MISSION IMPOSSIBLE?

THE IMF AND THE FAILURE OF THE MARKET TRANSITION IN RUSSIA

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Introduction

Until the second half of the 1990s Western commentary about the former Soviet Union and the new Russia basically divided into two camps.[1] On the one side stood those who not only welcomed the end of the USSR but looked forward to the brave new world they hoped would be built on the debris left behind by the old order. Having failed to anticipate the demise of Soviet communism,[2] the optimists now predicted a bright new capitalist future for Russia.[3] With excellent access to those in power, they were clearly the most favoured group with Western governments in general and the American government in particular. Certainly, within the US foreign policy elite it was broadly assumed that successful reform in Russia and Russia's integration into the larger capitalist system, was both feasible and necessary. As Strobe Talbott, the architect of American strategy towards Russia, observed in the early days of the Clinton administration, reform in Russia was not just about Russia but the shape of the new international order waiting to be born in the wake of the Cold War.[4] Others were always more sceptical. Post-communist Russia, according to the pessimists, was likely to prove less susceptible to reform than the optimists claimed. The legacy of Russian history, the success of Soviet political culture in shaping the outlook of ordinary Russians, and the failure of the upheavals of 1991 to upset the basic structure of Soviet society, together meant that Russia would prove a particularly tough nut for the reformists to crack. Indeed, the most likely outcome it was argued was not a

[1] See my 'Russia's Flawed Market Transition', Paper prepared for the American Political Science Association annual convention, Washington D.C. 28-31 August 1997.

[2] On the issue of predicting the demise of the USSR see Michael Cox (ed) *Rethinking the Soviet Collapse: Sovietology, The Death of Communism and the New Russia* (London: Cassell Pinter, 1998)

[3] See Philip Hanson, 'What Sort of Capitalism in Russia?' *Communist Economies and Economic Transformation*, Vol. 9, No. 1, 1997, pp. 27 – 42.

[4] See Strobe Talbott, 'US must lead Strategic Partnership with post-Soviet Reform', *US Department of State Dispatch,* 4:17, 26 April 1993.

'normal' Western type socio-economic order, but a specifically Russian style system with distinctly Russian characteristics.[5]

By the end of the decade this lively and open debate about Russia's possible future had reached an impasse, and had done so not because the protagonists had run out of ideas, but for a more basic material reason: Russia was no longer in transition to a functioning market democracy. [6] The crisis of August 1998 obviously made the point clearer than the truth. But long before then it was evident that the reforms were in trouble, and that far from leading to economic renewal, the great trek to capitalist normality had led to decline and despair. The failure of reform, not surprisingly, precipitated another big debate about Russia's fate. This time, however, it did not revolve around Russia's likely prospects and whether or not Russia could or could not escape its past and build a bright new future, but who or what exactly was to blame for the reforms having failed.[7] Two convenient whipping boys were soon found.

The most obvious target of abuse was what was seen by many as those cold, calculating technocrats of the International Monetary Fund.[8] These would-be reformers, it was felt, had either pursued the wrong policies,[9] or, more malevolently, were part of a global capitalist conspiracy whose purpose was to eviscerate the Russian economy while bringing its natural resources to market at the cheapest possible price. According to critics, the IMF was the bearer of the disembodied logic of globalization and the universal laws of the market, neither of which respected the need to preserve cultural identity or political community. Moreover, behind the veneer of altruism and the rhetoric of global advancement lay the crude logic of self-interest. The likely beneficiaries of Russia's subordination to the West were many, and included, amongst others, an

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[5] See Zbigniew Brzezinski, 'The Premature Partnership', *Foreign Affairs*, 73:2, March-April 1994, pp. 67 – 82.

[6] The growing pessimism about Russian economic reform can be found in 'Russia's reforms in trouble', *The Economist*, 22 November 1997, and 'Russia's crisis: could it lead to fascism?', *The Economist*, 11 July 1998.

[7] For an official American response to the Russian crisis at the end of the 1990s see Strobe Talbott, 'Dealing with Russia in a time of troubles', *The Economist*, 21 November 1998.

[8] See my 'The IMF:savior or sinner? *OMRI Analytical Brief*, no. 10, 1996.

[9] For an early version of this argument see Jeffrey Sachs, 'The Reformers' Tragedy', *New York Times*, 23 January 1994.

increasingly assertive United States, Wall Street, global corporations, Western oil companies, and naturally enough, the various Western consultants who carried the message of capitalism to Moscow. [10]

If the IMF proved a handy scapegoat for some, this was not true across the board, and many found it both more convenient - and less embarrassing - not to blame the messenger of neo-liberal economic reform but the recipient of all this sound advice: Russia itself.[11] Russia it was felt had its own distinct identity, its own particular traditions, and its own very unique way of doing things which made it an unlikely candidate for western-style reform.[12] From the Mongol yoke onwards, Russia it was argued (by both conservative historians and post-modern theorists alike) was an icon of otherness; a living example on the one hand of how not to run a society, and on the other of the power which the past was always likely to exert over utopian day-dreamers, whether they be Bolshevik revolutionaries or liberal modernizers.[13] The debacle in Russia post-1991 was therefore no accident, nor merely the consequence of poor decisions, but yet another example in a long historical list of catastrophes that have befallen the country over the centuries. What made things much worse, of course, was the failure of the reformers to draw lessons from Russia's more immediate past, and to ignore what to wiser observers must have seemed obvious. That the venality and greed of Russia's rulers was bound to derail the reforms. It had happened under Gorbachev in the 1980s: it was bound to happen again, and did, under Yeltsin in the 1990s [14]

This dramatic picture of an irresistible force meeting an immovable object is certainly appealing; unfortunately, it is over-simplistic and wrong-headed. The collapse of Russian reform was the result of multiple and profound historical causes which cannot be reduced to the machinations of small cliques of

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[10] For a detailed discussion of the IMF and Russia see Nigel Gould-Davies and Ngaire Woods, 'Russia and the IMF', *International Affairs,* Vol 73, No 1, January 1999, pp. 1 – 22.

[11] See Peter Truscott, *Russia First: Breaking With The West* (London: I.B. Tauris, 1997).

