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### **External Instability in Transition: Applying Minsky's Theory of Financial Fragility to International Markets**

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## **ABSTRACT**

This inquiry argues that the successful completion of the transition process in the post-Soviet economies is constrained by the prevailing social structure and low levels of technological progress, both of which require institutional reforms aimed at increasing growth in national income, productivity, and the degree of export competitiveness. Domestic policy implementation has not shown significant improvements on these fronts, given its short-term orientation, but instead resulted in stagnating growth rates, continuously accumulating levels of external debt, and decreasing living standards. The key to a successful completion of the transition process is therefore a combination of policies targeted at the dynamic transformation of production structures within an environment of financial stability and favorable macroeconomic conditions.

**KEYWORDS:** Transition Economies; Soviet Mode of Production; Technological Decay; International Capital Flows; External Instability; Debt Repayment

**JEL CLASSIFICATIONS:** B25; F13; F34; G15; P30

After the collapse of the Soviet Union at the beginning of the 1990s, mainstream economic theorists blamed centralized planning and state ownership of the means of production for driving the disintegration of Soviet socialism. As a result, it was advised that the newly emerged independent economies immediately switch to free markets and private property. Based on the idea of efficient and self-regulating free markets, crude implementation of market reforms occurred throughout the post-Soviet arena.

While some countries minimized the negative spillover effects of drastic institutional shocks, others found themselves in the downward spiral of growth trends accompanied by a sharp increase in unemployment rates, hyperinflation, bankruptcy of massive state enterprises associated with the institutional crisis, and unsustainable debt burdens (Bogdankiewicz 1993, 340). Rapid growth of consumption, rising inflation, and low levels of gross investment prevented the expansionary policy needed to promote basic capital reproduction and technological innovation.

This inquiry argues that a successful completion of the transition process has been constrained by the former Soviet Union's prevailing social structure and low levels of technological progress, both of which require institutional reforms aimed at increasing growth in national income, productivity, and the degree of export competitiveness. To this purpose, this paper investigates the relationship between the inherent problems in the physical production processes of Soviet-style economies, the interconnectedness of financial flows, and the defining effects of external debt burdens—all of which are often overlooked by policymakers, leading to policy mismatch.

## **THE SOVIET MODE OF PRODUCTION**

It has been recognized by a number of post-Keynesians scholars (see Gehrke and Knell [1992]) that the major economic problems with a Soviet-style economy are related to extensive—as opposed to intensive—output growth and the persistence of a seller's market as opposed to a consumer's market. The roots of these economic phenomena lie in the underlying Soviet policy

strategy directed toward satisfying the basic social needs of economic agents, which serves to maintain the power dynamic of the prevailing political regime.

The production process in a Soviet-style economy is not only planned and strictly supervised by the state; given that the size of the private sector was insignificant in the USSR and is still insignificant even in 2017, it is also predominantly financed by government expenditures.<sup>1</sup> Investment spending in a Soviet economy primarily comes from the state, which means that the production strategy is not profit driven. This creates a set of perverse incentives for any enterprise willing to engage in the production process, regardless of how risky it may be, considering the Soviet habit of extensive unlimited state financing of the production process. A traditional Soviet planned economy primarily experiences positive rates of economic growth through an extensive growth path—where the expansion of inputs exceeds the expansion of final output. Maintaining extensive growth then requires perpetual overinvestment, which further contributes to the discrepancy with productive capacity. But maintaining extensive growth and suppressing inflationary pressures leads to a continuous drop in potential capacity (Rider and Knell 1992). As a result, bottlenecks occur. This further intensifies the problem of shortages, creates supply distortions over time, and lowers growth rates as a whole. Furthermore, given that the economy is at full capacity,<sup>2</sup> there is no room left for necessary adjustments because of planning mistakes—at the aggregate level or at the micro level in terms of the changes in the combination of final output (i.e., switching from industrial to consumer goods).

