperately.

Most urgently, the value-subtracting enterprise has to be able to sell its product for cash in order to pay wages. This explains the ironic feature of the system that while it is itself a nonmarket system, it requires the existence of the market. It is only the market that allows some of the economy's product to be realized for the cash needed to pay workers. Some of the product can be sold inside Russia. But the main source of cash is outside, on the world market.

Since 1992, exports have been regarded as a successful part of the Russian transition. It has generally been assumed that the growth of exports meant that a large part of Russia's economy was meeting the ultimate market test. In fact, this is far from true. Many Russian exports actually lose money. But for participants in the Virtual Economy the goal of exporting is not profit, but cash. Enterprises continue to export because they need to meet the cash constraint. The losses they incur are considered a necessary cost of staying in business in the Virtual Economy.

Households in the Virtual Economy operate with a similar kind of cash constraint. They allocate effort between working in M and earning cash on their own or otherwise sustaining themselves through activity not directly connected to the system (e.g., street vending, production of food in family garden plots, etc.). This sort of activity is thus good for the Virtual Economy, not a threat or alternative to it. It reduces the minimum amount of cash that has to be supplied to households from within the system.

Finally, one should note that the minimal amount of cash in this system does not mean cash is irrelevant in Russia. Just the opposite. In the land of the cashless, the man with pocket change is king... or at least, an "oligarch," as Russian big capitalists and financiers are called. Some Russian capitalists certainly have more than pocket change, but in international terms they are not particularly big. Perhaps the most famous of the financial barons, Vladimir Potanin, heads a bank, Oneximbank, that would not rank among the top 100 by size in the United States. (The combined size of Oneximbank and one of its chief rivals, Menatep, is smaller than that of Centura Banks in Rocky Mount, N.C.) It is the Russian tycoons' relatively cash-rich status in a cashless economy that gives them so much power.

IMPLICATIONS

This system has a number of significant—and negative—consequences. Suffice it to mention three areas of impact: (1) enterprise restructuring; (2) measurement of economic performance; and (3) the public sector.

The effect on enterprise restructuring is the most obvious. Even those (admittedly few) enterprises that probably could restructure and become viable in the marketplace do not. They don't restructure, because restructuring is costly *and* because they can survive as value-subtractors.

The effect on apparent aggregate economic performance, things like GDP and output, has already been suggested. Output in the Virtual Economy is overpriced by a factor of two or three, even up to five times. Russia's GDP is inflated. Russia's economy is likely even smaller than official figures suggest (not bigger, as many people say). Its year-to-year growth is also exaggerated. When value-subtractors increase their output, it is bad news, not good, even though in the Virtual Economy it shows up as increased GDP. Russia's statistics agency has reported that GDP grew by 0.8% in 1997. The extra value-added it reports is almost surely "virtual," not real.

The effect on the public sector may be the most important of all. The Virtual Economy changes the whole nature of a budget. A budget should be a plan of priorities for public spending. In a democracy, the reason for a budget to be debated and adopted by the legislature is to democratically decide what society's priorities are. Because cash allows full freedom and flexibility in meeting the needs as defined by the budget, it ensures maximum efficiency and equity. Payment of taxes in kind upsets this. Take, for example, the case of the Chelyabinsk subway.

On March 23, the governor of Chelyabinsk oblast (province) declared the construction of a subway system in the city of Chelyabinsk to be one of the most important construction projects in the region. The project is being financed by the tax debt of construction companies to the federal, oblast, and local budgets. The Chelyabinsk subway story is a good illustration of how public policy priorities become shaped by the rather fortuitous existence of tax obligations by certain companies. In this case, construction companies in Chelyabinsk were deeply in arrears on their taxes to the local and to the federal government. At the same time, the federal government owed Chelyabinsk funds but was late with disbursement. The local government was more or less forced to accept the construction companies' offer of a big construction project in lieu of the debts, while the federal government canceled the companies' tax arrears in lieu of the federal contribution to Chelyabinsk. The end result is a subway. It does not matter if the city and oblast have more pressing needs. When goods are delivered in kind as tax offsets, it's a seller's market.