[12] According to one seasoned Russian observer there was little the West could ever do in Russia: Russia's problems were largely of its own making. See Georgii Arbatov, 'Neo-Bolsheviks of the IMF', *The New York Times,* 7 May 1992

[13] See Iver B. Neumann, *Uses of the other: "the East" in European identity formation* (Manchester: Manchester University Press, 1999), esp. pp. 65 - 112.

leaders in either K Street or the Kremlin. Conspiracy theory may be comforting, but it is rarely correct. And while it might be reassuring to think that everything that happens is the result of someone willing it to happen, real history is usually far more complex, messy, indeterminate and unpleasant. This is not to say that individuals should be absolved of all responsibility. There is plenty of blame to go around, especially in post-Communist Russia. Decisions by individual agents matter, to be sure. But more often than not in a situation of chaotic, systemic change it is the unintended results of these decisions that are more important than the intended consequences. That surely is the lesson which screams out from the collapse of the Soviet Union, the result in the last analysis of an abortive reform program launched by a leader whose intention was not to destroy the USSR, but save it. A similar perverse logic was also at play in Russia: a logic that condemned to failure the capitalist transition in Russia. [15]

But before looking at the rise and fall of Russian reform, it might be useful firstly to examine the situation back in 1991. That done, we will then assess the proposed cure for Russia's economic ills in the shape of shock therapy. Following this we will go on to see what went wrong and what the likely consequences are going to be for the international system. The message here is a mixed one: on the one hand the West has to be concerned about the emergence of a potential zone of instability stretching from the centre of Europe to the Pacific, especially when the zone in question borders so many other countries and possesses thousands of nuclear warheads; on the other hand, Russia itself has diminishing international assets – as its marginal role in Kosovo indicated – while its economy remains very much dependent on Western largesse to keep it solvent. Russia moreover is in decline. Thus while the future might be bleak for the majority of Russians, it need not necessarily be so for the West's relations with Russia. Russia's tragedy need not be the West's problem.

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[14] Martin Malia, 'In Russia, the Liberal Western Model Has Failed', *International Herald Tribune*, 5-6 September 1998.

[15] For a highly critical discussion of the specific American role in post-communist Russia, see Stephen Cohen, 'America's Failed Crusade in Russia', *The Nation*, 28 February 1994, and 'Transition or Tragedy', *The Nation*, 30 December 1996.

In the beginning: 1991 and all that

To help us explain what has happened in Russia since the great collapse of 1991, three rather banal observations need to be made at the outset. The first is that the crisis in 1991 was as much a political crisis as it was an economic one; the second is that reform did not start with a blank slate in 1992; and the third is that the structure of the ex-Soviet economy was peculiarly unsuitable for market reform. No doubt the last observation might come as something of a shock to economic reformers and economists.[16] They, after all, would like us lesser mortals to think that they have discovered the intellectual equivalent of the alchemist's stone; that there is a set of rules which if followed will lead to prosperity for all; and that the introduction of private property and competitive market prices are bound to work their magic in any society, at any time. Were that life were so simple. However, the idea – that a strong dose of capitalism would resolve Russia's problems – was one which fell on ready soil in Russia in late 1991, and for good reason. Four years of stunted reform under the leadership of Mikhail Gorbachev had wrecked the control systems of the centrally planned economy, without creating any effective mechanism to put in its place. Wage payments, money supply, and government spending had gone through the roof. Production had slumped as plan targets were abandoned. The federal budget had effectively collapsed. Goods had disappeared from store shelves. And inflation was rampant. Nor was this all. Repeated efforts to reform the Soviet economy had failed, and the rulers of newly-independent Russia were desperate for new economic ideas. [17]

1991 was therefore a genuine turning-point economically. However, it also represented a political cross-roads as well. First, in August 1991, the abortive coup effectively unseated Gorbachev. Then, within a few days, the mercurial Yeltsin took over. And by the end of the year, the USSR fell apart when Russia and Ukraine defected from the Union. This somewhat unfortunate combination of events meant, in effect, that

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[16] Two American observers who were not shocked by Russia's failure to make the transition were, Marshall I. Goldman, *Lost Opportunity: why economic reforms in Russia have not worked* (New York: Norton, 1994), and Robert V. Daniels, *Russia's Transformation: Snapshots of a Crumbling System* (Lanham: Rowman & Littlefield, 1998), pp. 149 – 210.

[17] For a discussion of the crisis, see Michael Ellman and Vladimir Kontorovich (eds) *The Disintegration of the Soviet Economic System* (London: Routledge, 1992)

Russia's new rulers faced not just one task - of revamping the economy - but the other equally important tasks of building a new Russian nation and constructing novel democratic forms in a period of imperial collapse. [18] The situation was hardly propitious, as even some of the more optimistic of Western commentators noted at the time. It certainly made Russia very different to China, where a stable leadership was not only able to contemplate economic reform without the dangerous trappings of democracy, but could do so without a threat to its periphery or the position of those of its citizens living outside the main core.[19] Moreover, whereas in China there was a distinct sense of identity constructed over nearly 3000 years of history, there was no such thing in Russia. Too closely bound up with the communist era to be of much practical use to the new Russian elite, nationalism might have been something that Russians paid lip-service to, but it was not something that could be used easily to mobilize the new Russian nation.

Under these difficult circumstances the regime set out along the yellow brick road which it hoped would bring Russia, sooner rather than later, to the market. The market however did not just promise prosperity and abundance: it appeared to furnish the new, and rather insecure Russian ruling group, with a ready-made objective around which they hoped to unite the Russian people. It also served to create the very strong impression that in spite of many other areas of continuity – especially at the top – the new regime was quite different to the old one, with a new set of goals, a new outlook and a new international mantle of respectability. Indeed, by parading its new-found market credentials, Russian leaders assumed they could win sympathy in the West and so tap into what they thought would be a particularly deep pool of Western economic loans.[20] Finally, one should never underestimate the motor power of self-interest, and the more cynical would later argue that the rhetoric of marketization was merely a smoke-screen behind which the old elite could ruthlessly set about looting the country's assets for its own private benefit.

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[18] For a good description of the situation in Russia in the early 1990s see Bruce Clark, *An Empire's New Clothes: The End of Russia's Liberal Dream* (London: Vintage 1995)

[19] For a guide to China's road to economic reform see Peter Nolan and Dong Fureng (eds), *The Chinese Economy and its Future: Achievements and Problems of Post-Mao Reform* (Cambridge, Mass: Polity, 1990).

