Ten Years of Economic Reforms in Russia: Windows in a Wall

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I. Introduction

The August crisis of 1998 had a devastating effect on financial markets in Russia. Russia announced a default on foreign debt payments for the three-month period (and is still having a difficult time meeting them), while the short-term debt was fully and unilaterally restructured towards long-term debt. In one year's time, the market volume of the Russian Trading System (RTS) stock market exchange has plunged from $70 billion to a mere $5 billion.

The 1998 financial crisis is reminiscent of another crisis in 1989–1990 when Russia was still a part of the Soviet Union. Ten years of reform, first towards a socialist market economy and then to a market economy, have focused on an irreversible change in Russian economy and policy. In this paper we try to assess some of the gains and losses of the first decade of transition. We argue that, while democracy is still at risk in Russia, a Russian citizen has matured as a voter, a consumer, and an investor. Political and economic progress, however, are still hampered by the poor and criminalized state of business and political spheres. Russia badly needs a president, parliament, and government having the will and power to face the country's tremendous challenges. The maturation of the electorate provides for a better

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chance to reach a social contract now than ever existed a decade ago. Reforms and transition in Russia remain primarily a political challenge.

The Russian government's announcement on August 17, 1998, in which it conceded default on the sovereign debt, managed to surprise the international community. Indeed, indicators of macroeconomic stability had appeared strong in 1997, although somewhat undermined by ineffective policy implemented by the successive Prime Ministers Chernomyrdin and Kirienko and their governments. The Russian collapse could not have occurred at a more inopportune time. Many financial institutions around the world were still struggling with aftershocks from the Asian crisis, debt restructuring and shifting speculation. Nonetheless, once the card was played, it was a formidable reality to be dealt with. Internally, the situation would be costly both in a literal and in a figurative sense. It would mean lawyers, conferences and evaluations of what assets might be salvaged and by whom. Where would surplus money materialize for the emergency rescue: from a different budget or from a camouflaged crisis account in some other part of the world?

Whether any such "secret funds" existed or not, whether or not the government was brought to the figurative wall, is really beside the point. What matters is that Russian decision-makers chose the now documented "mild" devaluation-restructuring of the GKO (Treasury bills) and OFZ (term-bond) markets package, proposing a planned three-month freeze-before-repayment arrangement. These ineffective decisions revealed to the world, in full light, the magnitude of Russia's malady. Reflexively, public and financial realms began trying to save what they could, which only led to a steeper downward spiral for Russia from mid-August until the end of September, followed again by a smaller peak in December 1998. Brazil followed Russia and defaulted only a few months later.

Russian citizens absorbed the news of the crash with disbelief. In a country synonymous with secrecy, they had believed some alternative would be found; some miracle would happen; the government would ultimately be able to avoid default. Prior to the collapse, percentages on savings accounts had been absurdly attractive, and GKO bonds were due to mature within the year. A deep-rooted conviction that special and hidden resources could invariably be relied upon was holy writ. Whether the public attitude was pure folly or credulity is difficult to say, but it speaks to some success on the administration's part in manipulating the aspirations of the ordinary population to acquire a better life.

What went wrong? How bad is it for the future? What are the lessons for the regulation of international economic activity?

First, we will discuss the postcrisis scenario, then proceed to analyze pivotal strategic decisions and events preceding the crash. This we do in an effort to speculate about what the reverse direction, or any other strategically different direction, might have better encouraged Russian transformation to a market economy in its first decade of democracy. Having said this, even altering or reversing mistakes of the recent past will not provide a sufficient solution, for much weight rests on future decisions and events. Of notable significance are the upcoming June 2000 elections, in which President Yeltsin's successor will be named. When considering how much new leadership or new policy will indeed affect Russia's second open decade, the timeless adage persists: *change occurs slowly*.

Postcrisis introspection is important notably in providing domestic incentives to improve the society as a whole, except that no Russian citizen can ignore the bleak scenario. The actual recovery of the Russian economy is pitted against a busy political agenda. One year after the crisis the main surprises are: a rather decent behavior of the ruble, a modest recovery of the financial market activity, some unexpected survivors in the banking sector, and some signs of growth in industrial production. How, exactly, has this scenario evolved?

II. Postcrisis Democratic Russia: 1999–2000

The devaluation of the ruble and the exit or sharp cutting-down of western firms' presence on the Russian domestic final consumption market has changed the structure of market demand, which has switched back to local products (when they are available) or to lower-priced imports from Poland, Turkey or other East European and Baltic States. Some modest import substitution has emerged, protected by the ruble barrier. Some enterprises are coming out on the visible market from the "shadow market" (many enterprises in Russia prefer to remain obscure in order to avoid attracting too much attention from organized "Robin Hood" crime). Also emerging are financial market players who have managed to wrest themselves from the GKO/OFZ market squeeze.

Some smaller individual investors have survived because their positions before the crash were insubstantial enough that they could backpedal and reset their market position the instant that indicators spelled certain loss. But many actors, such as young institutional investors and portfolio managers, held on until the very end, increasing their detrimental positions.[1]

Some reports claim that the average morale of the Russian population today is rather positive. This contingent supports the assertion that no matter what the difficulties, Russians are ready to go back to the market and wager still more hope on the recovery of economic activity, although they adamantly believe that *no credit for any recovery will be attributed to the actions of various governments.* Others say that a more accurate picture of Russian morale today can best be described by malaise and frustration, despite the fact that most citizens believe that they would not turn back the clock, even if given the chance.