THE GOVERNMENT'S ROLE

The Virtual Economy is not an exclusively negative phenomenon. In the most general sense, it is Russia's social safety net. The most important contribution it makes is jobs, albeit at minimum wages. Because of this role, Russia has indeed enjoyed social stability. Wage arrears rose to an all-time high in the first quarter of this year. Yet, during the month of March, there were a total of only 70 officially declared strikes (strikes lasting longer than one day) in the entire country. Of those, 22 were in industry, involving a total of 7,700 workers. (Russian industry employs over 15 million people in all.) On April 1, only seven industrial strikes continued.

But there are limits to the stability. In May Russia experienced a nationwide protest by coal miners over wage arrears. They blocked trains carrying passengers and freight, and their protest was only ended when the government (again) promised to pay wage arrears. This is an instructive example of how things operate in the Virtual Economy. The fundamental problem in the mines is that most are not economically viable. The proper policy would be to shut down the mines and compensate the miners so that they can seek jobs elsewhere. The promise to pay the wage arrears thus represents a capitulation to the dictates of the Virtual Economy.

The events in the coal miners' strike underscore one of the roles in government in the Virtual Economy, that of arbiter. To pay the miners' wage arrears required shifting value from some other use, as Boris Yeltsin recognized when he noted that miners were no more deserving than teachers or others whose wages are in arrears. Since the Virtual Economy necessarily produces expectations that cannot be met for everyone at all times, conflict and rivalry are inherent. The government must be an arbiter among participants in the system.

"LEAKAGE"

The second task that falls to the government is to make the system more efficient by reducing "leakage" of value from the system. Leakage raises the cost of operating the Virtual Economy. Keeping more value within the system by plugging the leaks conserves on the value needed to continue the system.

Leakage from the Virtual Economy takes several forms. It can be legal or illegal, sanctioned or unsanctioned. The value that leaks out may stay inside the country or may be transferred abroad (capital flight). The most important distinction, however, is whether the leakage is good for the system or bad for it. Good leakage can be thought of as a necessary cost of keeping some participants in the game. That would be one way of thinking about Gazprom. In our example, Gazprom contributes all of the value it produces to the system. As a privatized company one would assume that its owners would prefer to export all the gas for hard currency. But this is politically impossible. In practice, Gazprom is allowed to siphon off (and pocket) a certain share as payment to keep it performing its role in the system.

While some leakage is thus good for the Virtual Economy because it makes the system work (like the Gazprom cut), other leakage is damaging (like the theft of wage funds, which makes it more difficult to meet the cash constraint, or diversion of cash from taxes). Viewed in the context of leakage, the relationship between fighting corruption and economic reform takes on greater complexity. Reducing corruption is typically considered a key element in accelerating economic reform. In Russia's Virtual Economy, the opposite may in fact be the case. If reducing corruption results in less leakage from the system, more value remains to support the continued operation of loss making enterprises.

A NEW DEFINITION OF REFORM

Recognizing government's role in the Virtual Economy is critical for understanding recent political events in Russia. Improving the administration of this system is what is now being defined as "reform" in Moscow and throughout the country, quite in contrast to what we in the West may believe. The new government team in Moscow are thoroughly conversant with the Virtual Economy, much more than they are with the "market." The heralded group of "young reformers" in Moscow are in fact almost to a man sons of the Russian "Rust Belt," the large industrial cities of the Urals and the Volga Valley that are the home of the Virtual Economy. The local governments, even the banks and oil companies, in which they served before coming to Moscow, were all active and willing participants in their regional Virtual Economies.

We can already see how the new government is shaping what in the West are regarded as instruments of market reform into something that serves the purposes of the Virtual Economy. Take, for instance, the institution of bankruptcy. The new cabinet has announced that it will initiate bankruptcy proceedings against directors of state-owned enterprises who fail to "pay wages, keep jobs and pay taxes," in the words of Deputy Prime Minister Viktor Khristenko. They will, said Mr. Khristenko, be replaced with "more efficient" managers.[3]

In other words, contrary to practice in a market economy, bankruptcy in the new, "reforming" Russian economy does not mean selling off an unviable enterprise to new ownership who will restructure, cut costs, and make it profitable (a value-adder), no matter what it takes. Rather it means plugging leaks of value from the system.

A perceptive Russian journalist once wrote that "Russian directors are not divided into those who steal and those who do not steal. They are divided into those who steal *from* the plant and those who steal *for* the plant." The reform program of the Russian government means replacing the manager who "steals

[3]AFP release dated 27 May 1998, "Candidates for bankruptcy proceedings to be named Friday."

from the enterprise" with one who "steals for the enterprise"—i.e., one who does not abuse his position for his own personal benefit at the expense of his labor force and the good of the entire system.