[20] President Clinton was clear in his own mind however that there would be no Marshall Plan for Russia. See his important speeches, 'A strategic alliance with Russian reform', *U.S. Department of State Dispatch*, 5 April 1993, and 'New democratic partnership between the United States and Russia', *U.S. Department of State Dispatch*, 12 April 1993.

This then brings us to our second point. While post-Soviet leaders might have claimed they were singing from an entirely new hymn-sheet largely written in the West, this was hardly the first time in modern history that Russian leaders had set out to reinvigorate a sluggish economy with Western-style economic reforms. This is often forgotten by commentators who start the clock of reform debate ticking in January 1992. There was however a long track record of reform efforts, both in the former USSR and Eastern Europe. In fact, reforms began to be discussed in the Soviet Union in the late 1950s, were then attempted in 1965, subsequently abandoned under Brezhnev, only to be revived again in the latter part of the Gorbachev era. The details of this history need not detain us here. But it is important to recall this heritage, for two fairly obvious reasons. First, it would suggest that some form of economic change was long overdue; and second that actually implementing (as opposed to talking about) change in the Soviet economic system was always likely to be very difficult. This should have made Western reformers in 1992 a little less gung ho. In the former Soviet Union powerful vested interests and the logic of the economic structure had served to block all reform efforts; and there were strong suspicions to think that the same forces would block reform once again.[21]

This leads logically to our third observation, about the quite unique structure of the Soviet economy. In 1992 there was a brief flurry of debate about precisely this issue, and a number of experts familiar with the region wondered whether or not reforms would founder on the rocks of Soviet reality. This was not a view which found many adherents in the West. Here the consensus seemed to be that the logic of supply and demand knew no national boundaries. Thus there was no reason to think that the outcome in Russia would be any different to that in other communist economies in transition. But this was naïve in the extreme. As anybody familiar with the old Soviet bloc could have pointed out - and did at the time - the economy of the former USSR was nothing like those of the other East European countries. It had been existence for much longer; it was much bigger; and it was very heavily militarized, with from 25-40 percent of the economy

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[21] The problems of implementing economic reform in the former Soviet Union and Russia are discussed in Hillel Ticktin, *Origins of the Crisis in the USSR*, (New York, M.E.Sharpe, 1992).

devoted to the development of the nation's arsenal. [22] It was also very widely spread out. Held together by a thin network of railways and pipelines (but few roads), the Soviet economy was a nightmare in terms of structure. Transport alone accounted for a much higher proportion of final cost than other economies with either easy access to excellent roads or to the world's oceans.

These were not the only obstacles, however. A large number of Soviet industries were located in the more peripheral and distant parts of the former USSR, and had been placed there for reasons which had little to do with economic rationality and everything with national security or the need to exploit a crucial raw material. This raised the obvious question - what would happen to these and the people employed in them, if, and when, they were exposed to the forces of supply and demand? Take the industries and the three million people living north of the Arctic circle. There is no way that a market economy could sustain either. The military facilities there would have to be closed and the mining towns reduced in size. But how would the surplus citizens be moved south? And who then would employ them? Furthermore, what was one supposed to do with the several cities and their populations (again usually a long way away from the centre) whose only purpose had been to produce a single item, such as tanks, nuclear missiles, and the like that were no longer needed in a new international system where co-operation rather than hostility was becoming the norm and where Russia simply could not afford to maintain a huge defence budget? There was no easy answer to this, or, as we shall see, to a number of other problems facing Russia after 1991.

The IMF takes the lead

Late 1991 thus found the Soviet Union disintegrating and its economic system in chaos. Into this environment stepped the International Monetary Fund and sundry advisors with the ‘Cure’, one which had been implemented elsewhere in Central Europe (notably Poland) without killing the patient. So why, it was reasoned, should the same medicine not be equally effective in reviving Russia? But why did the West

[22] See Clifford Gaddy, *The Price of the Past: Russia’s Struggle with the Legacy of a Militarized Economy* (Washington D.C.: Brookings Institution, 1998).

decide to use the IMF, rather than any other body, to be its point man? There were at least three important reasons.

One, clearly, was to justify the Fund's existence.[23] Set up in the immediate post-war period to manage the fixed exchange rate regime of the post-war economic order, by the 1970s and the abandonment of that regime in favor of floating rates, the IMF appeared to have lost its raison d'etre. It had become, in effect an organization without a clear mission.[24] The collapse of communism in Eastern Europe in 1989, followed two years later by the implosion of the USSR, at last seemed to provide it with one. Moreover, the Fund had already gained valuable experience in the 1980s putting together structural adjustment packages for the heavily-indebted economies of Latin American and Poland, and it was assumed that it would be able to do the same again for the Russian economy. [25]

The IMF's willingness to shoulder the burden of the Russian transformation was also opportune from the point of view of US policy-makers. President Bush, recall, had put all his eggs in the now-shattered Gorbachev basket; caught off-guard by the abrupt turn of events, the US administration swam with the tide and backed Yeltsin's bold reform efforts. However, by the time Clinton took office in January 1993, he had neither the inclination, nor the authority, to craft a brand new approach to the Russian economic transition.[26] Thus, shifting the responsibility to the IMF made perfect political sense, especially for an administration more concerned to focus on domestic issues rather than foreign ones. Furthermore, even though the US had enormous influence in the institution (and could thus determine IMF policy towards Russia) it was unwilling to lend large amounts to support Russian reform. Working through the IMF, therefore, permitted the US to push Russia in a direction it hoped it would go, but without having to fork out huge sums of money itself. Indeed, far from being particularly generous themselves, the Americans overall tended to leave the

[23] In Nigel Gould-Davies and Ngaire Woods, 'Russia and the IMF', *International Affairs*, pp. 1 - 2.

[24] Harold James, *International Monetary Co-operation Since Bretton Woods* (Oxford: Oxford University Press, 1996).

