6.1 Introduction

Most people forget that reforms began in 1985 when Gorbachev came to power, not in 1991 or 1992. His early reforms set the course for Russia's changes. This first stage of Russia's reforms was characterized by rapid political change but (too) slow economic reform. When economic reforms finally began for serious in early 1992, the situation was quickly reversed: the main impediment to professional economic reform was the legacy of past political institutions and (too) slow political reform. There is no doubt that things could have been done much better.

Gorbachev's political reforms opened the Communist Party and the existing system to widespread criticism. The election of the Congress of People's Deputies for the USSR, and subsequent similar elections for a Congress in Russia in 1990, were key events that changed the nature of economic and political debate. However, in 1992 this same Russian Congress provided the rallying point for those opposing economic reform.

When serious change did start, the government was attacked from all sides. It was soon clear that political reform lagged behind economic change. There was a brief moment in early 1992 when comprehensive reform could have been introduced, but within weeks this opportunity was lost due to poor political management and the enormous pressures against clear reform measures.

In this paper we argue that one of the key factors that made Russia different from other countries with respect to its reform pattern was the enormous wealth and income that was to be redistributed after the breakdown of the old system. The assets that were up for grabs included the revenues from seigniorage (amounting to 32.7 percent of GNP), at least $10 billion in rents from natural resource extraction, another $12.5 billion from resources financed by bilateral credits, and around $600 billion from property to be redistributed.
The scope for gain undoubtedly played an important role in the subsequent pattern and politics of reform, and the cards were stacked against reformers from the start because they lacked clear legitimate authority and political skills. However, better management of the politics of reform, more decisive measures at the start, and more political reform at the beginning certainly could have improved the outcome.

Even with all the mistakes, and the lack of political certainty and clarity of direction, Russia has achieved much progress and the economic reforms have brought enormous change. As shown in Table 6.1, the economic decline has been severe, but it has been roughly similar to the declines in the other large countries of the former Soviet Union (FSU). While industrial production has declined, banking services have expanded, equity and bond markets have developed, and a large new service sector has appeared. Most Russian enterprises are now privately owned.

After 10 years it is high time to examine the mistakes and successes of Russian reforms and to consider the lessons from Russia’s experience. Section 6.2 outlines the main political changes that guided reform. Section 6.3 discusses specific components of Russia’s reform program and the problems that were encountered. Section 6.4 presents outcomes and lessons from the Russian experience.

### 6.2 Historical Background

The reform era can be divided into four sub-periods. (1) The early Gorbachev years, beginning in March 1985, marked the start of reforms. (2) A major break occurred in August 1989, when Ryzhkov’s government was appointed after the first elections for the Congress of People’s Deputies were held in the USSR. (3) The next break occurred in November 1991, when Yegor Gaidar was appointed deputy prime minister by Yeltsin and he was given the mandate to implement radical reforms. (4) The final period began in January 1994 after the first elections for a new Duma.

March 1985 to August 1989

The initial Gorbachev years were full of optimistic expectations but there was very little progress towards reforms. Gorbachev attempted to create a socialist market economy by embarking on gradual reforms. Since Gorbachev aimed to reform the planned economy, rather than introduce anything like a market system, it is no surprise that there were no milestones that make this era stand out, such as price liberalization, foreign trade liberalization, privatization, and establishment of new market institutions.

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### Table 6.1
Main indicators of the Russian economy

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Real GDP (percent change)</td>
<td>-4</td>
<td>-13</td>
<td>-19</td>
<td>-12</td>
<td>-15</td>
<td>-3</td>
</tr>
<tr>
<td>Industrial production (percent change)</td>
<td>-1.0</td>
<td>-8.0</td>
<td>-18.8</td>
<td>-16.0</td>
<td>-21</td>
<td>0.0</td>
</tr>
<tr>
<td>Retail prices (percent change)</td>
<td>5.6</td>
<td>92.7</td>
<td>1,354</td>
<td>896</td>
<td>302</td>
<td>205</td>
</tr>
<tr>
<td>Exchange rate (rubles per US$ at year end)</td>
<td>1.7</td>
<td>1.7</td>
<td>415</td>
<td>1,247</td>
<td>3,550</td>
<td>4,650</td>
</tr>
<tr>
<td>Dollar GNP per capita at market exchange rate (fourth quarter)</td>
<td>---</td>
<td>---</td>
<td>550</td>
<td>1,750</td>
<td>2,100</td>
<td>---</td>
</tr>
<tr>
<td>Unemployment rate (mid-year)</td>
<td>---</td>
<td>---</td>
<td>5.3</td>
<td>6.3</td>
<td>7.7</td>
<td>---</td>
</tr>
<tr>
<td>Gross external debt in convertible currencies</td>
<td>61.1</td>
<td>67.0</td>
<td>78.2</td>
<td>86.8</td>
<td>92.8</td>
<td>---</td>
</tr>
</tbody>
</table>


Perhaps the biggest achievement during this period was the introduction of the Law on Cooperatives. This law had nothing to do with cooperatives—it effectively legalized primitive private enterprise—but it did provide the first chance for many individuals to enter into small business. To this day businessmen remember this first opportunity for entrepreneurship as a golden bonanza. It was easy to start new companies in trade, services, and small-scale production, and this new segment
of the economy flourished in what was effectively a tax-free environment. A second breakthrough during this era was the creation of the first commercial banks in 1988.

However, the majority of economic reforms up to 1989 should be categorized as experimentation within a socialist market framework rather than as serious reforms of the system. Some measures were taken to elect managers in state enterprises, and there was much discussion of price reform and ways to provide greater incentives to managers, but none of these actions were effective.

In many instances these mistakes backfired and set the course for future changes. Gorbachev's anti-alcohol campaign is infamous for creating a large budget deficit as tax revenues from alcohol dried up. The government embarked on an external borrowing spree while at the same time spending foreign exchange and gold reserves. By allowing regional experiments with decentralization and greater autonomy, the government threatened dissolution of the state by bringing the separatists' demands to the foreground.

Furthermore, despite the reform-inspired discussions (e.g., convertibility of the ruble was first officially mentioned in June 1987), this period helped little in educating officials in the operations of a market economy. This was an era marked by very risky and painstaking hits and (mostly) misses. Apart from the creation of thousands of small cooperatives, few clear benefits could be identified by 1989. The economic debate during this time was often very far from the reality of a market system, and it proved to be a costly period for which Russian taxpayers today and in the future must pay.

August 1989 to November 1991

It was Gorbachev's political reforms, and mistakes in his economic policies up to 1989, that provided the main impetus for reforms. The growing shortage of basic goods, the separatist trends in the union republics, the gradual breakdown of interenterprise relations, declining discipline, and morale of government staff, and lack of definite progress in most areas of economic policy pushed Gorbachev to take more active steps.

This was a period when political reforms far outpaced economic reforms. With the growing tension between a highly controlled economic regime and a more liberal political environment, it was becoming clear that either political reforms would have to be stopped or economic reforms would have to accelerate.