With the volatility of day-to-day Russian events, certainly impatience has mounted to the point of sociological analysis. In other words, the notion of *tomorrow* is down-weighted in comparison to the notion of *today*. Naturally, instant gratification encourages greed and speculation—traits many older Russian citizens claim are even worse in their society today than during Soviet rule. Great hope exists that such mounting greed will bring about positive internal actions to redress this issue, especially since greed and corruption directly paralyze effective, constructive entrepreneurial activity. (It is prudent early in these discussions to point out that Russian citizens often expect and even accept calamity because they associate international embarrassment with subsequent national reform.)

All observers agree today that Russia has not exactly been equal to the task of successfully achieving the establishment of a market economy within its borders during the last decade. They worry about the democratic process. This consensus is quite *new*—prior to the 1998 collapse opinions were more diverse, if not optimistic.

Will history record the first decade of Soviet democracy as a success or failure? Doubtless the debate will be infinite because it is characteristic that opinions about Russia are rather polar. Respective opinions are as numerous as dots on a graph and their associated theories as subtle, yet obvious, as the difference between red caviar and Beluga. Today most Russian citizens, even cockeyed optimists, are frustrated to the bursting point because they can rarely find employment or, if employed, expect to receive payment for months. The average male life expectancy is fifty-two years! Even military employees sell weapons on the black market to feed their families. For instance, in June 1999, the Russian military agency launched a

1. Vadim Arsen'ev, *Finishnaja Prjamaia (The Finishing Line)*, KOMMERS. DENGI, July 22, 1998, at 36–37.

massive "employment shrinking" program. This is both a direct result of the 1998 crisis, the further cutting of government military expenditures in the budget (Primakov's government was able to pass through Duma a drastic reduction of expenditures), and a result of the dismantling of many defense missile sites. The Russian defense sector had been affected minimally during the nine years of reforms, but was one of the biggest victims of the 1998 crisis.

Needless to say, the average Russian citizen feels that his living conditions have generally decreased during the last decade. This is correct in some respects. In practical terms, most of the Russian population's living standards have worsened. Real incomes fell by fifty-five percent in 1992, after price liberalization, and real wages by forty-two percent by the end of 1992 as compared to the previous year. The average dollar wage in Russia at the end of 1994 was $94, compared to $200 in Poland and $250 in the Czech Republic. In 1999, the average dollar wage in Russia was believed to be around $60.

The worsening level of disparity creates mixed feelings of lassitude and malcontent, especially with regard to the subject of "reforms" or "reformers" and their promises of a better way of life. The mere mention of "reforms" invites sniggers or outright vocal cynicism—"here is yet another major farce," however, this attitude should be considered with caution. Indeed it is fashionable to claim that no real reforms are on the way, that no reforms have been implemented, that any appearance of reform is only lip service—a showcase for the International Monetary Fund (IMF). When asked point-blank to recall developments of the decade and to assess whether or not they would prefer to go back, however, we reiterate that most reckon that they would not. And this sentiment holds, notwithstanding other mixed feelings toward the new Russian society, including loss of security, shame, swallowed pride, disgust over widespread corruption, and international loss of position. President Yeltsin was both widely criticized and held responsible for an endless cortege of reforms that seemed to go nowhere or, rather, that appeared to profit some happy few: the weakened central power, the loss of prestige of the nation and its territorial and economic dismantling, the useless deaths in Chechnya, Dagestan, the chronic arrears in wages, pensions, the crisis and the routing of the banking system, and, above all, implementation of a personal agenda rather than action to promote the country's best interest.

In political terms, the media and public opinion agree that the president is fully out of power. And he seems to remain as unpredictable a player as in the past. One wonders, however, if this enigmatic behavior is a carefully planned tactic or the result of capricious powerlessness. Even in his difficult situation (including the scandals around his personal and family affairs), Yeltsin maintained an even stricter commitment toward a general line of reforms than professed in the past. This exacerbated the belief that only a very strong presidential power can substantially deter the actions of counter-reform forces. Yeltsin's agenda created a high ministerial and governmental instability, which is not understood by the population, and is viewed negatively by the entrepreneurial strata. (There is some movement towards modifying the constitution in order to attenuate disruptive economic consequences of rapid-fire economic changes.)

Recent money-laundering scandals must stimulate reassessment, as the reappraisal of economic policies reveals some uncomfortable aspects of "financial, advising and consulting arrangements made with Russia [in recent years]."[2] What are the consequences for the

2. Irina Y.o Kuzes & Lynn D. Nelson, Radical Reform in Yeltsin's Russia: Political, Economic & Social Dimensions 59 (1995). "Private firms would come on the scene to offer expertise of various types to

international architecture of such "outlaws"? On the other hand, is it fair to pawn off the whole 1998 disaster on Russian money-laundering and other forms of self-serving forms of corruption? Is it fair to simply label Russia an "outlaw"? (We shall later discuss the subject of Russian corruption.)

