# Taming the Speculators: What Should Countries Do With Their Central Bank Reserves?

Yevgeny Primakov explains where Russia's Neoliberal Model Went Wrong

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Last week *Izvestiya* published an interview with former Premier Yevgeny Primakov, now president of the Chamber of Commerce and Industry. (Johnson's Russia List published a translation on May 8). The discussion centered on a universal problem – what China and other Asian countries, as well as OPEC and Europe should do with the export surpluses and proceeds mounting up in their central banks from mortgaging or selling off their real estate and industry. Or to put matters in retrospect, what should they have done to avoid the neoliberal monetarist ideology that governments should do nothing at all with these surpluses, not even use them to fuel economic growth.

If U.S. diplomats had their way, countries would simply let their foreign exchange reserves accumulate in the form of loans to the United States, in the form of Treasury bonds and other securities. Mr. Primakov has long opposed what his interviewer called "the fetishization of the Stabilization Fund – our beloved 'piggy bank.'" Urging that it be spent on "primary needs," to buy tangible capital goods, undertake infrastructure investment and finance imports to rebuild Russia's dismantled manufacturing sector, he explained, "I was always opposed to having the Stabilization Fund considered something saved for an emergency. Money needs to be spent inside the country. Naturally not all of it. Some part should certainly be kept as a reserve." But it was Vladimir Putin's own "initiative to divide the Stabilization Fund into the Reserve Fund and the Fund for Well-Being. The latter was to be used to develop the economy and for social needs. It is too bad that they did not get to it in time."

Ever since the Asian financial crisis of 1997, countries that have built up foreign exchange reserves have found themselves targets of global raiders. The tactic has been to sell a currency short, that is, to promise to deliver a few hundred million (or nowadays a few billion dollars) of it to a buyer (usually the central bank) near the current price, and then drive down the exchange rate by selling. The central bank tries in vain to absorb the selling wave, until finally its reserves are exhausted and the currency depreciates.

Under Prime Minister Tun Mahathir Mohamad, Malaysia protected itself by not making its currency available for foreign speculators to buy and cover their short-sale position. But most other countries have passively built up reserves in an attempt to outspend potential raiders. Today, however, underlying trends are using up these reserves. The global financial crisis has ended the real estate bubble that enabled many countries to cover their trade deficits by selling off their real estate or simply taking out foreign-currency mortgages against it. The Baltics and other post-Soviet countries in particular have been financing their trade deficits by fostering a property bubble that has led real estate owners to borrow mortgage credit from Western banks. In the absence of putting in place a viable domestic banking system, Scandinavian, Austrian and other Western banks are the only institutions able to create credit. Now that the global real estate bubble has burst, this foreign exchange credit is no longer forthcoming. The financial End Time has arrived. Rather than facing the new state of affairs – chronic trade deficits are now over-layered with heavy foreign-debt service. Countries that have built up foreign reserves are running them down.

Many countries are trying to delay the Day of Judgment by borrowing from the IMF, dissipating the proceeds by subsidizing capital flight by investors and speculators who can see that exchange rates for chronic trade-deficit countries are about to plunge steeply. Russia has joined in expending its foreign-exchange reserves to stabilize the ruble in the face of capital flight and foreign speculative selling.

In retrospect this appears to have been inevitable, and indeed was widely foreseen by critics of the neoliberal Washington Consensus. The reserves built up during the oil-price run-up last year and the recent boom in minerals prices are being spent without having used the proceeds to develop its industry so as to replace imports and develop export markets for what used to be a high-technology economy prior to the Yeltsin "reforms" (that is, dismantling of industry). Russia continued to rely almost exclusively on raw materials and oil exports. "In our country," explained Mr. Primakov, "40% of GDP was created and is created through raw material exports. The share of industrial enterprises engaged in development and introduction of new technologies barely comes to 10%." The problem is that having given away its mineral resources and other public enterprises to insiders and their cronies, Russia has relied on what they choose to leave in the country from their exports and sale of shares in their companies. "The prolonged refusal to inject the capital being built up into the real economy and its direct investment in American treasury securities instead of its use inside the country to diversify the economy. … As a result, Russia will most likely come out of the recession in the second echelon – after the developed countries."