In March 1989 the first elections for the Congress of People's Deputies were held in the USSR. While the elections were controlled to restrict the types and number of candidates, it was a God-sent miracle in this situation. The new Congress led to the formation of the first Soviet government, and the new government was somewhat reform-oriented. The academician L. Abalkin became head of the reform commission and deputy prime minister.

In late 1989 Abalkin's reform program was officially announced and adopted. It was a gradualist strategy and contained many of the important measures needed to update the Soviet economy and start market-oriented reforms. His program was clearly a step upwards, albeit a small one, in the quality of reform ideas that penetrated high circles.

Abalkin's approach accomplished little because it was unsuited for the economic and political situation in the country. It underestimated the importance of rapid changes in the price and trade systems, the role of the central bank, and fiscal reform and privatization. The reform strategy was so gradual in design that it was doomed from the moment it was conceived.

The other reason for the imminent failure of the program was the weakening position of Moscow vis-à-vis the union republics. The loss of central control meant that economic policy actions taken in Moscow would have little impact on the country.

The problems facing the central government and the failure of current measures became so apparent that more accelerated reforms came on the agenda. For example, in March 1990 N. Petakov, one of Gorbachev's assistants, convened a meeting of economists to try to devise an alternative program. When this plan was completed, Gorbachev welcomed the ideas but never attempted to implement them or use them in a practical manner.¹

1. The Congress of People's Deputies was elected in March 1989 with subsequent runoffs lasting until May. It met in June and the proceedings were televised throughout the country. The Congress elected the Supreme Soviet, which then approved nominees for the Council of Ministers. The debates in each of these forums were surprisingly open and included harsh criticisms of economic policies.

A similar Russian Congress of People's Deputies was elected in March 1990, and it was responsible for choosing the Russian Supreme Soviet (or Parliament). Since in 1990 the Russian Congress seemed inconsequential, and most prominent Russian politicians preferred to stand as candidates for the Soviet Congress. It was this Congress and the Parliament chosen by it that Yeltsin dealt with until its dissolution in September 1993 prior to the December 1993 elections.

Rules for candidacy in each of the elections ensured that the majority of candidates were predisposed towards the Communist Party. Officially there was no party structure in either Congress.

² Boris Fedorov, one of the authors, took part in these meetings.
The situation changed dramatically when Boris Yeltsin became head of the Russian Parliament, which swiftly declared Russian sovereignty. This was the turning point when the internal debate became so highly politicized that issues related to economic reforms faded into the background. From here on, major discussion of economic reforms came about only in response to dire political need.

An attempt to save the situation was undertaken in August–September 1990, when an advisory team, which included G. Yavlinsky, N. Petakov, S. Shatalin, and B. Fedorov, designed the famous “500-day Program.” This advisory team was formed under a joint ordinance by Gorbachev and Yeltsin. (Abalkin was invited to join the team but refused to participate.)

The “500-day Program” was a major step forward in the economic reform debate. It called for rapid reform of virtually all sectors of the Soviet economy, including price liberalization and privatization. The program failed to be implemented because none of the highest politicians seriously wanted it. At this time, the Russian and Soviet governments were living in two separate worlds; they hardly cooperated on any issue and each side was waiting for some resolution of the crisis. The actions they did take were out of desperation, such as the Pavlov-Geraschenko confiscatory monetary reform in 1991. Such types of desperate measures led to chaos and loss of credibility of the authorities, with no tangible positive results.

The impasse was broken with the abortive August 1991 coup d’etat when the Russian government became the political master of its own territory. As the republics gained power relative to the center, they withheld revenue transfers; in addition, their own central banks started issuing ruble credits without authorization from Gosbank, the central bank of Russia.

The last months of 1991 were characterized by record food shortages, price increases, uncertainties, and total paralysis of the authorities. The growing crisis played one clear and positive role: it emphasized to the Russian leadership that urgent economic reforms were needed and that the old economic system had irreversibly broken down.

November 1991 to January 1994

The growing crisis in late 1991 clearly required the acceleration of economic reforms. However, with very little progress made after the abortive coup, it was not clear that anything was actually going to be done. This changed suddenly when Yeltsin unexpectedly asked Yegor Gaidar to head an economic team to design Russia’s reforms. Gaidar’s appointment was largely due to strong support from Yeltsin’s political advisor and later first deputy prime minister, Gennady Burbulis. Nobody had predicted that Gaidar would be named deputy prime minister in charge of economic policy.

But this miracle happened out of desperation, and Gaidar was given enormous authority to conduct economic policy. This was the breakthrough that the Russian reform process needed. In a few months Russia was transformed into a new country by measures that included the following:

- near complete price liberalization,
- liberalization of foreign trade,
- freedom to conduct economic activity,
- unified and convertible foreign exchange,
- start of a mass privatization program, and
- attempts at financial stabilization.

The problem in this first stage of real reforms was that the members of the Gaidar team remained isolated within a small part of the bureaucracy and they never received sufficient support from the political elite.

While Yeltsin backed the reformers strongly at the start, over time presidential support appeared to wane. By early spring, Gennady Burbulis, who had been the main supporter of Gaidar on Yeltsin’s team, was being attacked by the Parliament and was beginning to lose favor with Yeltsin. During this period Yeltsin surrounded himself with much less reform-minded advisors. Gaidar never developed a strong rapport with Yeltsin; their policy meetings were irregular and infrequent.

The government was attacked from all sides from the very beginning. In December 1991, then Vice President Aleksander Rutskoi labeled the Gaidar team “small boys in pink shorts with yellow boots,” and in January 1992 the Speaker of the Parliament, Ruslan Khasbulatov, was

4. Former Prime Minister Silaev was sent to Brussels as ambassador to the European Community (EC).
5. The Gaidar team included A. Chubais, head of the privatization ministry; A. Nечаев, minister of the economy; P. Aren and S. Glazier, minister and deputy minister of foreign trade; L. Grigoriev, foreign investment committee chief; A. Shokin, originally the deputy prime minister in charge of social affairs; and other advisors, such as S. Vasilyev and K. Kazalovsky.
6. Yeltsin initially appointed himself prime minister in order to avoid an early confrontation with the Parliament over the choice of prime minister.
7. Burbulis was Yeltsin’s most important political strategist and advisor during autumn 1991 and spring 1992. He was strongly supportive of the Gaidar team, and it was largely due to his influence that Yeltsin chose Gaidar to lead the reforms (see Yeltsin 1994, 150–2).
calling for their resignation. During the crucial time in November 1991 when the Gaidar team needed to ensure sound monetary policy, the Parliament refused to relinquish control or replace the central bank chairman with a reform-oriented leader.\(^8\)

The Gaidar team had no experience and few of the skills needed to deal with the executive and legislative branches. Rather than attempt to build support in other branches of power, they isolated themselves within the government, and even their power was gradually eroded as some ministers resisted reforms and as bureaucrats prevented changes. In his autobiography, Yeltsin writes "... by sophisticatedly refusing to ‘dirty their hands with politics’ and leaving all political initiative to [Brezhnev], the Gaidar team made a tactical error that cost us all a great deal."\(^9\)

This inexperience led to the eventual downfall of the team. Gaidar responded to attacks by making too many compromises and he tended to trust "old specialists" who eventually outwitted and ousted him. While he brought some excellent economists to the government, he also kept for no apparent reason anti-reform personnel such as Vasily Banchuk in the powerful position of Minister of Finance. One of his greatest mistakes was to support the former head of Gosbank, Viktor Gerashchenko, to become head of the Russian Central Bank in July 1992. Gerashchenko immediately expanded monetary growth, ending any hope that Russia could stabilize in 1992.