As pointed out by Nell (1992, 86), under socialism the efficiency and productivity of inputs are assumed and investment is planned in order to reach the highest expansion rate consistent with planned consumption. This means that it is not only supply that is controlled by the state, but also demand that is generated by a system that is continuously fueled by overinvestment. The Budapest School emphasizes this privilege of defining the public's needs and wants as a uniquely repressive posture (Brown 1988). However, when a large share of national income is devoted to public investment, it leads to distortions in the supply of consumer goods, which results in the constant pressures of excess demand, as the consumers' needs are essentially

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<sup>1</sup> With exceptions of larger, higher-income economies like Russia and, most recently, Kazakhstan.

<sup>2</sup> Which creates the illusion of full employment.

ignored. The resulting shortages eliminate the incentives for an enterprise to improve quality, productivity levels, or decrease costs, since there is no uncertainty about having the market for their output. Engaging in such a production strategy means that, within limits, anything produced in the economy will be absorbed by the market.

## **MARKET REFORMS SOLUTION**

Based on the idea of efficient and self-regulating markets, a series of market reforms (in the form of gradualism or shock therapy) were implemented throughout the newly independent Soviet states during the 1990s in order to resolve the inefficiency problems caused by lagging economies. The idea of market reforms as a suitable means for reorganization of the production process has its roots in the neoclassical model of economic theory and its view on the efficiency of property rights that has been universally promoted by regulations originating from the Washington Consensus. On the contrary, the system of centrally planned production (with its large, heavy-industry-oriented, state-owned enterprises and soft-budget constraint) was considered an inefficient model, mainly due to a principal agent problem caused by asymmetric information within the administrative structure of the decision-making hierarchy.

According to a standard neoclassical model, economic adjustments emerge from the decision making of rational economic agents who maximize known objectives with perfect information, resulting in continuous long-run equilibria. The transition to a market system based on such an approach ignored the significant impact of sociocultural barriers to the drastic changes associated with market shock therapy; rather it focused solely on blind imitation of policy proposals borrowed from other nations that developed under a different set of institutions. As a result, the first years of transition were characterized by utter economic disarray.

While certain formerly centrally planned economies managed to absorb the negative consequences from such drastic institutional shocks (Hungary, Poland, Slovakia), others seeking to achieve positive growth rates reverted back to a command-style organization of the production process and fell into the trap of production reversibility and historical backwardness in the

second half of the 1990s (after facing the disappointing results of market shock therapy) by reverting to the plummeting economic conditions of negative growth rates, mass unemployment, and hyperinflation near the levels last seen in the 1980s.

These disappointing and counterintuitive results are not only consistent with the evolutionary paradigm of economic thought (according to which institutions emerge slowly and sequentially in a path-dependent manner), but are even consistent with the ideas of the proponents of the efficient market hypothesis. Joseph Schumpeter, together with a number of modern economists, realized that even with a much narrower magnitude of anticipated change, the uneven pace of contraction of working capital and sluggish output growth in declining sectors would be greater than the possible expansion of newly privatized enterprises.

Instead of dismantling the entire system of planning, it needed to be restructured. Instead of engaging in an unregulated privatization process en masse, hoping for the self-correcting mechanism of free markets, Soviet institutions needed to be reorganized and supervised. The key to accomplishing this is to find a balance between the necessary public-sector activity (i.e., provisioning of public goods) and discretionary public-sector involvement (i.e., state finance) that is consistent with the existing value structure (Forstater 1997). Market forces and central planning elements<sup>3</sup> should have been recognized as complements in order to make the transformation process smoother. Central planning should be complemented with market reforms—such as privatization, the restatement of the social contract, and budgetary adjustments—in order to modify the incentive structure by directing the production mechanism to profit-based autonomous spending, therefore driving income growth (following Kalecki, Kregel, Eichner, etc.).

As new institutions are introduced, the former social context in which microeconomic behavior was formed is then dissipated in a profound way. Appropriately dealing with this disturbance requires a significant degree of flexibility, which is a very desirable feature of any economic

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<sup>3</sup> These elements include a centralized hierarchy, with state ownership and control over distribution of the means of production; the planned provision and distribution of information; an amplified role of the state in production financing; and an implicit safety net.

system, as the lack of flexibility causes sluggish growth, inflationary pressures, and bottlenecks.<sup>4</sup> The abrupt, unregulated price liberalization, eradication of the public-goods sector, and mass privatization of state enterprises failed to address the lack of demand. The idea of market distribution was appalling to the Soviet mentality, which was used to viewing the state authority as the ultimate troubleshooter. The command system, however, sought to guarantee the economic and social equality of economic agents, because it granted the right for everyone to remain within the production process and satisfied basic social needs, creating a sense of stability and security that free markets could not tolerate. But this satisfaction of basic social and economic needs came at the cost of maintaining the dominance of the political power held by government elites.