Placed in perspective, the changes in recent Russian culture have been rather rapid-fire, even if considered more gradual than radical. Such environmental changes have aroused grave uncertainty among Russian citizens about the future. Despite the negative forces in power during post-World War II Soviet rule, the standard Soviet citizen's life was then characterized by a remarkable stability.[3] Prices, labor and political structures remained practically unchanged. Today's blurred events are, thus, all the more difficult to accept. The stability of post-World War II Russia exacerbates the current general perception that the newly formed Russian State cares even less about individuals and older generations than the former Soviet State (if that is possible). Many Russians question whether their restructured government even constitutes a democracy. A businessman from Perm encapsulates the general sentiment: "Inflation, ruble instability, unpredictable price rises, political musical chairs all lead to the absence of any idea of what tomorrow brings and an inability to plan for the future."[4]

For example, housing rental agency business in Moscow is often closer to a virtual incarnation of Victor Hugo's "middle-age miracle courtyard" than anything else. So caution is appropriate when assessing buoyant Russian urban businesses. Small entrepreneurial business *does* exist, even if the Mafia attempts to squelch it. Small business is as much alive today as in the early days of Perestroika, when it started booming, but the problem is acquiring "clean" credit sources (the few Russian banks in place still offer prohibitively expensive loans; to accept a "clean" bank loan is about as precarious as borrowing money from the Mafia itself). Besides the need for "clean" credit security, protective measures must be implemented to propagate any entrepreneurial activity.

A dirty money-laundering investigation is proceeding full scale, with the IMF and World Bank being the main targets. Sharp critiques about inflation-targeting programs and other monetarist solutions to crisis and structural transition programs are voiced. The discourse expressed by Josef Stiglitz on the necessity to go beyond the "Washington Consensus" is evidence of the intensity of the debate.[5] Maybe Russia is in no worse shape than other Commonwealth of Independent States (CIS) countries or even some developing countries, although the ensuing reverse of development and industrialization that is in process is disturb-

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facilitate Russian economic reform. These activities would often be funded with U.S. dollars—particularly from the U.S. Agency for International Development (USAID)." *Id.* Another interesting fact is that: "With so much aid money involved, there has already been a feeding frenzy in Washington. USAID says 1,200 consultants applied to get into the program, a record for the 33-year-old agency." John J. Fialka, *Helping Ourselves*, WALL ST. J., Feb. 24, 1994, at A1.

3. *See* MARIO I. BLEJER & C. COTARELLI, FORCED SAVINGS & REPRESSED INFLATION IN THE SOVIET UNION: 1986–1990 256–86 (IMF Staff Papers, vol. 39, no. 2, 1992). Between 1960 and 1980, the retail price index (RPI) stayed almost constant, reflecting price controls. *See id.* Statistics indicate that between 1960 and 1985 prices grew by less than $0.25 percent per year on average. *See* Vladimir Popov, Central Bank Independence and Inflation in Russia, Address at the Conference on Central Banks in Eastern Europe and the NIS (1994).

4. THE WORLD BANK, *Creating Private Enterprises & Effective Markets*, *in* THE WORLD BANK: STUDIES OF ECONOMICS IN TRANSFORMATION (I.W. Lieberman, J. Nellis, E. Karlova, J. Mukherjee, & S. Rahuja eds., 1995).

5. *See* Josef Stiglitz, More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus, UNU/Wider Lecture (1998).

ing. The fact remains that the international community cares about the fate of Russia, or perhaps is afraid of Russia (old fears die hard). More emphatically, some just wonder why the "market-economy jelly" did not set, a gripping problem for economists and politicians.

Whatever the new consensus is, it cannot be based in Washington. The Washington Consensus has advocated the use of a small set of instruments, including macroeconomic stability, liberalized trade, and privatization, to achieve a relatively narrow goal: economic growth. The post-Washington Consensus recognizes that a broader set of instruments is necessary and that Russian goals are also much broader. Russia seeks not just increases in measured GDP, but improved health and education. It seeks sustainable development, which includes preserving natural resources and maintaining a healthy environment. It seeks equitable development to ensure that all groups in society, not just those at the top, enjoy the fruits of development. And it seeks democratic development in which citizens participate on numerous levels in making the decisions that affect their lives.

If policies are to be sustainable, then, developing and transition countries must claim ownership of their respective policies. A second principle of a newly emerging consensus is that a greater degree of humility is called for, which acknowledges the fact that no one has all the answers. Continued research and discussion, not just between the World Bank and the IMF but throughout the world, is essential if Russia is to better understand how to achieve its many goals.

As Earle and Estrin point out, long before the Russian Federation defaulted on Western bankers in 1990, "[Russia] defaulted on its own citizens, failing to pay wages and entitled social benefits."[6] Yet an urban fringe of the population has had a taste of "market economy" and found it savory. Although they sometimes have been carried away when the emerging Russian market looked so promising, only to be discouraged by the brutal wake-up call of August 1998, their hopes and dreams of a better life have not lessened. The new diversity of brand preference appearing on Russian consumers' markets is appreciated for what it is, even if consumers cannot always afford what is available. Consumers are becoming more aware of their rights, and sophistication for quality and comparison has begun to form. The average Russian may or may not believe that there is much hope for a better future, but his or her conviction is still that Russia is a wealthy "land of opportunities." Cultural, educational and scientific institutions are highly developed, and yet newspapers report that per capita GNP (around $1,000) is a little below that of Bolivia.[7] The Russian citizen believes Russia is an industrial nation, but reads in the newspaper that its current exports consist of almost entirely raw materials (for example, oil, gas and nickel).[8] Media reports indicate that perhaps the most important Russian asset is its population, both massive numbers of impervious Russian residents who have remained, as well as the valued brainpower of those who have chosen and managed to leave the country.