By April 1992 there was not much fighting spirit left in the reformers. The government narrowly survived an April meeting of the Congress of People’s Deputies after they submitted their resignation as the Congress began. One demoralizing moment came when Vladimir Lopukhin, one of the members of the Gaidar team, was abruptly dismissed by Yeltsin in May 1992 and replaced by Viktor Chernomyrdin, the former director of Gazprom (the gas company). This was the first in a string of cabinet changes that would weaken the Gaidar team and raise the power of the industrial lobby.

The end of the Gaidar era came on December 12, 1992, when the Congress of People’s Deputies rejected Gaidar for the position of prime minister. He was replaced by Viktor Chernomyrdin. Chernomyrdin’s appointment did not turn out to be a decisive turning point against reforms that so many commentators at the time predicted. Chernomyrdin proved to be a very able and tough leader. His experience in Gazprom and as minister of energy from May 1992 gave him the ability to deal with old Soviet directors and bureaucrats, and he was able to preserve a balance between reform measures and the anti-reform actions demanded by the industrial lobbies.

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### Table 6.2

<table>
<thead>
<tr>
<th>Party factions in the state Duma (December 1993 elections)</th>
<th>Number of deputies</th>
<th>Share of vote (%)</th>
</tr>
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<tbody>
<tr>
<td>Russia’s Choice (liberal)</td>
<td>74</td>
<td>16.5</td>
</tr>
<tr>
<td>December 12 Union (liberal)</td>
<td>32</td>
<td>7.1</td>
</tr>
<tr>
<td>Yabloko (liberal)</td>
<td>29</td>
<td>6.5</td>
</tr>
<tr>
<td>FRES (centrist)</td>
<td>31</td>
<td>6.9</td>
</tr>
<tr>
<td>New Regional Policy (centrist)</td>
<td>60</td>
<td>13.4</td>
</tr>
<tr>
<td>Russia’s Women (centrist)</td>
<td>23</td>
<td>5.1</td>
</tr>
<tr>
<td>Democratic Party of Russia (centrist)</td>
<td>15</td>
<td>3.3</td>
</tr>
<tr>
<td>Agrarian Party (communist)</td>
<td>55</td>
<td>12.3</td>
</tr>
<tr>
<td>Communist Party (communist)</td>
<td>45</td>
<td>10.0</td>
</tr>
<tr>
<td>Russian Way (nationalist)</td>
<td>13</td>
<td>2.9</td>
</tr>
<tr>
<td>Liberal Democratic Party (nationalist)</td>
<td>64</td>
<td>14.3</td>
</tr>
<tr>
<td>Independent</td>
<td>7</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>448</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>


Chernomyrdin’s government kept key members of the Gaidar team in power. Most importantly, the head of the State Committee for Privatization, Anatoli Chubais, remained. He has proven to be one of the most skillful politicians amongst Gaidar’s initial appointees. He designed and implemented the mass privatization program.

Yeltsin also brought Boris Fedorov, a professor of economics and previously the Russian Minister of Finance in 1990, into his government as Minister of Finance. Fedorov had the reputation of being a sound macroeconomist and a strong political fighter. Fedorov renewed efforts to coordinate monetary policy and prevent a threatening hyperinflation by reconstituting a credit committee that was responsible for coordinating all decisions over new credits. He also eliminated import subsidies, raised energy prices, abolished subsidized government credits to agriculture and northern territories, and introduced government bonds.

However, in this period political debate again interfered and prevented full stabilization and rapid reform. The Supreme Soviet and the Congress of People’s Deputies became more aggressive—instead of just attacking the government they now opposed the president outright. This conflict increasingly led to a stalemate.
The culmination of this stalemate came on September 21, 1993, when Yeltsin dissolved the Supreme Soviet and Congress of People's Deputies and called for new elections and a referendum on a new constitution. The violent response of the Congress led to its abolition, and this ended the immediate political uncertainty and gave voters a chance to show their assessment of economic and political changes.

The December 1993 election results were negative, if not disastrous, for the reformers (table 6.2). Yegor Gaidar's party, "Russia's Choice," received only 15 percent of the vote. The combined vote for the liberal parties was only 30 percent, while the nationalists, under Vladimir Zhirinovsky, gained 22 percent. The Communist Party gained 12 percent of the vote. When individual seats and party lists representatives were combined, the end result was a Parliament that was roughly equally divided between liberals, centrists, and a third grouping of communists and nationalists (the so-called "red-brown coalition").

The election results forced changes in the government. Chernomyrdin, who had associated himself from the election campaign, was able to stay on as prime minister by playing the role of a technocrat with substantial appeal to the centrists. Yegor Gaidar, who had been brought back into the government briefly as a deputy prime minister from September 1993, resigned on January 16. Boris Fedorov resigned on January 20. Chernomyrdin called for a new "non-monetary measures" to control inflation, and he defended Gerashchenko's stewardship of the central bank. The most prominent reformer left in the cabinet was A. Chubais, who continued in his original assignment of privatizing the state sector.

January 1994 to end of 1995

In the December 1993 elections, voters also approved a new constitution that gave substantial economic and political powers to the president.10

Thus, while the government faced a relatively hostile Parliament, the new constitution ensured that the president held the main power over the direction of economic policy.

The December 1993 elections did not prove decisive in redirecting economic reforms in any particular way. Instead, the subsequent period was characterized by gradual improvements but lack of serious reforms in many key areas.

Most of 1994 was wasted in terms of reform efforts. Not a single economic measure of any serious importance was implemented during this period. The government tried to stabilize the economy in early 1994, and the monthly inflation rate fell to 4 percent in August. However, stabilization was abandoned when the central bank and ministers caved in to pressures for agricultural credits and subsidies to northern territories in the summer and the fall. By December 1994, inflation was back to a monthly rate of 17 percent. The softened policy stance was foreseen in financial markets and led to a 27 percent depreciation of the ruble on October 11, 1994, as investors lost confidence in the government. This has been immortalized as "Black Tuesday," but it marks a positive step forward in the policy-making environment. Government and central bank officials now recognize that financial markets can and will abruptly penalize unsound credit policies.