Tax reform should be viewed in the same light. When tax reform means trying to collect more cash taxes from value-subtracting enterprises, it is doomed to fail and will be detrimental to social peace. To the extent, however, that tax reform means collecting taxes from those who actually have the means (the value) to pay, it may mean reducing harmful leakage from the Virtual Economy. It will thus make it more efficient.

THE WEST'S RESPONSE

How should we react to all this, as the West is now being called upon once again to provide emergency funds for Russia? The first step is to acknowledge how severely the existence of the Virtual Economy constrains us. We have been complicit in the emergence of the Virtual Economy. It could not have developed to the extent it has, and arguably might not have become as corrupt and inefficient as it has, unless we had infused funds from the outside—well over $70 billion since 1992. It is futile to think that today, six years later, we can force the Russians, as a condition for our aid, to put themselves through the wrenching process of dismantling this system. It would not work, and the attempt to do so on our part would damage us severely in the eyes of ordinary Russians.

We are left with two choices. The first is to concentrate on keeping Russia stable in the short term by bailing out the Virtual Economy. If we choose this course, we should be aware of the price for ourselves and for Russia. It will mean further consolidation of a backward, noncompetitive economy.

Our second option is simply to discontinue financing such a costly dead-end. We can refuse a bailout. Here, too, we must weigh the consequences. What concretely would happen? In the absence of a bailout, it is highly unlikely that the ruble's value could be maintained against the dollar. Foreign capital will flee the equity markets and, most importantly, the domestic government debt market. Russia would have more difficulty borrowing from abroad. All of these events would have some immediate negative effects on the Russian economy. But we do not believe that any of them would be calamitous. More important is that in the longer run the effects would be salutary.

The most direct impact of a ruble depreciation would be on those with large dollar-denominated liabilities. The largest commercial banks would be in the most difficult straits, and some would not survive. But it is important to be clear on the impact of this. Nearly 80% of Russian households' bank deposits—and disproportionately more for lower-income households—are in the state savings bank, Sberbank, which would be relatively immune. The demise of some commercial banks would certainly have an adverse impact on the economy, but it would not cause a collapse in the monetary system, primarily because such a large share of transactions already take place outside it. One major result of a banking collapse would be a decline in the power of the banking oligarchs. But it is not clear that is all bad.

How about inflation? It is true that the past three years' battle against inflation in Russia seems to have been a success. A return to the era of continuous price rises of the 1992-1995 period would be unfortunate. But a revival of inflation would depend on more than a depreciation of the ruble. The crucial factor in avoiding a resurgence of inflation is to maintain the Central Bank's policy of not printing money to cover budget deficits. This will be the big test for the government. Here, too, the key is to abandon pretense. Until now, the government has been able to sustain its policy of not monetizing the deficit by simply borrowing, at home and abroad. This is a big part of the problem that led to the current crisis. On that count alone, a depreciation can help rather than hurt because it will make it more difficult for Russia to borrow to finance current deficits. Currency risks that have been underappreciated, not to say ignored, will now raise the cost of external borrowing. Even domestic debt will become more expensive, as much of the increase in treasury debt during 1997 was purchased by foreign investors. Thus depreciation will raise the

cost of finance. It will make more apparent the true state of Russia's public finances. But if Russian economic policy is currently addicted to borrowing, then cutting off the supply of credit may be the best way to eliminate this dangerous habit.

In short, we do not think that even the short-term economic consequences of refusing Russia a bailout would be overly serious. There may well be, and probably should be, some political repercussions. But for any conceivable scenario of backlash that would result today, the outcome of a default and financial crash after another year, or two, or three of continuing along the same path as now would be much worse.

Our proposal is not a "magic bullet." It is merely the better of two bad alternatives. Refusing a bailout will not in itself guarantee any good results, and it will have some bad ones. It will of course save the money that otherwise would go to refinance Russian debt. But perhaps more important is that we would finally place responsibility for Russia's economic future with the Russians themselves. By abandoning the pretense that our aid is contingent upon adoption of market reform (since it has not been and cannot be), we would be sending the message to Russians that the choices you make on economic policy are yours alone. You appear to have chosen the Virtual Economy. Fine, stick with it if you like. But now you must know the price, because there is one.

Denying Russia a bailout is not without risks. But bailing out the Virtual Economy is sure to increase those risks for the future.