History shows that as Yeltsin came to power, radical economic and societal restructuring initially won out over a gradual approach much praised by Gregory Yavlinski and his fol-

6. J. Earle & S. Estrin, After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing Industry (CEPR Discussion Paper no. 1736, 1998).

7. *See* Aleksandr Koksharov, Oleg Leonov & Elena Sherbinina, *Don't Cry Argentina! Manipulation of Domestic Currency Does Not Guarantee a Way Out of Crises*, Expert, Aug. 16, 1999, at 12–14.

8. *See* Vadim Arsen'ev, *Structure of the Russian Industry: Ranking of the 150 Most Prominent Russian Firms*, Kommers. Dengi, at 33–34. The 1998 crisis strongly affected the developing telecom sector in Russia, as well as electrical giants adversely affected by the increase in import prices and the decline in domestic consumption.

lowers. But, as mentioned earlier, the real chain of events was dangerously gradual. Thus the Russian civil society and economic landscape, at the end of the decade, have indelibly changed. Whether for better or worse, this is subjective. On the economic front, results are somewhat mitigated. On the civil society front, they seem more promising. Citizens might be winning a battle—that of getting hold of their rights. The question now is whether they might actually be able to express this victory in the next elections.

III. Precrisis Democratic Russia (1990–1998)

The path Russia followed throughout the 1990s has indeed moved it hesitantly toward a transition to both market economy and political harmony. But the chosen (gradual as opposed to the preferred radical) route has been costly. Russia has faced, and still faces, deep financial, economic, social, and political difficulties. The Russian population has once again experienced a number of hardships: food shortages; hyperinflation (1992–1994); a portentous default on western loans (1990); and two financial near-crashes (1994–1995) culminating with the 1998 sovereign default. This sequence is directly correlated to social and income inequalities gaping wider than ever. Other significant realities include: a dizzying rise in unemployment; Mafia activity and political coups (August and December 1991, December 1993); what is perceived by many as "territorial dismantling"; two wars (Chechnya and Dagestan); numerous border skirmishes (Tadjikistan); and a recent upsurge of blind terrorism directed at the civilian population. These are but some of the flashbulb montages straining Russia's framework, since the physical wall came down.

Indications of macroeconomic stabilization were promising in 1997, but thwarted in early 1998 by hit-and-miss policies of the Chernomirdin and Kirienko governments. The state budget remained in deficit as a result of poor tax collection efforts, large expenditures and loose regulation over them. Simultaneously the administration continued financing its deficit by borrowing even *more* from internal and external markets. Because Russia's dependence on a consistent flow of foreign capital was heavy, it found itself almost powerless when the events of August 1998 put an abrupt stop to foreign lending while its other sources of foreign revenues were depressed on world markets (oil).

Many analysts also emphasize that the reforms undertaken during Perestroika (1985–1991) made the task of 1990s reformers more difficult. Let us recall some vivid aspects of the Perestroika era. A legal framework for modifications of a fully centralized economy was created and, in part, implemented. In 1985–86, campaigns against alcohol and unearned incomes were waged in response to declining productivity of Soviet workers. In March 1986, a partial reform of agricultural structures was implemented, in effect decentralizing decisions within state and collective farms (*kol-* and *sovkhozes*). In August 1986, a decentralization of foreign trade decisions was also implemented. In January 1988, the Law on State Enterprises also decentralized decision processes for state firms (followed by a sharp increase in wages). This first set of legal reforms, then, mainly consisted of decentralizing the decision-making process in the productive branches (agriculture, industry, services, handicrafts, and construction), in an effort to revive declining production and productivity.

One must admit that the Russian Federation, emerging out of the collapse of the Soviet Union in the beginning of the 1990s, inherited a tough legacy—a large-scaled and ultra-concentrated industrial sector mostly tailored to satisfy defense objectives and the extensive road and railway network (qualification of the labor force was less emphasized). Many productive activities were focused on the large defense and military sector. Most sectors had been set up according to misguided economic objectives rather than those prevailing in market economies; location and technology choices did not satisfy market profitability criteria.[9] Neither was production quality a subject of concern. Jakov Urinson, who served as the first deputy of the Russian Minister of Economy in 1994, says: "We produced absurd men's coats with stupid astrakhan fur collars, which then remained 10 years in storage. Clearly our country does not need that kind of growth."[10]