The results in 1995 have been more positive. In January 1995 Chubais was appointed first deputy prime minister in charge of economic affairs, and he implemented a stabilization program. The initial results of this program are promising, but it is too early to judge its success or failure; much will depend on the results of upcoming parliamentary and presidential elections. The government avoided pressures to loosen policies in the autumn as they did in 1994, and by November 1995 the monthly inflation rate had fallen to 4.5 percent.

One of the more surprising results has been the gradual normalization and improvement of macroeconomic policy making and the parliamentary process. A new central bank law was passed by the Duma which gave substantial independence to the central bank chairman. The new president of the central bank, Sergei Dubinin, is pro-stabilization and was approved by a wide margin in the Parliament. In addition, for the first time since 1991 a budget has been passed prior to the start of the new fiscal year (1996).

6.3 Components of Economic Reforms

The former nomenklatura, the old political elite, and overly sympathetic observers have combined to criticize Russia's reforms as having too much shock and too little therapy. But such diagnoses ignore the
realities of reform. In many areas reforms have been far too slow and very incomplete. To draw lessons from Russia's reforms, it is worthwhile to highlight major achievements and failures of the various components of economic reform.

Price Liberalization

This major step was made on January 2, 1992, but unfortunately price liberalization was stretched over too long a period. Price liberalization was simply a necessity in January 1992. In 1991 the government had begun a set of haphazard price reforms, first partially liberalizing producer prices in 1991 and then raising consumer prices to limit enterprise losses and shortages. A small private market for goods was permitted to flourish, and here prices rose well above official prices due to the exploding monetary overhang. The 1991 price reforms merely reflected the turmoil and there was no clear plan or program. By the end of 1991 goods had almost completely disappeared from state shops, and the state price system had completely broken down.

On January 2, 1992, most prices were freed. Price controls were maintained for energy and transportation, and there were controls on some key consumer goods, including certain types of bread, milk, medicine, and public utilities. Local governments also kept the right to control prices of basic foodstuffs and to limit markups in retail stores.

The Gaidar team had hoped that the reforms would lead to a rapid improvement in the availability of goods, but the situation improved over a much longer period of time than anticipated. For example, Goskomstat data showed that meat was available in only 27 percent of towns by December 1992, up from 14 percent in March 1992.

Lack of more rapid progress was due in part to continued controls; in part, to the poor nature of the national distribution system; in part, to the monopolies that some local entities continued to have over distribution. High inflation and low interest rates also encouraged enterprises and households to hoard goods. There is no doubt that price reforms were needed and that they helped, but more needed to be done to increase the supply of goods.

11. We can define the monetary overhang as the excess of money supply over money demand at official prices. There were two sources of the increasing monetary overhang. The first was the rapid growth of the money supply due to the budget deficit and loss of control over the issuance of ruble credits after the breakup of the USSR. The second was a sharp decline in the demand for rubles as expected inflation caused a flight to alternative assets. The latter was underestimated at the start of the reforms, and was the main reason why the government and the IMF expected far lower price increases than actually occurred in January 1992.

The Ups and Downs of Russian Economic Reform

It is worthwhile to evaluate some of the arguments advanced at that time in favor of price controls. Some argued that because Russian industry was overly energy intensive, it needed a respite to restructure and reduce energy dependence. Although there may be some truth to this argument, it is only true for a subset of enterprises, and it is really a question of weighing the political and economic costs against the benefits of maintaining controls. The most intensive energy users are very often exporters (such as metallurgy). These exporters made substantial profits from trade liberalization, and energy price controls merely raised their profits. The less intensive users could adjust wages and product prices to compensate for the higher costs. On the budgetary side, the higher energy tax revenues from the liberalized prices would have reduced the budget deficit significantly.

Another argument for price controls was that price liberalization would paralyze industries due to endemic monopolies. But in fact, as a study by Brown, Ickes, and Ryterman (1994) has shown, Russian industry is no more monopolized than in the West. They found that only 43 out of 21,391 civilian manufacturing enterprises constituted monopolies at the national level, and enterprises with 55 percent of market share accounted for only 4 percent of all employment.

In retrospect most key participants agree it was a clear mistake to take three years to reach the present degree of price liberalization. There is a case to be made for maintaining controls on rents and utilities to households (as part of the social safety net), but the costs of not fully liberalizing other prices were a loss of tax revenues, corruption, and energies wasted on political infighting generated by the remaining price controls.

Trade Liberalization

The main part of trade liberalization occurred at the start of 1992. Most state orders were effectively abolished, thus fully liberalizing domestic trade. Thousands of private trading companies quickly appeared. There was, however, only partial liberalization of foreign trade.

The most important remaining restrictions on foreign trade were the export licenses and quotas established on energy and raw materials that make up to 50 percent of Russian exports. The export quotas and licenses served as a system to claw back some of the large expected profits in the natural resource sectors. The initial plan was to auction the quotas so that the government could raise revenue for the budget. In 1992 these exports amounted to $22 billion (table 6.3). Approximately $10 billion of this amount was to be collected via export taxes and sales of quotas.

The idea was that by limiting the export of raw materials one could avoid a sudden collapse in domestic availability of these resources (or
Table 6.3
Foreign trade and balance of payments (CIS and non-CIS countries, $ bln)

|----------------|------|------|------|------|------
| Exports        | 53.9 | 41.1 | 43.9 | 50.0 | 75.0 |
| Energy and minerals | 26.3 | 71.7 | 22.2 | —    | —    |
| Imports         | -45.1| -36.9| -27.1| -36.8| -51.0|
| Energy and minerals | 1.3  | 1.0  | 0.9  | —    | —    |
| Net services plus grants | 4.1  | -1.3 | 11.1 | 4.1  | 12.0 |
| Current account balance | 0.4  | -3.7 | -13.0| -12.5| —    |
| Long- and short-term capital | —    | —    | —    | —    | —    |
| Errors and omissions | 1.9  | -7.6 | -12.7| 1.5  | —    |
| Capital account  | -1.5 | -11.3| -25.7| -13.0| —    |
| Overall balance  | 2.6  | -12.6| -14.6| -7.5 | —    |
| Net international reserves (= increase) | 0.6  | -1.3 | -3.3 | 3.9  | —    |
| Arrears on debt service and deferrals | 1.7  | 13.9 | 18.3 | 3.6  | —    |

Source: Russian Economic Trends, various issues.
a. Projections based on data from first three quarters of 1995.

In the late 1980s there was still much discussion over how quickly the ruble could be made convertible. Analysis often made the mistake of likening Russia's situation to post-war Europe, and argued that Russia should follow Europe's example of gradual introduction of convertibility over a period of 10 to 20 years. This would have merely led to continued inefficient allocation of foreign exchange. The central bank and the government were in no position to choose who should receive foreign exchange, and exporting enterprises had too many means to avoid surrender. The result of a new official exchange rate different from the market rate would only have been evasion of surrender requirements.36

Convertibility on the current account came into practice in July 1992. This was preceded by a sharp devaluation of the ruble at the start of the reform, and pressure from the IMF forced through unification of the exchange rate in July 1992.

