BILKENT UNIVERSITY

INSTITUTE OF ECONOMIC AND SOCIAL SCIENCES

THE RUSSIAN ECONOMIC TRANSFORMATION IN THE EARLY 1990S AND SOME ASSESSMENTS IN THE WEST

BY

ÖMER KOCAMAN

A THESIS SUBMITTED TO THE DEPARTMENT OF
INTERNATIONAL RELATIONS IN PARTIAL
FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE
OF MASTER OF INTERNATIONAL RELATIONS

SEPTEMBER 2000

ANKARA

Devoted to Yörük* Ali

* My father is called Yörük Ali in Alanya.Yörük means nomad. Before he was married to my mother, he used to be a nomad in the Taurus mountains. Thanks to my dear father for his endless devotion to my education.

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ANKARA

Approved by the Institute of Economic and Social Sciences

I certify that I have read this thesis and have found that it is fully adequate, in scope and quality, as a thesis for the degree of Master of International Relations.

N Stone

(Thesis Supervisor) Prof. Norman Stone

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ABSTRACT

The Russian economic transformation is a fascinating story on many grounds. When the Soviet Union disintegrated at the end 1991, the new question pervaded the West was how to integrate the post-communist Russia into the international community, politically and economically. As to the economic transformation and integration, the economists and other intellectuals produced an enormous literature on how to convert centrally planned socialist economies into capitalist market economies. Many Russian and foreigners, who have dedicated large energies to the economic transformation of Russia in its first years, argued that Russia would end up in economic growth if it followed the proposed reform packages. Although Russia realized many proposed reform packages, it ended up in economic failure. This master thesis strives to explain the Russian economic transformation between 1992-1995 and its assessment or perception in the West.

ÖZET

Rusya'nın ekonomik gelişiminin birçok açıdan büyüleyici bir öyküsü vardır. 1991 yılı sonlarında Sovyetler Birliği dağıldığı zamanlarda, Batı dünyasında yeni bir soru sorulmaya başlandı, bu soru kominizm sonrası Rusya'nın politik ve ekonomik açılardan nasıl uluslararası bir devlet haline getirileceğiydi. Ekonomi değişimi ve ekonominin yenilenmesi açılarından bakıldığında, birçok ekonomist ve entellektüel'in merkez dayanaklı sosyalist ekonomilerin ne şekilde kapitalist pazar ekonomilerine dönüştürleceği konusunda tezler ürettikleri görülür. Rusya'nın ekonomik değişiminin ilk yıllarında özverili çalışmalarıyla gündemde olan birçok Rus ve yabancı ekonomist, Rusya'nın önerilen reform paketlerini kabul etmesi halinde ekonomik büyümenin gerçekleşeceği konusunda uzlaşmışlardı. Rusya önerilen ekonomik paketleri kabul ettiği halde ekonomik gelişme başarısızlıkla sonuçlanmıştır. Bu master tezi, 1992-1995 yılları arasında Rusyadaki ekonomik gelişmeleri anlatmak ve Batı ülkeleri tarafından nasıl değerlendiridiğini veya algılandığını açıklamak üzere hazırlanmıştır.

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Introduction

The Russian economic transformation is a fascinating story on many grounds. Russian capitalism is a subject of heated debate in academic and business circles. On the one hand some see nothing but robber barons, a giant mafia in place of government, universal theft, economic stagnation, ostentatious luxury for a few, and impoverishment for millions, on the other hand, the others evaluate the previous argument as an oversimplified and distorted picture.

The truth about Russia, today, is that it is ruled by a handful of men who are called "the oligarchs" since Yeltsin's victory in 1996 presidential elections was distinguished by the rise of a new class of oligarchs. The new oligarchs are humiliating and stopping factor in the transition to market economy since they are so self-interested. So little of their wealth finds its way into the Russian economy, the rest is stored in foreign banks. The estimates of capital flight over the past seven years range from \$50 billion to \$150 billion.[1] Throughout the transition period the nomenklatura continued its firm existence and manipulated the transitional polices into its own advantage. The economic and political reform policies, which were followed during both Glasnost-Perestroika period and post-communist Russian economic and political transitional period under the lead of Yeltsin, not only strengthened their place but also provided them with enormous wealth. Other actors such as the black market and Mafia members were also principal winners in those both transitional periods.