[25] On Poland, see Jeffrey Sachs, *Poland's Jump to the Market Economy* (Cambridge, Mass: MIT Press, 1993).

generosity to their various allies - especially Germany; not because Germany was richer, but because Germany had to reward Russia for not standing in the way of unification between 1989 and 1990.[27]

It was also believed, finally, that if the US could work through a body like the Fund this might reduce popular Russian opposition to economic reform. The political logic here was quite straightforward. If America was seen to be imposing painful reform upon its vanquished foe, then there was every chance this would be used by Russian communists and nationalists alike to attack the reform programme - using anti-Americanism as the obvious vehicle for doing so. If however the IMF was seen to be in the vanguard of change, this might lessen the political reaction to reform from within Russia itself. Whether this was a reasonable calculation or not was not at all clear. However, the assumption was that if change was seen to be coming from an ostensibly independent, multilateral institution and not the US, this would make the reforms more palatable. [28]

How well-suited the IMF actually was to carry out the job it had been allotted is, of course, a moot point. The organization after all 'had no more experience than any other institution in supporting the transition from communism to capitalism'. [29] The Fund was also an economic instrument at heart. Hence, it was not suited nor required to think about the political implications of its decisions. Nor was it asked to reflect about the larger strategic questions and the West's more general interests in making Russia a stable partner in the international system. It had one brief and one brief alone: to sit down with the authorities in Russia and provide them with irresistible arguments (under pressure) as to why they should abandon the economic habits of a lifetime and go for the market.[30]

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[26] For a more sympathetic account of Clinton's policy towards post-communist Russia, see Michael Cox, ' The necessary partnership? The Clinton presidency and post-Soviet Russia', *International Affairs*, Vol. 70, No.4, October 1994, pp. 635 - 658.

[27] Of the $150bn that Russia owed the West in 1999, 40% was held in Germany.

[28] How successful this was is examined by Peter Reddaway in 'Visit to a maelstrom', *The New York Times*, 10 January 1994.

[29] See Nigel Gould-Davies and Ngaire Woods, 'Russia and the IMF', *International Affairs*, p. 2.

The Cure

The Cure - known by its critics as 'shock therapy' - consisted of a Holy Trinity of policies: monetary stabilization; liberalization; and privatization. Most of these policies, generically known as the Washington consensus, had already proved their effectiveness in a wide variety of other circumstances. [31] And the hope obviously was that they would be equally effective under conditions in Russia. Let us deal with each in turn.

Monetary stabilization was seen as the most pressing of the policy troika. Money after all is the essence of capitalism, and without stable money the price system cannot work, and investment cannot take place. One thing that the state can and must do is introduce a stable currency; in particular it must prevent hyper-inflation. Given the problems with measuring price levels and money supply, an easy way to check whether a country is succeeding in price stabilization is to make the currency convertible and use the exchange rate as the nominal anchor of your stabilization program. This has the virtue of simplicity - everyone from the Wall Street banker to the street-corner babushka knows what is the rouble/dollar exchange rate on any particular day. Given the resource constraints under which even the IMF must operate, using the stability of the exchange rate as a signal for how reform is doing in Russia was attractively simple.

The second supporting leg of the tripod was liberalization, and involved lifting restrictions on business activity, domestic and international. Price controls would thus be removed and subsidies ended. Restrictions on new business formation would also be scrapped, and private businesses given free access to foreign trade. Quotas and duties on exports would in turn be eliminated and import tariffs lowered. Liberalization of foreign trade was important because import competition would force the monopoly suppliers inherited from the Soviet economy to become competitive or go out of business. Free trade would reveal Russia's comparative economic advantage and would draw resources into the sectors with growth potential. Trade

[30] See Michael Camdessus, 'Russia's Transformation Efforts at a Turning Point', *IMF Press Release*, 29 March 1995

[31] See *World Bank Development Report: From Plan to Market* (Washington D.C.: World Bank, 1996).

liberalization was also a prerequisite for the influx of foreign investment and technology that Russia urgently needed. [32]

Finally, privatization meant the transfer of economic assets into private ownership in order to unleash entrepreneurship and to create competitive markets.[33] Inspired in large part by what had been happening in other parts of the world throughout the 'deregulating' 1980s, privatization aimed to sell off State enterprises to whomever was willing to buy them, while those enterprises which stayed in state hands would be weaned off subsidies and given hard budget constraints. At the same time, bankruptcy legislation would be introduced and enforced to ensure the closure of loss-making firms and the redistribution of their resources (machinery, premises and labor) to more efficient producers. Though this formula may have worked elsewhere, in Russia it faced a serious problem: there were no private agents with the capital necessary to purchase enterprises. This meant that state-owned firms had to be either sold to foreigners - a politically difficult path to follow – or given away to domestic buyers at below market value. This is precisely what happened with the result that the privatization process essentially became a vehicle for the legitimization of the seizure of state assets by the more energetic members of the old communist-industrialist nomenklatura.

Overall, then, the IMF approach focused primarily on macro-economic policies. Questions of market regulation and institution-building were to be postponed to a later date. It was argued that premature moves to increase state control – before liberalization was completed - would merely provide a cover for communist reactionaries to re-impose a state-controlled economy. It was assumed that the institutional infrastructure (laws, regulatory agencies, etc.) was either in place already, or could be built quickly - either imported or driven by the enlightened self-interest of the new elites.[34] The underlying assumption was that

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[32] Non-Communist Russia's exports however continued to be very 'Soviet' in nature: about 45% being in oil and gas and 15% in metals. Moreover, the revenues earned privately from the sale of these commodities were not reinvested back into their respective industries. For a critique see Yurii Yeremenko, ''Bessmyslennost' eksporta dlya Rossii' {Exports are senseless for Russia], *Ekonomichekaya gazeta*, No. 33, 1996, pp. 2 -3.

[33] See Roman Frydman and Andrzej Rapanczynski et al, *The Privatization Process in Russia, Ukraine and the Baltic States* (Budapest, Central European University Press, 1993).

[34] For an uncritical but revealing examination of this self-serving notion see Maxim Boycko, Andrei Shleifer and Robert Vishny, *Privatizing Russia* (Cambridge, Mass: MIT Press, 1996).

getting the incentives right would lead to the emergence of economic agents who would have a vested interest in creating institutions to protect their long-term property rights. Thus in a neat display of recursive logic, the provision of a rule of law was treated as endogenous to the transition model. The demand for secure contracts would create the supply of institutions to provide them.

Democracy from above or Yeltsin rules - OK?