One of the most important and striking reforms during the period was in local commerce. Millions of Russian citizens went into the streets to trade just about everything. This explosion of trade occurred after Gaidar pushed through a decree in January which explicitly stated that enterprises and households were permitted to trade anything, at any price, and anywhere they chose. This decree broke the early resistance of the police and local governments to free domestic trade.

Budget and Monetary Policies

The lack of coherence in trade and price liberalization mirrors the failure of policies aimed at macroeconomic stabilization. In order to understand the failure to stabilize the economy and to conduct coherent reforms, we need to remember that few of the political elite supported such measures. At any time only a handful of people in the government were truly in favor of economic reform, and they rarely had the support of Prime Minister Chernomyrdin, President Yeltsin, or Parliament.

This problem was most readily seen with the budget. The Gaidar plan for 1992 called for an annual budget deficit of 1 percent of GDP. During the first quarter of 1992 the cash budget surplus turned out at 0.9 percent of GNP compared with a deficit of over 25 percent of GNP in 1991.

12. According to Russian Economic Trends (1995, vol. 2, no. 1, table 11), the revenues to the budget from foreign activity taxes were approximately $1.5 billion in 1992. Very rough calculations show how far this was from potential revenues under the announced regulations. The domestic price of oil in 1992 was roughly $20 per ton, and this compared to a price of $315 for Russian oil on world markets. Allowing for transport costs of $15 per ton, a competitive scheme should have netted the government the difference between the world price net of transport costs and the domestic price, or $70 per ton. Sixty-six million tons of oil were exported to non-CIS countries in 1992, so this could have raised $4.6 billion. In addition, natural gas exports and other mineral exports, according to tax laws, should have raised substantially more than this amount. The $10 billion figure quoted in the paper is a rough estimate of potential revenues.

13. The practical importance of the official exchange rate was actually related to the pricing of imported goods distributed through government channels. This was particularly important for imports resulting from disbursements of official bilateral credits. Once these credits were reduced, and due to pressure from the IMF to unify the exchange rate, the political balance shifted in favor of unification.
Table 6.4
Government fiscal indicators and deficit financing (percent of GNP)

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<tr>
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<tbody>
<tr>
<td>General government</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>33.1</td>
<td>25.7</td>
<td>27.3</td>
<td>—</td>
</tr>
<tr>
<td>Expenditures</td>
<td>37.2</td>
<td>35.3</td>
<td>37.3</td>
<td>—</td>
</tr>
<tr>
<td>Deficit</td>
<td>4.1</td>
<td>9.6</td>
<td>10.0</td>
<td>—</td>
</tr>
<tr>
<td>Federal deficit</td>
<td>—</td>
<td>10.4</td>
<td>10.4</td>
<td>3.2</td>
</tr>
<tr>
<td>Sources of financing federal deficit</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monetary</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.0</td>
</tr>
<tr>
<td>External finance</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>0.8</td>
</tr>
<tr>
<td>Bonds</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>2.0</td>
</tr>
<tr>
<td>Other non-monetary</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>0.6</td>
</tr>
</tbody>
</table>

a. General government includes federal, local, and extra-budgetary funds, expenditures, and revenues.
b. The federal deficit refers to the federal budget only.

But then things fell apart. Revenues from foreign trade failed to materialize, (because of the corruption endemic to the export quota system), and President Yeltsin granted tax exemptions to regions and enterprises. One saving measure would have been to tax domestic energy and raise energy prices, but there was no political support for such measures at that time. Yeltsin fired the energy minister, Vladimir Lupukhin, in April 1992 precisely because he proposed such measures.

The opposition to Gaidar’s policies got stronger over time. By June, Yeltsin had reshuffled the cabinet to include three industrialists, and the government effectively had given up on monetary and credit control. The governor of the central bank at that time, Georgy Matyukin, while not a member of the Gaidar team, was increasingly being forced into their camp as the Parliament attacked him for raising refinance rates and rationing credits. Instead of supporting Matyukin in his fight with the Parliament, the government ousted him. In retrospect, monetary policy was perhaps the weakest link in the stabilization program.

14. In his autobiography, Yeltsin writes, “There was a very concrete reason for Lupukhin’s dismissal. Using him a battering ram, Gaidar was putting pressure on me to release prices on energy resources simultaneously with other prices without any restrictions.” (Yeltsin 1994, 167.)

The Ups and Downs of Russian Economic Reform

Table 6.5
Monetary aggregates and the allocation of seigniorage

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M2 money (brs bll)*</td>
<td>1.0</td>
<td>7.1</td>
<td>36.7</td>
<td>104.7</td>
<td>156.8</td>
</tr>
<tr>
<td>Average monthly M2 increase (%)b</td>
<td>7.0</td>
<td>18.2</td>
<td>14.7</td>
<td>9.1</td>
<td>7.5</td>
</tr>
<tr>
<td>Velocity (GNP/M2) c</td>
<td>1.9</td>
<td>5.4</td>
<td>10.0</td>
<td>10.0</td>
<td>7.5</td>
</tr>
<tr>
<td>Seigniorage (percent GNP) d (via credit issue only)</td>
<td>32.7</td>
<td>13.3</td>
<td>9.8</td>
<td>1.3</td>
<td></td>
</tr>
<tr>
<td>of which allocated to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>—</td>
<td>13.7</td>
<td>4.8</td>
<td>1.8</td>
<td>0.4</td>
</tr>
<tr>
<td>Government</td>
<td>—</td>
<td>10.5</td>
<td>5.9</td>
<td>7.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Other FSU</td>
<td>—</td>
<td>8.5</td>
<td>2.6</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Monthly nominal interest rates on central bank loans e</td>
<td>—</td>
<td>7.5</td>
<td>11.7</td>
<td>14.2</td>
<td>15.0</td>
</tr>
<tr>
<td>Inflation (CPI)b</td>
<td>8.3</td>
<td>31.2</td>
<td>20.5</td>
<td>10.0</td>
<td>10.7</td>
</tr>
</tbody>
</table>

Source: *Russian Economic Trends and author’s calculations.*
a. Value in December.
b. Geometric average annual increase.
c. Arithmetic average of monthly values.
d. Monthly interest rate of the CBR at mid-year.
e. This is calculated as the monthly change in net credits issued by the CBR divided by monthly GNP and then averaged over the 12 months of each year. Note that in 1995 M2 money growth has largely been due to accumulation of foreign reserves at the central bank along with a rising money multiplier.

The July appointment of Viktor Gerashchenko as head of the central bank came just two weeks after Russia signed its first standby agreement with the IMF, and ironically it marked the start of a near-hyperinflationary period. Gerashchenko immediately responded to enterprise demands for credits. With interest rates controlled at low levels, the demands for credits were enormous. At the same time Gaidar made compromises with the industrialists and the fiscal budget was loosened, with large credits directed to agriculture, industry, and the northern territories. These became known as the “Gaidar credits,” and Gaidar justified them as the only means to maintain the privatization program.