One of the main issues surrounding August 1998 Russia and its shattered economy is whether the economic policy choices made at the beginning of the 1990s were sound. The proponents of the implemented reform program insist that reforms did not go far enough and that most of the industrial sector was irreversibly doomed. The critics emphasize that heavy weight on monetarist issues proved extremely destructive for the existing Russian potential, which they deem disorganized, dismembered, and subject to daylight robbery. Moreover, the latter claim that the monetarist path solved none of the structural problems diagnosed at the end of the Brezhnev era. These analysts continue attacking monetarism as one of the main culprits responsible for unexpected features of Russia's actual international trade structure. Nelson and Kuzes write:

> By 1994 Aslund was insisting that "the structure of Russia's total exports will change towards larger exports of raw materials." With such statements as part of the public record, it should not be surprising that a widespread conclusion in the Russia of late 1994 was that the radical reform agenda included making the Western world safe from potential competition with Russian products while exploiting the country's natural resources.[11]

But it is all the *more* surprising because the country is resolutely modern in a "western" sense. The infrastructure (even if aging) is remarkable, the quality and education of the labor force in itself distinguishes Russia from developing countries, and the capacity to adjust to new, imported technologies is excellent, as is research and development of new products.[12] The words of Nelson and Kuzes ring true for the 1995–1999 period as well.

9. *See* Richard Ericson, *The Structural Barrier to Transition Hidden in Input-Output Tables of Centrally Planned Economies*, ECON. SYS. (forthcoming). "A structure of production location, capital, employment, materials and energy, etc., had been created without any regard for economic opportunity costs . . . This legacy of the Soviet system constitutes a structure of capital and economic activity that is fundamentally non-viable in an environment determined by market valuation, and hence requires massive transformation at its very roots." *Id.*

10. Jakov Urinson, *Kakoi rost nam nuzhen? (What Kind of Growth Do We Need?)*, EXPERT, Mar. 1998, at 8.

11. Kuzes, *supra* note 2, at 103.

12. *See* H. J. Wilson, *Restructuring Large Enterprises in Preparation for Privatization: A Case Study*, *in* CREATING PRIVATE ENTERPRISES & EFFECTIVE MARKETS (1995); *see also* WORLD BANK, *supra* note 4. As Wilson, in his very interesting account of a rare successful restructuring of large Russian military-civilian enterprise, describes:

> Enterprise's hospital products, on the other hand, were in a rapidly growing segment of the increasingly important medical equipment industry. This relatively new product group offered good-quality products to both hospitals and patients, with lower costs to all. A few big international companies had come to dominate the world market and many more wanted to enter. The Russian market was quickly becoming important, and Enterprise, among a few local suppliers, became a target for acquisition itself. The transistor radio market was an easy target for cheap Eastern and Chinese consumer products. While some imports did not offer the *same technical quality*, their designs were more attractive, and rapidly gained market shares.

Id. at 162.

Thus, one cannot help wondering whether the actual policies will lead to a new structure of specialization and whether the restructuring of industrial potential has started at all.

IV. Private Property in Post-Communist Russia

The legalization of private property and enterprise began with the following steps: the November 1986 "Law on Individual Labor Activity;" the May 1988 "Law on Cooperatives;" and the mid-1990 set of laws for "joint stock companies and securities on banking activity in the USSR and small enterprises."[13]

A. The State Property Fund Set to Handle Privatization

The May 1988 "Law on Cooperatives" ruling proved to be quite successful in stimulating business ventures. It stipulated that any private activity with at least three owners could qualify as a cooperative and, therefore, make decisions for (act on behalf of) itself (1998–1999). Thanks to this law, the first wave of entrepreneurial activity was observed. Fifty to one hundred banks were created as cooperatives. In the early 1980s, three "specialist banks" had been created to channel credits to enterprises in the agricultural, construction and social investment sectors, and their subsidiaries extended all over the country: AgropromBank (APB), Pronstroibank (PSB), and ZhilosotsBank (ZHSB). New cooperative banks served other branches. Finally, in 1990, the second wave of a banking establishment had become much linked to the specialized banks of the Perestroika period: over 800 banks emerged—700 of them regional banks of which 600 were exfilials of specialized banks.[14] Many of these have been leading the banking sector throughout the past decade.

Aslund writes: "However, these cooperatives became so dynamic that the law was amended several times in a restrictive direction," a fact that critical observers of post-Perestroika reforms stress as contrary evidence of the vivacity of small to medium to fully new, private entrepreneurial activity at that time.[15] Other analysts argue that existing state-enterprise managerial teams had successfully curbed these reforms.

At the end of the 1980s, the Soviet Union was plagued by significant industrial shortages and rising foreign debt (the Soviet State defaulted on its foreign payments at the end of the 1980s).[16] In the beginning of the 1990s, a set of policy choices was rapidly implemented in the form of an installation manifesting the features of a market economy. These policies were mainly the result of economic expertise and brainstorming (Sachs, Schleifer, Aslund and Layers were the main economic advisors at the time). However, financial aid that would have helped stabilize macroeconomic imbalances and allowed room to maneuver conduct

13. T. Troyanov (Secretan-Troyanov) describes how after arriving in Moscow to establish his Swiss-Russian law firm, he was offered many symbolic entrées to "Russian joint-venture stock companies"—proof that a foreign stockholder could be availed of fast and uncomplicated registration.

14. *See* Anders Aslund, The Brookings Institution, How Russia Became a Market Economy 1–10 (1995).