One of the real and many paradoxes of the West's approach to economic reform in Russia was that while it made great play of the need for more economic choice, it put an enormous amount of pressure on Russian decision-makers to go down one particular path. Equally, while Western policy- makers talked easily about the need for democracy and greater political freedom in Russia, the form of democracy they promoted was especially elitist in nature.[35] This had a particular impact both upon the way the reforms were introduced and perceived within Russia itself. Indeed, whereas in East-Central Europe, shock therapy was introduced by governments that came out of parliaments elected in post-1989 free elections, in Russia the reform program was mostly implemented by presidential *ukaz*, by a man who until the age of 59 had been a leading functionary of the Communist Party. The Russian legislature was treated not as source of legislation and a vehicle for democratization, but as an annoyance that was to be avoided at all costs. There were no fresh elections to president or congress after the collapse of the Soviet Union. The first new elections came in December 1993 - two years after the launch of shock therapy; two months after the previous parliament had been dispersed by force; and under a constitution hand-crafted to maximize President Yeltsin's powers. Russian voters expressed their discontent by electing a legislature dominated by communists and nationalists, with Vladimir Zhirinovsky as the leading vote-getter. Knowing that the parliament would have little influence over the composition of the government, voters had little incentive to behave responsibly.

While some reform programs in Russia were introduced by means of laws passed by the legislature (most notably the 1992 voucher privatization program), most were introduced by presidential decree (most

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[35] I have explored this issue in more detail in my 'Russia's Flawed Democracy', *Current History,* October 1998.

notoriously, the second-wave of privatization by means of shares-for-loans auctions in 1995). Bureaucratic institutions charged with implementing the reforms such as the Central Bank or the State Privatization Committee were not directly accountable to the parliament, or to anybody in particular.

Significantly, however, these characteristics of the new Russian political system were not seen as problems but instead regarded as virtues by Russia's Western advisors. In fact, in their eyes, it was absolutely vital to by-pass all potential opposition to economic reforms coming (as they feared) from conservative groups with a vested interest in the pre-1991 status quo - that is communist bureaucrats and workers in subsidized industries (such as military plants). And such impediments, it was believed, could only be overcome with speed, international leverage and by a highly presidentialist system which vested great powers in the man at the top - in this case Yeltsin. This model of vested interests blocking reform certainly looked plausible. It also looked familiar. That was the pattern of social interests that had undermined Gorbachev's reform efforts in the 1980s. It was also typical of the political economy of protectionist coalitions in Latin America - entrenched elites and periodically-mobilized urban masses.

As it turned out, these fears proved groundless. To all intents and purposes, the old Soviet military industrial complex was politically disemboweled by the rapid collapse of communist institutions and proved totally unable to defend their interests in the transition economy. As for the masses, they proved politically inert despite (or perhaps because of) shattering social changes, a massive fall in living standards, and tremendous uncertainty about their future well-being.[36] Indeed, some radical critics of shock therapy have argued that this is precisely what the reforms were intended to do; to literally bludgeon any potential social opposition into submission. After all, people who are worried about keeping their job, or feeding their family, are less likely to resort to political violence. Whatever the truth, the workers did not rise up. [37] Nor did anybody else. The serious opposition, in fact, did not come from communist reactionaries or proletarian discontent, but from some of the very elites who had led the original charge towards the market economy. Using the

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[36] Sarah Ashwin, *Russian Workers: the anatomy of patience* (Manchester: Manchester University Press, 1999).

privatization programme to secure their control of industrial and financial assets, this group with close ties to Yeltsin proved extremely resistant to genuine market reforms - largely because genuine reform would have challenged their new-found monopoly position. However, before examining the consequences of their actions, let us first examine the reforms in practice. [38]

Capitalism in command?

How, then, did the Russian reformers do when it came to implementing shock therapy? Better than one would have expected, but worse than one would have liked, and not well enough to save Russia from financial collapse in 1998. [39]

Liberalization had the most dramatic initial effect. Most price controls were lifted on 2 January 1992, and the rudiments of a market economy quickly surfaced. Not all prices were freed up however: energy prices for example were fixed for several years, while housing and utilities remained price-controlled. Measures to liberalize foreign trade were also undertaken. This led to a flood of imports - including food - and soon accounted for about half of all consumer spending. After a year's hiatus there was also an export boom, as producers switched their sales of oil, gas, metals, and chemicals from the CIS to hard-currency markets. There were however a number of obvious flaws in the programme of liberalization. For one thing, small

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[37] See Simon Clarke, *New Forms of Employment and Household Survival Strategies in Russia* (Coventry: Centre for Comparative Labour Studies, 1999).

[38] See Anders Aslund, ed., *The post-Soviet economy: Soviet and Western perspectives* (London: Pinter, 1992).

[39] For a more positive assessment see Anders Aslund, *Russia's Economic Transformation in the 1990s* (London: Pinter, 1997).

businesses did not flourish, unlike in Poland where they became a vital engine of growth. Organized crime and bureaucratic regulation also did much to undermine Russian entrepreneurship. And while some effort was made to encourage foreign investment, the barriers - from political obstruction to the lack of legal protection - always remained high. Consequently, there was no great rush by Western firms to invest in Russia and by 1998 Russia had cumulative foreign investment of some $6 billion - less than Hungary, a country one tenth its size.

Stabilization took longer than liberalization to accomplish. The rouble was quickly made convertible into dollars, but inflation clocked 1,600 percent in 1992, wiping out people's hard-earned savings. It was not until 1995 that the money supply and budget deficit were reined in, and inflation (monthly, not annual) came down to single digits. This stabilization was a house built on sand, however, since the tightening monetary policy was accompanied by the dollarization and de-monetization of much of the economy. Many people kept their savings in dollars and many businesses conducted their transactions in dollars. Barter also spread apace, and by 1997 accounted for 50 percent of all transactions in some industrial sectors (especially energy). Arrears also became a money-substitute: arrears to suppliers, to tax authorities, and in paying wages to one's workers.

In 1995, on the advice of the IMF, it was decided to finance the budget deficit in a non-inflationary way - by issuing treasury bonds (GKOs) rather than by printing money. On the surface, everything looked fine. From 1995 the rouble held its value against the dollar within the corridor announced by the Central Bank - even gradually appreciated in real terms. But this had its downside and very soon two parallel economies began to emerge: one monetized, taxed, and recorded for the international community; and the other hidden from view, demonetized, and at best paying taxes in kind, in goods and services, at local level. Gaddy and Ickes have referred to this barter system as a 'virtual economy' since it was based on subsidized, value-destroying enterprises. But one could equally argue that the financial sector was almost ‘virtual’ as well, particularly in light of the collapse of the banking system in August 1998.[40]

[40] Clifford Gaddy and Barry Ickes, ‘Beyond the Bailout: Time to face Reality’, *Foreign Affairs,* 1998, No. 77, pp. 53 - 67.