We were losing contact with all of the industrial structures. We could not even count any longer on unlimited support from the President ... it was evident that policy would have to change, leaving us with two options: either accept the change of economic policy ... or resign immediately. (Gaidar and Foh 1995, 57)
The other real problem for policy making at this time was the ruble. There was never a clear plan for dealing with the ruble, and so long as the Central Bank of Russia (CBR) honored the credits of other republics, they effectively had license to print money at Russia’s expense. By June 1992 these credits already amounted to 8.5 percent of GNP in 1992 (see table 6.5) and were a major source of inflationary money.

Russia very much needed to take control of her domestic currency and to prohibit other countries from issuing rubles, but this required political decisiveness which no one was prepared to undertake. The issue was complicated by the IMF when, in a May 1992 meeting of CIS officials in Tashkent, they proposed and actively promoted an unworkable program to maintain a ruble zone throughout the CIS. This would have required voluntary and unverifiable constraints on credit issue at every central bank—this of course was impossible in the existing political situation.

The sheer size of credit issue in Russia reached proportions that were unheard of in other high-inflation countries, and this undoubtedly explains why it was so difficult to stop the process in those early months and years. In 1992, seigniorage to the central bank from credit issue equaled 32.7 percent of GNP (table 6.5) and was primarily directed to enterprises and other republics. These levels of seigniorage could only be supported while the payments system remained inflexible and enterprises did not conserve on money balances to avoid the inflation tax.

But over the next few years both these factors changed. As enterprises and households stopped saving in rubles and began holding spare cash balances in other currencies, the demand for rubles fell and inflation rose. In 1993 and 1994 while seigniorage fell, inflation remained high for precisely this reason (figure 6.1). With the relaxation of monetary and fiscal policy in the summer, the ruble-dollar exchange rate collapsed by 27 percent on October 11, 1994. This brought home once and for all the message that the days when the central bank could issue large credits without causing hyperinflation were over.

**Tax Reform**

One of the biggest failures of Russian economic reforms is in the area of tax collection and tax reform. Before 1991 the Soviet Union and Russia had no real tax collection system, and it had to be developed hastily in order to avoid financial collapse in 1991 and 1992. This is why so little thought was given to details and the overall efficiency of the system. Under the current rules there is too heavy a reliance on corporate taxes and little attention to individual taxes. The array of taxes on businesses have cumulated into excessively high marginal tax rates on corporate income.

It is already clear that the tax system needs a major overhaul. The government has planned to undertake major tax reform only in 1997. This delay will undoubtedly slow the development of private business. Listed below are several basic measures which need to be taken as part of any tax reform.

- abolishing the excessive wage tax;
- redefining the concepts of income, costs, and profits;
- phasing out double taxation and lowering value-added tax (VAT);
- increasing property taxes;
- phasing out export duties and many import tariffs; and
- introducing accelerated depreciation.

**Privatization and Enterprise Reform**

Privatization is hailed as a major success in the Russian reform program. The voucher program, designed and carried through by Anatoli Chubais, has been a major success when measured by the number of enterprises
that have ultimately been privatized. The speed and scale of privatization in Russia has far outpaced every other formerly socialist country: as of April 1995, three-quarters of Russian industry was privately owned.  

The program has had a great impact on the political debate within Russia. By divesting assets from the state, the government has reduced the overall ability of line ministries to interfere in the activities of enterprises. Further, by transferring these assets to private individuals, the program has created a large number of shareholders with a vested interest in maintaining enterprise autonomy and ensuring rapid development of property rights. These benefits are most clearly seen in the December 1995 election campaign: while all the parties have criticized the details of the program, not even the communists are calling for a serious reversal.  

The economic impact of voucher privatization is less clear. Early empirical evidence based on survey data by Earle, Estrin, and Leschenko (1995) shows that privatized companies do not perform or behave differently from state-owned enterprises. This is a common finding in other Eastern European countries also, and it appears that only the de novo private sector really acts and operates as we would expect market-based private enterprise to operate. Privatization may still promote the de novo sector, since it permits state enterprises to divest assets legally, but the direct impact on state enterprises does not appear large, at least in these initial years.  

The weak performance of these privatized enterprises is less surprising when we examine ownership structure. The voucher privatization program offered two main alternatives to enterprises. The workers and managers could maintain 51 percent control of the enterprise by purchasing shares at inflation-eroded book value prices, or they could receive 25 percent of shares free and then be able to purchase another 10 percent of shares at a discounted price. The remaining shares were to be held by the state property fund and sold in auctions for vouchers.  

Boycko, Shtelfer, and Vishny (1995) point out that the major reason this set of options was chosen was political. Enterprise managers and workers already had a de facto claim on enterprises because they controlled daily operations, and through strikes and non-cooperation they could have jeopardized any program that threatened their control. The government's options were either to wait until it became strong enough to fight off these interests (if it ever did) or to move ahead with a program to create clear ownership rights and control. Survey evidence

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15. As of April 1995, 73.7 percent of industrial enterprises have been privatized and these accounted for 84.6 percent of total industry output.

16. There was a third option that was not used. See Boycko, Shtelfer, and Vishny (1995) for a discussion.

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reported in Earle, Estrin, and Leschenko (1995) suggests that workers or managers are the dominant owners of 55 percent of privatized state enterprises, while the state remains the dominant owner in 34 percent, and outside owners are dominant in only 11 percent.  

In theory, insider control should not be so serious a problem. Once property rights are defined, enterprise managers and workers can always sell their shares on open markets or to bidders that wish to gain control of an enterprise in order to restructure it. For these equity markets to operate, however, there must be clear rules and procedures.  

There are several incentives operating today that suggest insider owners may still wait before they restructure enterprises or divest assets. When there are outstanding shares held by the state, or by workers with weak control rights, it is only normal that a director would want to take actions to limit the market value of these shares so that management or friendly entities can buy up the remaining outstanding shares at low prices.  

Thus a serious problem arises because the incentives of enterprise owners clash with the government's desire to create well-functioning property rights. There are many examples of enterprises restricting access to shareholder registrars, limiting information on their boards, and hiding or underestimating profits. The legislation guiding shareholder rights is only now being established by the Duma, but it will still take several years for these measures to be effectively enforced. In the meantime, a handful of enterprises, such as the oil producer LUKoil and the large utility company Mosenergo, are creating their own security registrars operated by independent authorities. These companies choose this approach because they want to raise money in equity markets. However, for the vast bulk of firms that could not raise external financing, or for those firms whose managers and workers still hope to buy up shares at low prices, there are few incentives to create effective ownership rights.  