Consequently, the disappointing results of the market reforms animated the revival of central planning and state control over the distribution of goods, while further consolidating the old Soviet institutional structure and momentarily relieving some of the havoc spurred by market reforms. This path dependence contributed to a retarding of the technological progress, while it is precisely technological advancement that remains crucial for progressive institutional change.

This, however, does not mean that it is impossible for the former Soviet republics to improve the institutional organization of society in a way that will promote dynamic technological changes. The key is for every individual to have the ability to noninvidiously participate in modifying the existing institutional structure. Tool (2000, 103) affirms that “so long as democratic means of deliberation and social action are available, the community is prompted to continue its experimentation with alternative institutional forms until the most efficient options, on present warranted knowledge, are chosen.” This means that a democratic form of government is needed, as it functions as the only type of community organization that does not forcefully impose ritualistic judgments established by the state elite that prevent proper adjustments of the institutional structure. Such a claim, however, does not imply that the process is not feasible in an environment of centralized planning. As Knell (1992, 18) asserts, the transition of a Soviet

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<sup>4</sup> As defined by Forstater (1997, 1), flexibility is “the elasticity of the production system, the adaptability of the production system in the face of structural and technological changes, such as capital- or labor-saving technical innovations, changes in labor supply or the supply of natural resources, and changes in the composition of final demand.”

economy requires changing the nature of the role of state to one that is oriented toward incentive-based instead of directive planning, and democracy instead of despotism. Given this, one can conclude that the key for a successful completion of the transition to a market-oriented economy is to find equilibrium between freedom and order.

## **EXTERNAL INSTABILITY**

Over time, the consequences of extensive growth and public overinvestment have further intensified potential problems associated with excess demand pressures. These additional complications are primarily related to the degree of openness to foreign markets or “insertion” into the world economy—financial and trade relations with other countries—which is a pivotal structural issue for any developing country (Ocampo and Parra 2007).

A shortage of productive investment necessary for technological improvement and increasing export capacity has resulted in transition economies’ increasing reliance on imported goods and services. This reliance had led to negative dynamics influencing the national current accounts, causing them to be dominated by trade deficits. Chronic trade deficits have also been intensified by slow rates of increase in the productivity necessary for export earnings; this is due to the aforementioned outdated Soviet mode of production and their specialization in producing old types of commodities. Moreover, the absence of a developed financial system to aid investment financing has further intensified this problem.

The involvement of an economy in trade with market-oriented nations requires the development of a relatively sophisticated financial structure, for which the rigidities of a Soviet institutional system are not suited. Mishandling of the financial sector has created an unstable economic environment in already fragile transition economies. External debt issues, in turn, generate financial fragility, restricting the domestic sector’s ability to improve unsustainable debt ratios and maintain overall economic development.



Furthermore, persistent current account deficits and diminishing foreign reserve assets result in an increased dysfunction in the official exchange markets, pushing central banks to impose strict capital controls and fees (Huett, Krapf, and Derya Yusal 2013). Central banks have continuously exercised aggressive monetary policy in order to suppress inflation and maintain the promised stability of fixed-exchange markets. Inflationary pressures, however, still continue to grow and are accompanied by declining inventories of imported consumer goods.

Insufficient discretionary investment financing, import dependence, and exchange rate instability have pushed the government authorities to acquire additional external funds to finance growing foreign debt, with accruing interest payments resulting in a balance of payments crisis (WB Group Country Economic Updates 2008–15). Severe exchange rate instability, in turn, creates additional volatility in debt commitments, lowers export competitiveness through a reduction in real capital, and negatively affects interest rate changes.