Even more worrying was the fall in industrial production. GDP plunged alarmingly in 1992, with a cumulative loss in economic output of between 40 and 50 percent. Recovery only began in 1997, and then with an anaemic GDP growth of 0.8 percent. Federal tax revenues also plummeted from 25-30 percent of GDP in 1989 to 10-12 percent by 1997, even though spending was still running at 15-18 percent. These problems however tended to be explained away by the reformists. Thus the slump, they argued, was merely a product of changes in statistical reporting: formerly managers over-reported output for the planners, now they under-reported output for the tax man. And to the extent that the output fall was real, it reflected an end to the production of non-goods like nuclear submarines and busts of Lenin. Likewise, the fall in government revenue was nothing to be too concerned about either. The Russian state's share in GDP was too large anyway for an economy at its level of development. The government, moreover, had to learn that it must get out of the business of subsidizing farms or paying the utility costs of residents in economically non-viable parts of the old communist economy.

This brings us to the issue of privatization. Hailed as a major victory for the reformers, within the space of a few years up to 70 percent of productive assets had been transferred out of state ownership into private hands. The privatization took place in three phases.

First, there was the conversion of state firms into private corporations at the stroke of a pen. The shares of these firms were held by federal and regional governments, or given to other firms (suppliers and customers). Gazprom, Russia's largest company, was privatized in this manner already in 1990, with the incumbent directors acting as trustees for the federal government's 40 percent stake in the firm. Most of Russia' commercial banks were also created in this way, and they grew fat through currency speculation, handling government accounts, and trading in treasury bills.

Second, there was the voucher privatization program of 1992. Citizens were given vouchers which they could use to bid for shares in former state enterprises, now registered as private corporations. Unlike the Czech scheme, however, workers and managers could opt to acquire a majority of the shares in their own firm, using a combination of vouchers and ploughed back profits. Seventy percent of firms chose the worker-manager buyout. However, in most of them control over the shares was quickly concentrated in the hands of a small group of managers.

Third, there was privatization through cash sales, beginning in 1994. As we have already noted, the government was reluctant to sell to foreign investors while Russian buyers lacked the necessary capital. Thus in 1995 the privatization 'tsar', Anatolii Chubais, decided to go with the idea of swapping packets of shares in some leading oil and metals companies in return for loans from Russian banks. The transactions reeked of corruption: the prices were low relative to the firms' quoted earnings, and most of the auctions were by an affiliate of the bank organizing the bidding. Furthermore, much of the money that the banks were lending to the government came from state coffers. The loans-for-shares scheme enabled the Moscow-based banks to move into the industrial sector and try their hand at wealth creation. After the hiatus of the 1996 presidential election campaign, during which the oligarchs circled the wagons to ensure Yeltsin's re-election, privatization sales resumed.[41]

The 1998 August crisis

In spite of this very patchy record, Western advisors were brimming with optimism five to six years after the collapse of the USSR. One noted Western economist close to Yeltsin wrote effusively in 1995 about how Russia had become a market economy.[42] A year later two other apostles of neo-liberalism predicted a new Russia boom. [43] Even in 1997, the IMF seemed to be brimming with good cheer. [44]True the reforms had been uneven in their consequences, but that they argued was only to be expected. After all, one could not

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[41] For a critical examination of the consequences of privatization see Joseph R. Blasi, Maya Kroumova and Douglas Kruse, *Kremlin Capitalism: The Privatization of the Russian Economy* (ILR Press, Cornell University Press, 1996).

[42] Anders Aslund, *How Russia Became a Market Economy* (Washington, D.C.:Brokkings Institution, 1995).

[43] Richard Layard and John Parker, *The Coming Russian Boom* (New York: The Free Press, 1996).

[44] So optimistic were the reformers that in September 1997 it was predicted that fairly soon Russia would need no further IMF funds. See Yeltsin's statement in *RFE/RL Newsline,* 18 September 1997

hope to make a fine market omelette without cracking a few eggs along the way. The political situation was also far from hopeless. Hence, while the Russian Communist Party remained strong, it did not pose a serious threat to the reforms or to Yeltsin who was re-elected to the presidency in 1996. In spring 1997 moreover a new reformist government led by First Deputy Prime Minister's Anatolii Chubais and Boris Nemtsov launched a second liberal revolution designed to tackle the yawning state budget deficit, boosting tax collection while cutting subsidies to energy users. In the same year, the Russian stock exchange surged by a full 85%. And a year later, in March 1998, Yeltsin replaced premier Chernomyrdin, the grandfather of Gazprom, with Sergei Kirienko, a move which provided the opportunity for a renewed surge of Western optimism that another political barrier to the reform programme had been removed.

Yet all was not well, as even the youthful Kirienko was to admit on taking office. Russian reformers might have scored a few victories: nonetheless many of those who had been the beneficiary of change - the new oligarchs - were now standing in the way of further radical surgery. They were not even paying their taxes, while most of the money they were making was flooding out of Russia into Western bank accounts. Nor, he argued, could serious people turn a blind eye to the fact that Russia was living on the ‘never, never’ with a foreign debt now standing at well over $140bn and rising. Workers were also not being paid, and while a few at the top were getting fabulously wealthy, living standards for the overwhelming majority of Russians were continuing to decline. The outlook he concluded was by no means rosy. Others agreed. *The Economist* was one, and in the summer of 1998 published a particularly alarming report about the state of Russia. Its conclusions were bleak, alarmist even. Russia, it opined, stood on the edge of an economic precipice, with the rouble about to collapse, foreign investors beginning to panic and ‘intelligent Muscovites’ talking seriously (and for the first time in five years) about a financial and political crisis that could only be settled by force of arms. What it called a ‘nightmare scenario’ faced Russia and the only way of avoiding it was by taking even more thoroughgoing measures.[45]

[45] ‘Russia’s Crisis: Could it lead to Fascism?’, *The Economist*, 11 July 1998.