The impact of these issues on the prices of energy stocks can be seen in table 6.6. Share prices have collapsed after initial euphoric rises in early 1994. Today Russian shares sell at the lowest price/earnings ratios found in any nation in the world. The market value of enterprises such as Mosenergo, the main electricity generator for Moscow, today equals roughly 18 months' earnings, i.e., the value of P/E is 1.5. This compares with a typical price of ten times earnings for electricity generators in Eastern Europe, and fifteen times earnings in the United States. The market values of oil and gas producers, as shown in table 6.6, are similarly

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17. These estimates are based on results from their random sample of 325 privatized enterprises.
low when measured by market capitalization relative to known reserves, and by market capitalization relative to production. 18

Table 6.6 shows that all market prices the top ten oil producers in Russia are worth only 0.6 percent of GNP, but if property markets develop and risk is reduced then they could be expected (based on conservative comparisons with Western standards) to rise closer to 15 percent of GNP. Political uncertainty and vague shareholder rights are believed to be the two most important concerns that keep share prices low.

The size of the wealth distribution underlying the privatization program is unprecedented anywhere in the world. Enterprise profits of former state enterprises in the national accounts are roughly 20 percent of GNP, 19 so at a P/E ratio of 1.5, these assets are worth 30 percent of GNP ($900 billion). But if P/E ratios rise to more reasonable levels, e.g., as in Poland, where they are around 10, then the assets would be valued at 200 percent of GNP ($600 billion).

The current low valuation of assets means that part of this redistribution is still to come—i.e., once asset prices rise. But low equity prices pose a serious problem for the government in its next stage of the privatization program. In most cases, authorities do not even try to enhance the value of companies by inviting independent organizers of auctions and allowing foreigners to participate. The goal now is to raise revenue for the budget by selling remaining shares in state enterprises for cash. With the top ten oil companies valued at only 0.6 percent of GNP, government leaders can only expect modest revenues and they are certain to be criticized for selling assets at too low a price.

There has been much less progress in private land ownership. Boris Yeltsin first advocated private land ownership five years ago, and various decrees on the issue have been published since then, but the problem is still unresolved. Indeed the Duma recently adopted a land code that in effect precludes privatization of land. The opposition to land

| Table 6.6 |
| Market values of Russian oil producers |
| | Daily production (M bbl) | Reserves (M bbl) | MCap at Feb. 1995 stock market value (US$ billion) | MCap based on typical Western MCap/production ratios (US$ billion) |
| Surgutneftegaz | 250 | 10,880 | 0.6 | 10.0 |
| Yuganskneftegaz | 209 | 11,680 | 0.4 | 8.4 |
| LUKoil-Kogalymneftegaz | 185 | 7,860 | 0.1 | 7.4 |
| Noyabinskneftegaz | 165 | 4,650 | 0.2 | 6.6 |
| LUKoil-Langepanskneftegaz | 108 | 4,530 | 0.1 | 4.3 |
| Megionneftegaz | 96 | 2,100 | 0.1 | 3.8 |
| Tomskneft | 82 | 3,500 | 0.1 | 3.3 |
| Pernneft | 65 | n.a. | 0.1 | 2.6 |
| Purneftegaz | 60 | 6,900 | 0.2 | 2.4 |
| Orenburgneft | 54 | 2,164 | 0.1 | 2.2 |
| Total | 1,274 | 53,454 | 2.0 | 50.9 |
| (Total, as % GNP) | — | — | 0.6 | 15.5 |

Source: Russian Economic Trends and Brunswick Brokerage. Note: A typical Western ratio of market capitalization in million dollars per thousands daily production is 39. An alternative would be to calculate market value based on known reserves. This would lead to even higher estimated values for Russian producers (approximately three times the reported value in the fourth column of this table).

reform comes from the groups that are most threatened by it—namely, the leaders and managers of the collective farms who are represented by the left-wing Agrarian Party. They continue to do everything in their power to limit disintegration of collectivist agriculture.

In this environment reform and change in the agricultural sector has proceeded at a snail's pace. State and collective farms continue to operate in the same inefficient manner and are supported through import tariffs and regular subsidies. The first wave of private farmers has met so many difficulties, in part due to non-cooperation from the state sector,
political power of the leaders and managers of collective farms in the form of the Agrarian and Communist Parties, it is possible that agriculture will continue to stagnate and be sheltered for years to come.

Legislative Process

The reforms in Russia began to a large extent with destruction of political and legal process. This left many people with the erroneous view that Russia lacked the legal infrastructure needed to support reforms; hence they argued that this was a major handicap to implementing reform measures.

But in fact Russia’s problem was in many ways the opposite. There were enormous numbers of reform-oriented laws adopted between 1990 and 1995, but at the same time there was widespread disregard for the law at every level of decision making. Often the groups passing laws and signing decrees knew they were in conflict with other legislation, and they used the resulting confusion to frustrate attempts by others to introduce (or limit) reforms. The legal process became another weapon in the battle between the various groups, and each group paid little regard to the costs and final outcome. One major conclusion from this is that we cannot expect reforms to flourish until authorities at all levels develop greater respect for law and legal process.

The second problem is inherited from the Soviet era, namely, the practice of purposely writing vague laws in order to allow discretion when implementing governmental and ministerial instructions. The legal process would be better served if direct action laws were established so as to make clear rules of the game.

The third major problem with the legal system is the appalling lack of punishment for noncompliance with laws. The Russian system requires that all sanctions be included in the criminal code, and this means that many specific laws often cannot be enforced.

Foreign Assistance, External Debt, and Reserves

Gorbachev handed over a bankrupt state to Yeltsin. From 1986 to 1991 the Gorbachev regime tried to hold the state together by financing consumption through foreign loans, sales of gold, and foreign reserves. By August 1991 foreign reserves had been almost completely depleted; Vneshekonprombank, the main bank responsible for foreign transactions in the former USSR, was bankrupt; and external debt had grown to $67 billion.

The debate over foreign assistance to Russia began early and has changed significantly since the start of reforms. There is no doubt that foreign assistance could have benefited the reform efforts early on. For example, if small amounts of assistance were directed to the budget, and ideally if this assistance was in the form of grants rather than credit, then it might have strengthened the hands of the reformers to fight off pressures from the groups fighting against reform. But this could only have played a small role in the political battle, and it would not have dealt with many of the other problems plaguing the Gaidar team, such as the rapid alienation of the Parliament. These benefits must be contrasted with the Russian reality that very often foreign assistance has slowed reforms—because it allowed Gorbachev, and sometimes Yeltsin, to temporarily postpone making needed policy changes.

On balance, the outcome of the early debate over foreign assistance was probably harmful rather than helpful to reform. Gorbachev, Yeltsin, Yavlinsky, and Gaidar all helped encourage public expectations that foreign assistance could solve Russia’s economic problems. They played this card continually and helped create an expectation that large-scale Western assistance was just around the corner. The pinnacle was reached when the G-7 announced a $24 billion package to support Russia in April 1992. This came at a critical moment prior to a meeting of the Congress of People’s Deputies, which was threatening to fire the government. In his autobiography, Yeltsin remarks that in April “The mood in the government was one of concern, if not depression. The only reassuring note was the promise of the Group of Seven to rapidly provide major financial aid.” But apart from this moment, the history of foreign aid to Russia is riddled with mismanagement on both sides and enormous false hopes.