The alternative, Mr. Primakov said, would have been to use the Stabilization Fund "to switch the economy to the innovation track and for its restructuring. 'Patching the holes does not help for long.'" But he the then-minister of economics, German Gref, fought off attempts "to cannibalize the Stabilization Fund." Under the kleptocracy the money was left to be stolen.

The problem is where to go from here. Neoliberal "monetarist" ideology conjures up the threat of inflation to deter public spending. This IMF and World Bank propaganda blocked Russia from investing in industry during the Yeltsin disaster of the mid-1990s. "Fear of inflation," Mr. Primakov explained, "was named as the main reason that huge amounts of money lay idle. They said that inflation would soar if what had been built up began to be spent. At one of the representative conferences, I asked: 'What kind of inflation can there be in building roads? The work would just spur on production of concrete, cement, and metal …' But our financial experts have a monetarist view of inflation. They are afraid of releasing an additional money supply into circulation. But in reality inflation rises much more strongly from that fact that we have colossal monopolization." Trade dependency leads the ruble's exchange rate to weaken, raising the price of imports and thus aggravating the inflation – precisely the opposite of what Washington Consensus orthodoxy insists.

I myself have heard Scandinavian and other European officials make this argument in almost the same words, and it has persuaded many Third World governments to do nothing with their raw-materials export proceeds but "save for a rainy day," not promote domestic self-sufficiency in food and consumer goods. The argument seems maddeningly stupid, because it pretends that all government spending is inherently inflationary, adding to the spending stream without producing any production to absorb it. The practical effect is to block countries from growing in the way that the United States and other developed nations have done – by investing in infrastructure and other capital formation, with the government providing basic infrastructure at cost or even freely (as in the case of roads) so as to minimize the cost of living and doing business. Instead of having investment in place to show for the foreign exchange earned by exporting raw materials (and selling off ownership of national assets), countries that follow this policy are now seeing their reserves drained rapidly. And as far as government spending is concerned, the economic collapse is increasing public budget deficits after all!

Contrast this behavior with Pres. Obama's February 17 economic stimulus plan for the United States. When the *Izvestiya* interviewer asked Mr. Primakov what he thought about it, he noted that: "In America investments in 'intellect' have been increased – in science, progressive technologies, and education, and expenditures for medicine are rising. … Doesn't it seem to you that our package of anti-crisis measures is less ambitious? … This law should be considered a plan of investment related to the American economy and society entering the 21st century and a new technological platform of competitiveness. That is why expenditures for science have been increased. The same thing, undoubtedly, with human capital."

But that is not the Russian strategy today, Mr. Primakov complained. Russia has been living in the short run. "The TPP (Chamber of Commerce and Industry) conducted a poll in 720 firms. Only a third of the managers said that they associate getting out of the crisis with producing new output. The rest are counting on staff cutbacks. If the ministries are given the assignment of reducing expenditures at their discretion, the first thing they sacrifice is scientific research and experimental design development. However, research and development should be classified as protected articles of any budget."

So much for the free-market policy of automatic stabilizers and do-nothing government policy, leaving choice in the hands of the nation's financial oligarchs. The situation calls for structural change, coordinated by the government. "If a plane is having trouble, the autopilot cannot handle an unusual situation. Only the personal skills of the pilot can save the ship. It is similar with the economy. Autopilot does not work in extreme conditions. … Self-regulation of the economy disappears as a factor."

When asked about the oligarchs keeping their funds abroad rather than investing them in domestic industry, Mr. Primakov replied that Russian officials did not "take into account that banks' interests do not coincide with the interests of the real sector of the economy. … It should have been explained that after receiving state support, in using it banks no longer [should] act as commercial structures but as agents of the state. It should have been watched to make sure that the state capital was not commingled with the banks' other assets in common accounts but was marked off with a red line. But that was not done. Probably some people were lobbying for the banks' interests at that point. And the bankers hurriedly began to convert the rubles into hard currency and export it abroad and build up their capitalization" instead of "extend[ing] credit to the real sector of the economy." Oversight was done poorly, and Russia did not even use its public funds to finance capital investment. But when it comes to what to do at this late point, Mr. Primakov acknowledged, "Punishing the banks for what happened means destroying them."