Policy proposals to manage external debt issues for many transition economies have been guided by international organizations, such as the International Monetary Fund (IMF) and the World Bank, whose external debt sustainability policy suggestions have focused predominantly on the availability of additional external financing in order to meet debt commitments. This vestige of the Washington Consensus's conventional wisdom is the so-called "short-term approach" that ignores the long-term prospects of paying off the full amount of a loan's principal, accrued interest charges, and other arrears (Kregel 2006, 234–35). As a result, external debt may quickly turn into a Ponzi scheme, whether it is due to a currency mismatch, volatility mismatch, or simply not having cash inflows.

The conventional approach<sup>5</sup> for handling external imbalances advocates liberalization of capital flows between more- and less-developed countries. Developing countries experience domestic saving deficiencies due to generally lower incomes, which sets strict limits on domestic investment financing. Such scenarios call for additional external funds (flow of foreign lending) for financing investment (discretionary spending), which in turn drives economic growth. Meanwhile, developed countries experience higher prospective rates of return on their

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<sup>5</sup> Originated in Domar's (1950) work.

investment in developing countries since domestically they experience diminishing returns due to excess saving. External lending from more-developed to less-developed countries supposedly turns into a “win-win” situation, since the savings of more-developed countries earn a higher return and less-developed countries acquire the necessary financing to boost their investment spending and, hence, improve their growth performance (Ostry et al. 2011).

Domar (1950) saw the solution to massive debt commitments in the borrowing of external funds to finance the already existing obligations. He suggested that if a developing country were to increase external borrowing (external resource inflows) at a rate that is equal to or greater than the rate of interest on their accumulated debt stock, then the inflow of these new funds would cover the interest payments on the outstanding debt.

But debt commitments on the accumulating stock of net foreign claims by definition implies additional external borrowing. When a more-developed country becomes a net lender to a less-developed country, it results in a negative current account balance in the developing country. This means that interest and amortization rates can only be serviced by extra foreign capital inflows. Such reliance on external financing makes the total debt repayment permanently dependent on external funds: a classic Ponzi profile where one is only capable of meeting one’s debt commitment if there is a constant stream of additional loans that pay off the stock of foreign claims (Kregel 2004, 579–80). While Domar’s policy prescriptions originally seemed plausible due to their focus on long-term growth and long-term debt commitment, it was generally overlooked that the suggested debt repayment plan was a Ponzi scheme and, hence, could not be a sustainable financing profile in the long run. Furthermore, in order to maintain a Ponzi profile, the borrower has to convince the foreign lender of its ability to service the debt. Within the context of a sovereign borrower, acquiring foreign financing would require accumulation of foreign currency reserves, having fiscal balances, and/or a reduction of domestic demand dependency on foreign goods and services.

Any economic unit can be defined based on its positions, which differ in terms of the elements from which they derive their present and future earnings (Tonveronachi 2006). Debt sustainability, therefore, can be analyzed by looking at balance sheets, which are interconnected

with each other in that every asset represents a liability elsewhere in the system. Every liability, in turn, has a cash inflow and a cash outflow. The stability of the system as a whole is then defined as the ability of agents to validate their outstanding debt commitments. Hyman Minsky (1986), in his analysis of domestic firms and domestic banks performing the role of lenders, distinguished three main types of repayment profiles as a classification of potential fragility: hedge, speculative, and Ponzi.<sup>6</sup>

Kregel (2004, 2006), analyzing external debt sustainability by adopting Minsky's theory of financial fragility, extends this idea to international markets, claiming that if a country were to manage its balance sheets by matching its earnings and commitments, it would be able to manage both internal and external financial fragility, leading to relative financial stability. The peculiarity of a foreign borrower, however, lies in the absence of the borrower's control over volatility and uncertainty of external cash commitments and receipts. Whenever a developing country finances by borrowing from abroad, it will have an external deficit and, by definition, external deficits do not produce cash inflows. A country's cash earnings are the inflow of export earnings, while a country's outflows are represented by spending on imports. Matching these inflows and outflows prevents a speculative financial profile from transforming into a Ponzi profile.