On the Russian government side, the real tragedy was that foreign assistance continued to be misused and wasted under the new regime just as it was in the past. In 1992 the major part of assistance came in the form of $12.5 billion of bilateral credits from donor countries. A large part of these credits financed equipment and machinery which was shipped directly to the purchasing enterprises. But the government took on the bill for these goods, and while in theory enterprises were required to pay the government in return, in practice either most of the funds simply disappeared or the ruble payments were only a tiny fraction of the true cost of the good.

Western governments and international agencies also played a negative role. Instead of meeting with the new Gaidar government to work out serious forms of assistance, the first step the West took after Gaidar was appointed was to demand that Russia be prepared to repay eventually all Soviet debt under the “joint and several” agreement with

other FSU countries. After this meeting many promises of assistance were made, and symbolic gestures such as airlifting EU beef and food into Russia were begun, but these efforts only had a minor impact on economic change, and they did little but raise false expectations among the population and politicians.

Today assistance from the IMF does play an important role in the stabilization program. The IMF program has conditionalities on monthly monetary and budget targets, and this no doubt plays a key role in maintaining coordination between fiscal and monetary policies. But such assistance also means that Russia’s public external debts continue to increase (the IMF promised $6 billion in 1995), and it relieves pressure on the government to cut wasteful expenditures. It would be even better if the government and the Central Bank of Russia took on the discipline of self-reliance as part of the stabilization program.

There is one clear area where foreign assistance is essential. This is to reschedule external debt obligations which can no longer be rolled over in private markets. Many of the debts taken on by the Gorbachev regime were short-term loans which are now due for repayment. These payments are due from the federal budget, but they must be rescheduled over a sufficiently long term in order to be repaid. This is one area where Western assistance could have been helpful early on, but both the London Club and Paris Club were reluctant to make agreements.

Corruption

One of the most compelling arguments in favor of clear, rapid, and principled reform measures is the need to limit corruption. There is no doubt that the gradual and unclear pace of Russia’s reforms contributed to, and were often motivated by, corruption at the highest levels. The step-by-step elimination of trade restrictions, gradual removal of price controls, large-scale subsidies issued by the central bank, unclear laws and enforcement procedures, and general lack of due process have been important sources and causes of the growth of corruption at every level of government.

There are few studies or reports that empirically measure these problems. In an interesting econometric study of the allocation of credit by the Moscow local government, Treisman (1995) found that a variable capturing whether an enterprise director had “connections with city officials” was the only variable that robustly explained who got credits. Variables that referred to official explanations for soft credits, such as whether an enterprise provided foods needed for Moscow city, had no explanatory power. Handelman (1994) provides a detailed discussion of profits gained from regional banks’ issues of fraudulent promissory notes which probably required duplicity on the part of central bank officials.

Undoubtedly the evolution of the rents to be gained from corruption will be an important factor determining the future pace of reform in Russia. We have identified four broad areas where rent-seeking and corruption gave prime incentives to distort macroeconomic policies and legal change in 1992. These were the large revenues from seigniorage, revenues from controls on exports of natural resources, the potential gains from property redistribution, and the distribution of bilateral credits.

There is good reason to believe that the scope for rent-seeking and asset-grabbing has now been sharply reduced. Enterprise shares and privatization provide the last broad area where large gains can still be made. One reason for the success of the current stabilization program is that potential revenues from seigniorage are now much lower, given the new financial instruments produced by the now more developed financial system (see figure 6.1). Likewise, the supply of bilateral credits has been cut, and the government has instituted a process where the budget prices foreign exchange at market rates. The (real) appreciation of the ruble has reduced the profitability of natural resource exports, and the new owners are demanding price liberalization, so there are fewer rents in this sector to be appropriated.

6.4 Outcomes and Lessons from the Reforms

It is very difficult to give recommendations to other countries based on the specific Russian reform experience; nonetheless, there are several important points.

The first absolutely clear point is that the Russian people and economy have responded to the introduction of market reforms in exactly the way that economic theory predicted. Under Soviet rule the economy was highly industrialized, with a strong military orientation, and it lacked sufficient services and consumer products. While there has been a sharp decline in industrial production, we do see rapid growth in some areas of services and trade that reflects restructuring. The sectors which are declining most quickly, such as textiles and light industry, are those that face the greatest world competition and suffer from the lowest productivity. Recent indicators show the industrial decline has stopped, and growth will probably resume in 1996 or 1997 (table 6.1).

Early fears that unemployment would explode and labor markets would not function have also been proven wrong. There is an active labor market in Russia, with levels of employee turnover (both hirings and firings) that match the most active labor markets in the West (Layard and Richter 1994). While the older generation has had more difficulty adjusting than the younger generation, the early view by some commentators that workers were unemployable was obviously unfounded.
The second lesson is that the debate over shock therapy versus gradualism and the discussion of optimal sequencing of reforms is simply uninteresting in the Russian case. There are economic arguments in favor of both rapid reform and gradual reform (see Blanchard, forthcoming) but these do not lead to clear conclusions. In Russia the choice was more straightforward and political.

Russian reforms began because Gorbachev launched the country into political reforms that were deeply inconsistent with the old economic system. The breakup of the Soviet Union and collapse of the planned system gave Yeltsin and Gaidar the first real chance to carry out economic reform. But within months of starting the reforms, the opponents to change were able to organize and rebel through the Congress of People’s Deputies.

After those first few months, reforms have proceeded haltingly and at far too slow a pace. In 1992 there were enormous resources to be divided amongst the winners. These included rents from natural resource exports amounting to $25 billion per year, monetary seigniorage equal to 32.7 percent of GNP for a period of time, bilateral credits of $12.5 billion, and some $600 billion of property to be distributed. It is no wonder that the political system became corrupted and deadlocked and macroeconomic policies took second place.

It may have been possible to avoid some of this disruption through more transparent rules and policy making. In retrospect it was clearly a mistake to delay introducing financial stabilization, full price and trade liberalization, full currency convertibility, and a national currency during that brief period in late 1991 when reforms were most possible. Many of these measures could have reduced the amount of resources “up for grabs” by limiting the future debate over the scope of further reform.

The irony of Russian reforms is that they began because political change outpaced economic change, but having begun, political reform soon lagged behind economic change. The Gaidar team never tried to build a working relationship with the Supreme Soviet or Congress of People’s Deputies, and hence from the start the reformers were politically isolated and dependent on Yeltsin. Yeltsin could and probably should have called for greater political reform right from the start. If the Constitution had been revised in autumn 1991 and spring 1992, and if elections for a new Parliament were called early on, then it might have been possible to build greater consensus at the start of the program. This would have given the government a longer respite and a clear mandate to complete the reform process.
Russian and Eurasian Books
from the Carnegie Endowment for International Peace

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