For once the experts (unfortunately) managed to get Russia right, and within a month of *The Economist* hitting the news-stands in July, Russia was facing a meltdown of epic proportions. [46] The immediate cause of the August crisis was the chronic fiscal deficit, in turn the product of an essentially unreformed economy in deep recession that produced little wealth, and a government unable to tax those profits that were being made. Experts are still divided over whether the August crisis was inevitable given Russia's deep structural flaws, or if it was just bad luck, the product of unfavorable international circumstances and some poor policy responses. Arguably the leading two policy errors, made back in 1995 and sustained to the bitter end, were fixing the rouble exchange rate at too high a level, and the decision to finance the yawning government deficit through international borrowing. Vladimir Popov has shown that the ratio of the rouble exchange rate to purchasing power parity (PPP) rose from around 50 percent (the level of most East European currencies) to 70 percent between 1995 and 1997. [47] This priced Russian manufactures out of export markets and exposed them to fierce import competition. Inevitably this led to a massive trade deficit (by mid-1998 Russia was running a $5.8 billion deficit). To add to its woes, Asian stock markets started to fold in October 1997, causing a Gaddarene flight from emerging markets by international investors. Then, to make matters worse - much worse - Russia was hit badly by the ongoing fall in the price of oil from an average of $18 a barrel to a mere $11 by the end of 1998. This not only weakened Russia’s trading position, but sent out a signal that it might not be able to underwrite its spiralling international debts (half of Russia’s export earnings came from the sale of oil and gas).

In light of these trends, there were increasing calls for a devaluation of the rouble - from maverick economist Andrei Illarionov to financier Boris Berezovsky. Outside observers discounted these concerns, operating on the assumption that Russia was too big to fail. They believed that the international financial institutions would always rally to shore up the reform efforts of the Yeltsin administration, and the rouble exchange rate was taken as the chief indicator of those efforts. A devaluation would cause panic in international markets,

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[46] See for example Marcus Warren, ‘Russians sleepwalking into crisis’, *The Daily Telegraph* (London) 18 August, 19987

[47] Vladimir Popov, ‘Will Russia achieve fast economic growth?’, *Communist Economies and Economic Transformation,* Vol. 19, No. 4, 1998, pp. 421 - 449

and would produce precisely the crisis that it was supposed to avoid. Indeed, the IMF came through with a $22.6 billion aid package (approved by the IMF board on 20 July), including $4.8 billion in ready cash, which it was confident would protect the rouble against speculative attack.

Concerns over the rouble's stability were also reflected in the market for treasury bills (GKOs). GKO nominal rates averaged 63 percent in 1996, fell to a low of 26 percent in 1997 (when inflation was 11 percent), but started to rise again in 1998. The rate hit 130 percent by June, by which time the total stock of GKOs was about $40 billion, of which about half were held by foreigners or by Russian banks who had borrowed from foreigners to buy the bonds. The GKO pyramid was by then a full-blown Ponzi scheme, with new bonds being used to pay the interest on old bonds. By June the government was finding it hard to find buyers for GKOs even at rates in excess of 100 percent. This left interest payments accounting for some 30 percent of federal spending. In July 1998 to reduce the exposure to a possible rouble devaluation they managed to convert $6.4 billion of GKOs into Eurobonds at 15 percent interest, denominated in dollars. That still left $11 billion of GKOs falling due by the end of September.

In return for its bailout, the IMF insisted on an emergency package of spending cuts and tax increases to bring the fiscal deficit below 3 percent of GDP. Meeting on 15 July, the State Duma accepted 12 of the government's proposed bills and rejected only two. Yeltsin anyway announced his intention to enforce by decree the tax increases which the Duma had rejected.

In the second week of August, as Russian government officials dispersed for their vacations in exotic corners of Europe, George Soros dropped a bombshell with his 13 August letter to the *Financial Times* predicting that Russia would have to devalue the rouble. On 17 August the Russian government announced a 90 day moratorium on foreign debt payments, a suspension of GKO payments, and allowed the rouble to devalue from $6 to $9. The financial system froze up, prices shot up, and by 9 September the rouble had fallen from $6 to $21.

After the crisis or what went wrong?

The August crisis dealt a deadly blow to economic reform. Two seasoned analysts summed up the situation with devastating accuracy. The collapse of the currency, they noted, had finally put paid to the 'the big capitalist lie' that the market had succeeded in transforming Russia. The dream was over. [48] Few seemed to disagree. Some feared - and talked openly about - a return to Stalinism, [49] while others speculated about the more likely rehabilitation of a middle Gorbachevian way between communism and capitalism.[50] The collapse in Russia was also interpreted by many as serving notice on the much larger neo-liberal economic project directed and overseen by the IMF. Certainly, coming when it did, in the midst of the Asian crisis, the implosion in Russia was regarded as having a significance that far outweighed its more immediate impact on the Russian economy. As *The Wall Street Journal* noted at the time, although the Russian economy was relatively minute in global terms - accounting for less than 2% of world output in 1998 - the impact of the situation there was bound to be great. Indeed, the paper very much feared that the events of August might easily set off a chain reaction that could end in a world-wide recession, if nothing was done to prevent it. [51]

While the August crisis shattered the Russian banking system, disrupted Russia's trade with its neighbours and pushed many firms into bankruptcy, dire predictions of hyperinflation, starvation, and economic turmoil did not materialize. A major crisis should have major consequences. After all, the dictionary definition of a crisis is that it is the critical stage in a disease after which the organism either recovers or dies. In this sense, the August crisis was most peculiar. The Russian economy did not recover of course. On the other hand, it did not die. Even so, there was little to celebrate. Living standards remained low, and continued to fall. Investment slumped. The middle class that had been created after 1992 was virtually wiped out. And what

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[48] Mark Franchetti and Peter Millar in *The Sunday Times* (London), 30 August 1998.

[49] George Friedman, 'Russian Economic Failure Invites a New Stalinism', *International Herald Tribune,* 11 September 1998.

[50] Adrian Karatnycky, 'The Rise of Russia's Third Force - Gorbachevism', *International Herald Tribune,* 15 September 1998.

[51] 'How Russia's Market Set Off a Global Chain Reaction', *The Wall Street Journal Europe',* 22 September 1998

had once been the world's second-largest economy was now reduced to the level of a Brazil or Mexico. Meanwhile, the majority of the population slipped into survival mode.