15. *Id.*

16. *See* Peter Aven, Problems in Foreign Trade Regulation in the Russian Economic Reform, Economic Transformation in Russia 81–83 (Anders Aslund ed., 1994). "During 1984–1991, exports from former USSR territories decreased: sharp decrease in oil extraction, collapse of COMECOM and the shift to mutual hard currency payments, and the overall depressed world conjuncture. 1991 sees a further slide in exports. On the other hand, the consumption of imported goods had increased in the USSR during the 1970's." *Id.*

of monetary policy after price liberalization failed to materialize. Russia, therefore, proceeded alone on the course of its first set of reforms: price and trade liberalization, distribution of state property through the voucher scheme (privatization), and a so-called legal apparatus that would specify private property laws. Many of the current problems, namely corruption, have also to do with this failed stretched-hand policy from the international community.

V. Chronology of Events

The early phase of formation of the Russian market (1991–1995) will be discussed in two subphases: 1991–1992 and 1993–1995, each phase initiating or concluding according to what we concur to be the starting point of a rather acute financial debacle. Price and international trade liberalization characterize the first subphase, with the emergence of a Russian commercial banking system. The second subphase is connected with privatization, the beginning of financial markets and macroeconomic stabilization attempts involving financial market structuring. This phase ends in the first market quasi-crash called "Black Tuesday."

The second phase (1995–1997) characterizes the next deeper wave of liberalization, that of integration to the world financial markets. Russia becomes the booming emerging market of the decade and a recipient for "hot money."[17] This part of the story ends in the crash of August 17, 1998.

The third, and current, phase (1998–2000) is characterized by a slight distancing from policies adopted before 1998. With the August 1998 crisis, Russia has experienced a period of involuntary protectionism (capital market isolation and outflow of "hot money"), and a relaxing of strict monetary targets (devaluation and controlled devaluation, i.e., the free-floating ruble is kept under control by open market operations). A restructuring of current short-term (GKO) debt has been forced upon national and international participants. The debt-servicing pressure has been relieved due to restructuring, delivery of IMF tranches and buoyant oil and gas world prices. There are even some positive signs in the economic landscape. For instance, there is a low-profile revival of financial markets (both stock, and to a lesser extent, fixed income) while the banking system is rallying. This is accompanied by an unexpected vitality of consumer-oriented industries, which seem to seize the opportunities resulting from ruble devaluation and lowered competition to introduce newly designed Russian products (import substitutes).[18] Tax receipts have increased relatively to 1998; capital flight is slightly more difficult because of foreign exchange controls. And, in fact, the economy *may* be growing modestly, an almost unprecedented occurrence in the last decade.[19]

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17. "Hot money" is defined as "excessive funds of short-term capital inflow." HANDBOOK OF EMERGING FIXED INCOME & CURRENCY MARKETS 199 (Franco J. Fabozzi & Alberto Franco eds., 1999). Liberalization of capital and trade accounts and relaxation of foreign exchange controls can encourage the flow of hot money into a system. This scenario may be inflationary and cause authorities significant difficulties in achieving monetary targets. Further, short-term capital tends to flow out of emerging economies during times of political or economic uncertainty, a process that is destabilizing.

18. The significant downsizing of foreign presence in Russia is clearly due to depressed markets and ruble devaluation: Procter & Gambles, KPMG, Siemens, Hilti Distributions Ltd., and Merrill Lynch have substantially cut the number of their foreign and local employees.

19. Only in 1997 do Russian statistics show a growth in GDP.

It seems that the progression towards a Russian market economy has narrowly centered on working out the notion of private property and understanding its complexities. In this regard, one must conclude in 1999 that this aspect of the market was significantly, if not fully, mastered. This progress is quite remarkable in the country where the tradition of private property weakly rooted before communism and was completely destroyed in its wake. Formally, all the elements of the market are in place.

VI. Corruption

"Russia's problem is that its reform program has not only been painful but, under Yeltsin, totally corrupt," writes Thomas L. Friedman.[20] He correctly points out that "Yeltsin has let business clans rip off Russia's gas, oil and minerals, and this wealth has gone to enriching individuals rather than cushioning the society in transition. That is why reform in Russia today has such a bad name."

The Washington Post voices a similar view: "Instead of a free-market model, Russia has become an oligarchy of competing financial, industrial and political clans, interlaced with criminality, all seeking to extract favors from a state that still clings to its overweening power."[21]

We do not deny that corruption is crucial to understanding the Russian reality. But the current trend is an almost obsessive focus on corruption, making only more delicate a genuine investigation and assessment of the outcomes (achievements and failures) of a decade of efforts to transform Russia into a market economy. At the expense of being naive or optimistic, we will concentrate some of our investigation on more positive aspects. Moreover, castigating corruption does not provide new solutions. Corruption may explain some dimensions of Russian economics and politics. The decrease in GDP, the emergence of the banking system, the building of financial markets, constitutional reform, dismissal of certain reformers, Yeltsin's apparent whims, and terrorism, however, are not merely a story about corruption. Even in Russia one might seek deeper explicative schemes. The contemporary status of Russia's economy (and its corruption) is the direct result of political options and policy choices that were implemented when the magnificent "window of opportunity" opened at the end of the 1980s.[22] The general goal, upon which all agreed, was to improve the economy and the society, but this preliminary agreement left open numerous options for *methods* of implementation. Was improvement expected to come through radical or gradual change? What were the possible policies: Keynesian, monetarist, gradualist, idiosyncratic, or none of these? Within the debate surrounding Russian transition, where did positive economy end and normative or ideological choices start? To say blithely that these are difficult issues is a platitude, yet they form the essence of the current domestic and international debate over Russia, the 1998 crisis and its general economic failure, a debate that remains sharply ideological. One cannot ignore this feature; therefore, an objective assessment of the entire decade's achievements is flatly unreasonable.