When a country borrows from international markets in foreign currency, it has to meet its payment commitments from its foreign exchange receipts. In order to maintain external stability then, it needs hedging: either borrowing in terms of its own currency or generating foreign currency earnings. These foreign exchange earnings can come from the following sources: positive current account balances, accumulated foreign exchange reserves from past current account surpluses, foreign borrowing, and debt forgiveness (Kregel 2004b, 7).

Instead, post-Soviet transition economies often follow the standard policy recipe encouraged by the international organization like the IMF and the World Bank.

Specifically, when the governments face a real and impending collapse of their Ponzi external debt, they find a universal solution in encouraging fiscal surpluses. The surpluses are achieved

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<sup>6</sup> For the definitions of each repayment profile, see Minsky (1992, 7–8).

through significant spending cuts (yet such cuts are detrimental to the economy given the necessity to maintain an extensive growth path, which requires increased government spending), aggressive anti-inflationary monetary policies, and an increased dependence on external cash flows to meet debt commitments with the hope of boosting domestic savings and competitiveness (Duenwald, Gueorguiev, and Schaechter 2005).

Given its short-term orientation (which has been adopted from the mainstream), domestic policy implementation has not shown any significant improvements to the transition economies of the former USSR, but only resulted in a continuously accumulating external debt. Foreign currency reserves continue to be depleted, consumers' panic exacerbates demand pressures on foreign goods, and fiscal surpluses are insignificant, which, in turn, exacerbates the inherent problems of domestic production organization, productivity levels, and economic growth.

The main reason why the domestic policy approach does not appear to be successful is its failure to yield the prognosed optimistic results, since most post-Soviet economies still have not experienced any sustainable increase in production or export volume necessary to stabilize themselves, both externally and internally. Sluggish growth in post-USSR economies in the 2000s is not enough to balance the continuously accumulating foreign debt stock. As pointed out by Tonveronachi (2006, 37): "if independent foreign funds do not influence the current account balance, they do not change the net debt position; with an unchanged current account balance they necessarily increase the foreign reserves and or the amount of foreign assets held by residents."

A positive current account balance can only be reached through a long-term policy of building real and financial capital, irrespective of exchange rate regime (Kregel 2004a, 574). Under the scenario of Ponzi-type external debt, building real capital should involve increasing net exports as a share of GDP. This approach requires increased domestic productivity, matching competitiveness of international markets to increase foreign cash earnings and finance debt commitments. This, in turn, calls for productive investment that maintains the current account balance, even in the presence of the foreign capital inflows that are necessary for discretionary spending in the first place. Policy, therefore, should aim at reorganization or a set of reforms that

modify the incentive structure by directing the production mechanism to profit-based autonomous spending, which drives income growth (following Kalecki, Kregel, and Eichner). Such a policy would imply complementary industrial and strategic trade policies that bring technological innovation into the production process, leading to a higher degree of export competitiveness. In a situation where current account measures are found to be ineffective and there is a continuous depletion of foreign reserves—but still an urgent need for capital inflows—Keynes’s idea of a supranational bank (clearing union) might be the proper policy prescription (though unrealistic due to political discontent) (Keynes 1976).

An alternative approach to policy formation should therefore include a set of structural reforms targeted at the transformation of input allocation toward more competitive industries, technological innovation in the production process, and strategic trade policies. These policies are expected to bring about increasing productivity levels, increasing economic growth, and a higher degree of export competitiveness.

However, increasing competitiveness requires a reorganization of the existing institutional structure. Oftentimes institutional constraints and the scale of structural reforms needed for such changes force the indebted countries to find alternative ways of improving current account imbalances—mainly through a reduction in imports and a substantial decline in income (Ocampo et al. 2009).

## **CONCLUSION**

Despite multiple attempts to adjust to a market economy, for almost two decades the values of totalitarianism have still played an important role in most of the former Soviet economies. Attempts at stabilization often turned out to be counterproductive when policy targets were misspecified or bounded by external forces, such as international financial institutions. External imbalances, in turn, only further intensified economic degradation at the national level, creating a vicious cycle of recurrent crises. The key to the successful completion of the transition process is therefore a combination of policies targeted at the dynamic transformation of production

structures within an environment of conducive macroeconomic conditions (such as positive growth rates, low unemployment and inflation, and reduced inequality) and financial stability.

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