The IMF, naturally enough, insists it did nothing wrong. The problem, it argues, was never its advice but rather the failure of the Russian government to follow its advice. [52] Moreover, in its view, there was really no alternative to what it originally advocated. But this is plainly absurd. On the one hand, this assumes there was no other middle way between neo-liberalism and central planning; on the other, it ignores the simple fact that its own remedies - whether they were applied in Russia or not - have always tended to lead to indebtedness, inequality and impoverishment.[53] Thus even if its medicine had been swallowed completely (and much of it was) it would still have had pretty appalling consequences.

In Russia there were of course very specific problems and here it might be useful to distinguish between two phases in the so-called transition. In phase one - primarily 1992 - Russian government policy was really quite simple: to stabilize the situation as quickly as possible. By 1995 the contours of the post-Soviet political regime had been established. It was only in this second phase, especially after April 1995, that IMF money started to flow into Russia in large quantities. By then, unfortunately, most of the damage had already been done. Yeltsin had become 'our man in the Kremlin'. The West had imposed its own particular brand of elitist democracy. And the oligarchs had taken over. At this point, the IMF now began to lend more and more money to the Russian government, just to keep it afloat. Thus between 1993 and 1994, it lent $3 billion in the form of a Systematic Transformation Facility. This was followed by a $6.5 billion stand-by loan in 1995, and an Extended Fund Facility commencing in 1996 which was to dispense $18.5 billion over three years. IMF approval was also taken as a green light for other sovereign and commercial lenders to continue to do business with Russia and to lend the Russian government even more money. Inevitably, the debt grew and by spring 1999 Russia owed $15 billion in Eurobonds, $11 billion in Finance Ministry bonds, $38 billion to the London Club and $26 billion to the Paris Club. [54] Nor did this include

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[52] See my 'IMF Meeting Weighs Results of Past Seven Years', *Jamestown Foundation Monitor*, I December 1998.

[53] See Charlotte Denny, 'Mountains of debts', *The Guardian* (London), 6 August 1999.

[54] *Reuters*, 2 June 1999.

Western bank purchases of domestic GKOs, which together with all other loans amounted to something close to $150 billion.

In effect, the international community bailed out the sinking ship of state and bought Boris Yeltsin four years in office between 1992 and 1996, a period in which some fortunes were made but which saw little lasting progress towards real structural reform. Certainly, the IMF were aware that the Russian government was failing to meet all the conditions attached to its loans; nonetheless, money continued to be released at quarterly intervals, although some tranches were delayed for a few months. Loan agreements with foreign governments are confidential documents, and it will be up to future scholars to reconstruct the precise record. However, it seems *prima facie* that the IMF fell into the trap of moral hazard. Once the Russian government realized that it could fudge compliance with loan conditions, it made it that much harder to try to make the conditions stick the next time round. The loans of course may never be recovered. There is also a very real danger that Russian politicians will seek to blame those who advanced the loans for their own economic mismanagement. According to a Public Opinion Foundation poll, when Russians were asked in 1998 whether the IMF had brought benefit or harm to Russia, 17 percent said benefit, 19 percent harm, and 46 didn't know. By March 1999 however opinion had shifted: 14 percent now said benefit, 43 percent harm, and 28 percent had no opinion.[55]

We thus seem to have the worst of all possible worlds: on the one side stands Russia, trapped by a huge overhang of debt that can only retard its recovery; on the other is the West, locked into an embrace from it cannot escape with a recalcitrant debtor that shows no signs of mending its ways. Ordinary Russians also feel cheated. They have been forced to give up what they once had - limited though that undoubtedly was - but have gained very little in return. The only people it seems who have no regrets are those Western advisors who helped get Russia into the mess it is now in. But perhaps even they should be regarded less as monsters and more as victims of their own false consciousness, and of a particular economic ideology that brooked no dissent. Certainly, in the climate of the early 1990s, there was no way that the US in particular was going to contemplate any other option for Russia than the one that was ultimately pursued. The central thrust of policy was the promotion of global trade liberalization - the creation of NAFTA, the conversion of GATT into the World Trade Organization and the opening up of the rest of the world to American products and ideas. Even if anyone had understood the possibility of another model for Russia, it would have created conceptual not to mention political dissonance to have voiced an alternative given the prevailing neo-liberal orthodoxy of the time.

Conclusion

According to some commentators, the failure of market reform in Russia can only lead to increased tension between an increasingly resentful Russia and the West, especially if the current impasse increases the political influence of the Russian Communist Party and its nationalist allies. This indeed would seem to be the view of the US itself, whose original support for economic reform was based not just on material considerations or the belief that capitalism is a good thing, but an assumption that a reforming Russia would be a friendly and co-operative Russia. Thus, it follows that if Russia is not reforming, it is bound to be, or at least more likely to be hostile.

This argument is not without some basis in fact, and one can point to Russia's opposition to NATO expansion, its awkward behaviour in the Balkans, and its sale of arms to regimes hostile to the West, as proof that an unreformed Russia is likely to be an unfriendly Russia. But this would be a one-sided conclusion. Russia might not be as compliant as many in the West would hope. On the other hand, it has not turned out to be much of a problem either. And for a good realist reason: it is simply not in its interest to be a problem. At least two factors need to be mentioned here. The first is Russia's debt to the West. Dependent and indebted states have few choices and even fewer options, and as long as Russia needs regular injections of Western money to sustain it, it is unlikely to bite the hand that feeds it. There is also the question of the new class ruling Russia. While the oligarchs might have been a critical factor undermining serious reform, this does not mean they want a fight with the capitalist world. After all, they have to put their money somewhere, and as long as the opportunities remain better outside Russia than in

[55] *The Washington Post*, 4 April 1999.

it, Russian foreign policy is likely to be guided by pragmatists with a stake in Western stability rather than nationalists hostile to the Western project. Finally, there is the even more basic problem of capabilities. In the end, the Soviet Union lost the Cold War because capitalism proved to be more productive than Soviet-style socialism. Economics is also likely to play an equally important role in shaping Russia's post-Cold relations with the West: and as long as post-Soviet Russia continues to decline economically while the West continues to prosper, it simply won't have the capacity to upset the status quo. As Vaclav Havel has pointed out, a weak and demoralized Russia is less likely to be a problem for the rest of the world than a strong Russia. 'Better an ill Russia than a healthy Soviet Union' he once noted. Whether the Soviet Union was ever really healthy is a matter of conjecture. What is not in doubt is the seriousness of Russia's illness and thus its continued inability to play a serious role in world affairs.