Recently Sergej Bodrov, former executive for the Central Bank of Russia, declared that the commercial banks were then formed by or "closely connected with GOSBank circles,"

20. Thomas L. Friedman, *Those Funny Russians*, N.Y. TIMES, Feb. 14, 1996, at A21.

21. Anders Aslund, WASH. POST (Moscow), Feb. 1996.

22. GRAHAM T. ALLISON & GRIGORII YAVLINSKII, WINDOW OF OPPORTUNITY: THE GRAND BARGAIN FOR DEMOCRACY IN THE SOVIET UNION (1991).

and that the main reason for their emergence was to enable highly ranked civil servants to conduct recently "decentralized" foreign trade operations as well as businesses of their own.[23] Many in Moscow claim that this period coincides with the first wave of rapid accumulation of almost overnight fortunes in 1990–1991, combining legal framework and initial price liberalization initiated by Yegor Gaidar in the mid-1990s.

The initial capital for creating many such businesses was acquired from connections within both the "Soviet banking sector" and industry connections (abroad, if possible). The principal mechanism was arbitrage.[24]

The late Soviet State had implemented hundreds of currency coefficients—individualized exchange rates specific to goods and enterprises, with a central system of hard currency distribution. Further, a double accounting system existed for sovereign currency: there were "cash rubles" *(nalichnyie)* and "noncash" accounting rubles *(beznalichnyie)* with an internal, informal, exchange rate of 2:1. Lastly, there was access to subsidized state production whose world price was substantially higher. Anders Aslund offers the following theory:

> For instance in early 1990, the Soviet wholesale price of a ton a crude oil was 30 rubles. This also happened to be the free market price of a package of Marlboro cigarettes. The black market rate of *nalichnyie* to *beznalichnyie* was 1:3. With the right connections it was possible to buy three tons of crude oil for one package of Marlboro cigarettes (less than $1), when the world market price of one ton of crude oil was in excess of $100.[25]

People allowed to "exchange" noncash rubles for cash rubles or who had license to get hold of hard currency cash (an extremely difficult coup at the time) or who were well connected with a particularly interesting "extractive" sector of the ministry (i.e., a specialized commercial bank) were privy to such arbitrage opportunities. One must mention, however, that not only purely speculative schemes were appearing: according to L.D. Weinberg, Russian businessman and CEO of the Siberian Ore and Mining Bank, many computer programming businesses, which were successfully subcontracting to Western firms, made a nice and quick profit.

An interesting view on the Russian entrepreneurship has been presented by Vladimir Potanin, once considered the archetypal oligarch (robber baron). He clearly positions himself as a clear-sighted entrepreneur operating for the future of Russia's market economy and declares:

> The Russian business elite should be open on two fronts: it should not only work with foreign capital, but also with the budding "second wave" businesses. We should take them in our club, give them access to investment resources, give them, if necessary and needed, political protection *(prikrytie)*. In two to three years from now, medium businesses—"Oneksim," "Inkombank," "Al'fa," "Menatep," "Most"—won't be needing us. They will have built their own financial networks with foreign banks, which will view them as interesting partners. We need now to succeed in our first step towards [assisting] these companies and as long as we are still useful to them—help them develop their businesses.[26]

As to an infamous recent money-laundering scandal, it may never be untangled.

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23. Sergej Bodrov, *Mamai Has Not Left Yet: Offering an Insider View on the Problems of the Banking System*, SOVETSKAIA ROSSIIA, Aug. 14, 1999, at 2.
24. Anders Aslund, *Russia's Collapse*, FOREIGN AFF., Sept./Oct. 1999, at 42.
25. Aslund, *supra* note 21.
26. Tatiana Lysova, *The Reform of the Oligarchs*, EXPERT, Mar. 1998, at 14–16.

> Elaborate shell games have become a dominant feature of Russia's post-Soviet economy . . . Government officials are now looking into whether Menatep [Bank] was used to move funds through accounts at Bank of New York linked to Benex Worldwide Ltd., a Russian firm that investigators have already said has ties to a major alleged Russian mobster . . . Now federal and international law-enforcement officials say they are looking into whether Mr. Kagalovsky [Menatep's first deputy chairman] helped construct a Byzantine network of offshore corporations that politically connected or mob-linked Russians may have used to siphon hundreds of millions of dollars out of the country. Included in that sum, investigators say, may have been many millions of foreign aid and funds pumped into Russia by Mr. Kagalovsky's old employer, the IMF, to shore up the reeling Russian economy.[27]