The problem is how to restructure the financial system to make it serve the objectives of industrial growth rather than merely facilitating capital flight. Throughout the world financial interests have taken control of government and used neoliberal policies to promote their own gain-seeking – financial gains without industrialization or agricultural self-sufficiency. Betting against one's own currency is more remunerative than making the effort to invest in capital equipment and develop markets for new output. So unemployment and domestic budget deficits are soaring. The neoliberal failure to distinguish between productive and merely extractive or speculative forms of gain seeking has created a travesty of the kind of wealth creation that Adam Smith described in *The Wealth of Nations*. The financialization of economies has been decoupled from tangible capital investment to expand employment and productive powers.

Central to any discussion of financialization is the fact that credit creation has been monopolized in the United States and Britain for their own national gain. What makes this interview so relevant is that Mr. Primakov is speaking as head of Russia's shrunken manufacturing sector. Russia "practically pushes big business outside our borders," Mr. Primakov noted, "to borrow money from banks there in places where the interest rates are incomparably lower." Just as the nation was becoming underdeveloped industrially, so it and other post-Soviet economies have failed to create domestic financial institutions to provide the credit that is needed to finance circulation between producers and consumers. As a result, these countries are simply fooling themselves to imagine "that credit can continue to be borrowed abroad 'for the crisis.' It is not out of the question that for the first time in 10 years, the state itself will even go begging for a loan again." So a byproduct of today's crisis will be to put the world outside of the creditor nations on rations, as it were.

Mr. Primakov was asked what he thought of Moscow Mayor Yuri Luzhkov's tracing "the sources of the present Russian crisis [to] the 1990s, when the liberal government permitted the 'stealing, squandering, and distribution of natural resources and the largest sectors of industry to those who could not support their development.'" He replied that there were many smart managers among the oligarchy's ranks, but acknowledged that "It is a different question that in buying up enterprises (mainly raw material ones) for a song and obtaining mega-profits, many from the beginning preferred not to raise the efficiency of production, but to skim off the cream. … Why think about some processing of raw materials if they bring in big money anyway in natural form? The state should have entered that niche long ago. To have done everything to make certain that some of the petrodollars were pumped into science-intensive industry."

Contrasting Russia's failure to industrialize with that of China and its anticipated 8% economic growth in 2009, Mr. Primakov noted: "China exports ready-made products, while in our country a strong raw material flow was traditional." Now that Western economies are shrinking, China is "moving a large part of the ready-made goods to the domestic market. At the same time, they are trying to raise the population's solvent demand. On this basis the plants and factories will continue to operate and the economy will work. We cannot do that. If raw materials are moved to the domestic market, consumers of such vast volumes will not be found." Increasing domestic purchasing power will "merely step up imports." That is the price that Russia is now paying for having failed to sponsor "structural changes in the economy."

I have cited these long quotations because they have been made by a man who once had a chance to steer Russia along different lines than the economically suicidal death trap promoted by the Harvard Boys and their Washington Consensus. It is the trap into which the Baltics and other countries have fallen. A decade ago Mr. Primakov proposed an alternative, based on a resource-rent tax to finance Russia's re-industrialization. The government would have collected the "free lunch" of its raw materials sales proceeds in excess of their low costs of production. Instead of retaining the revenue in the public domain from the decades of capital investment that the Soviet government had made to develop its mineral, oil and gas resources, instead of using it to finance economic modernization, Russia simply gave it away to political insiders and let them sell off shares in these resources to foreign buyers on the cheap. Anatoly Chubais and his Western "free-market" backers promised that giving property to individuals in this way would transform them into forward-looking Western-style industrialists. Instead, it turned them into Westernized finance capitalists.