Interestingly, Mr. Kagalovsky in his recent column for a Russian newspaper notes: "It's high time now to remember two old truths: The end doesn't justify the means and a state based on corruption and theft is, as a rule, far less effective than an ordinary normal state." He added, "The IMF can't pull out of Russia, but should give it as little money as possible."[28]

VII. Conclusion

Many either praise the patience of the Russian people or criticize their apathy. This absence of sentiment is only apparent. The Russian's interest in building a new societal model was, and is, strong despite the fact that there seems to be little evidence yet of an emerging comprehensive program for correcting the flaws of a "dual" economy. It is hoped that the past decade of hardship has brought about a new political and social maturity. The process is slow, but persistent. Although many parameters have changed, the goals in 1999 are the same as they were a decade ago: to achieve modernization, conversion and growth. New political teams will be faced with achieving progress toward these ends, but the task may likely prove more difficult following the events of 1998 and 1999 because Russia's credit market is tighter now than ever and the banking system, as a functional structure, is routed.

In the late Soviet system, the average nondissident citizen was *infantilized*. A subtle system of mixing reward with penalty had been imbedded in Russia's psyche that provided for a secure but somewhat decisionless, incentiveless social and working environment. How was anyone reasonably to expect, then, that in such a short period of time Russian citizens would seize the full right of their powers and duties?

In large towns, modest, but firm, evidence hints of a change in mentalities, manifested by more active behavior of a small segment of citizens. Consumers in Moscow have begun fighting for their rights by taking legal actions. These actions are cumbersome, but many cases have been successful. This is but another sign that alternatives to corruption exist in Russia as well.[29] It remains costly to the citizen, but feasible. Exposure to new concepts has

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27. M. Allen et al., *Brash Banker's Tangled Deals Become a Focus of Money-Laundering Probes*, WALL ST. J., Aug. 26, 1999.

28. *Id.*

29. A similar attitude appeared in the young executive layer in Bogota, Colombia (another country where corruption is rather the rule than the exception): young lawyers, central bank economists, and young Colombian entrepreneurs are realizing that the best way to fight corruption is to work within the legal framework. The results are encouraging, though it becomes a challenge to win a case legally. Recent informal discussions with young Russian executives confirm that the formulation of the "stake" is identical—indicating a love of the game, risk-taking, or perhaps a budding consciousness of one's right.

persuaded the urban population that a financial and banking system that functions well is quite useful in terms of life-cycle consumption and savings decisions. The notions of private insurance, pension funds, and their ability to smooth future consumption have been equally (more broadly) understood and awakened the interest of the Russian urban middle class (not talking about the "new Russians"). An article recently discussed the fate of Vladimir Potanin's efforts to set up the first private insurance companies in Russia: Renaissance-Straxovanie (insurance), Interros-Soglasie and the Interros-Doitsoinstvo (pension fund).[30] The crisis has not been able to bring them down totally: "There have been heavy losses but they are not dead." Of course, the confidence in such companies is not high. But the interest is still there, nonetheless. As soon as the legal framework will be able to guarantee some transparency in the working of financial and banking companies, there should be no difficulty in regaining the population's interest.

Because of the 1998 crisis, Russian consumers are less vulnerable to fraudulent schemes than in the past. For example, the summer 1994 financial scandal of the AOA-MMM Moscow fund is still alive in people's memories. This "fund," directed by Sergei Mavrodi, who proved to be a masterful swindler, promised huge returns on what was later revealed to be unsound securities. The operation was successful. Mavrodi allegedly spent several hundred million to advertise his fund and was able to attract a considerable number of investors. The investors' gullibility may be softened by the fact that the AOA-MMM fund was betting on the similarity (a deliberate choice by Mavrodi) of its name with the MMMinvest fund that had set up a rather sound share fund and a GKO fund. Mavrodi was arrested, but then released and wound up being elected to the Duma. Stories of other fraudulent schemes abound: the Russkii Dom Selenga ("Selling") company, neither registered as an investment fund or licensed for securities, attracted 1.5 million depositors.[31]

The reader might find these signs extremely tenuous (or even flimsy). And one cannot deny that anything can happen in Russia tomorrow or the next day or the next! But it seems that the country seems more poised today for a new, more realistic and pragmatic social and political contract than it was a decade ago. The decade has in a way been won, although at a terribly high price and certainly not as triumphantly as participators and spectators would have hoped. The U.S. Treasury Secretary Lawrence Summers notes:

> It is certainly true that in this new global economy, the market punishment for bad policies comes more quickly and takes a harsher form. But the reverse is also true that good policies are rewarded much more quickly. That is the positive lesson for Russia that can be gleaned from experiences in Mexico and elsewhere.[32]

Russia faces tremendous challenges in the months ahead. But it is also an opportunity to address Russia's fundamental economical and political problems. The Russian voters must make their voices heard more loudly and clearly this time, so that the country and its people do not miss the next "window of opportunity."

30. *See* Lysova, *supra* note 26.

31. *See* M. Kazer, Privatization in the CIS, Challenges for Russian Economic Reforms 81–97 (A. Smith ed., 1995).

32. Lawrence Summers, Russia & The United States: The Economic Agenda, Address at the U.S.-Russia Investment Symposium (Jan. 14, 1999).