When the Soviet Union was on the eve of political and economic chaos, Western commentators proposed many political and economic prescriptions for ameliorating the economic and political mess. When the Soviet Union disintegrated, Russian federation was on the agenda of the Western commentators. People such as Jeffrey Sachs, Anders Aslund, Richard Layard, Joseph Blasi and Andrei Shleifer served the Russian government as adviser

[1] Los Angeles Times, 3 September 1999

on economic and political matters. They firmly believed that if Russia followed the proposed reform packages, Russia would end up in the free market economy and with wealth. They played important roles in the Russian economic transformation. Today, Russia is in undisputable economic and political chaos. Although Russia has realized many proposed economic reform packages, it ended up in an economic failure. The reasons behind this economic failure make a fascinating story, which will be analyzed throughout this thesis work.

Throughout this paper, the Russian economic transformation between 1992-1995 will be analyzed. If Russia is, today, in severe economic problems, the root causes lie in the nature of the Stalinist economic model to a considerable extent. As Richard Sakwa pointed out, the post-communist system emerged out of the old nomenklatura system and its way represented the reconstitution of late Soviet forms of rule –but without CPSU.[2] If Russia today is under an overall social, economic and political crisis, the nomenklatura revolution gives us the hints to grasp the nature of the political and economic changes in post-communist Russia. The post-communist Russian transition to free market and democracy was in many respects an incomplete revolution with profound political and economic continuities with the past. In Russia, the pattern of political and economic transition left much of the old system in their place. From this point of view, the nature of Soviet economy with special reference to the nomenklatura's place in it has to be analyzed. This is very crucial to understanding the post-Soviet economic developments. Therefore, the first chapter will focus not only on the nature of the Soviet economy and its distortions in economic life but also the place of nomenklatura in the Soviet economic system.

As the Soviet system started to change under the impact of the Gorbachev reforms, so did the patterns of the elite advantage. As political positions became less secure guarantee of

[2] Richard Sakwa., **Russian politics and Society**, (London: Routledge Press, 1996), p.160

those advantages, the emphasis shifted to private property. Throughout the perestroika reform process, the nomenklatura elite by capitalizing their assets, by converting privileges into property, got prepared themselves for the post-Soviet struggle to retain their economic and political status. Therefore, with special reference to above-mentioned facts, Gorbachev reforms will be analyzed at the first chapter as well.

At the second chapter, the evaluations of Western academics and economists on the Russian economy and their policy prescriptions will be put forward. The economic policies that were advised to the Russian government by Western commentators and the followed economic policies share the responsibility in the Russian economic failure. The Western policy makers failed to grasp the dynamics of changes in the last years of the Soviet Union. A substantial literature concerning transition from a command economic structure to the market economy emerged in 1990s. On a number of points a broad consensus prevailed among Western and East European economists. First, the transition must be achieved rapidly if it is to stand a chance of success. Second, the transition must imply a comprehensive switch to a fully-fledged market economy with a strict macroeconomic stabilization policy, together with a comprehensive domestic and external liberalization. The domestic liberalization should comprise the freedom of entrepreneurship, production sales, purchases, and pricing. Foreign trade needs to be liberalized which requires a unified exchange rate. Differences remain on whether the exchange rate should remain floating or be fixed in order to serve as an anchor for the stabilization.[3] Some other issues such as privatization were subject to extensive criticism. The economic polices that were advised by the Western economist and academics will be mentioned in the second chapter extensively.

The third chapter will be look at what happened between1992 and 1995 in the Russian economy. In this part of the paper, the reform policies such as price liberalization,

[3] Anders Aslund, **The Post Soviet Economy: Soviet and Western Perspectives**, (London: Punters Publisher, 1991), p.168

macroeconomic stabilization, privatization and economic relations with other former Soviet republics and how the ex-nomenklatura and mafia strengthened their place through the ongoing reform policies will be analyzed extensively.

At the fourth chapter, the results of Russian economic transformation and western perception of economic change in Russia between 1992-1995 will be analyzed. There will be an over all analyses of economic failure as well.

The aim of this study is study is to reveal how western economists and academics failed to grasp the nature and pre-existing features of the Soviet economic system. They failed to understand the role of nomenklatura and other forces such as mafia, corruption in the Russian economic and political system. For this reason, the economic and political policies that they proposed doomed to failure in the post-communist Russia.

CHAPTER I: THE SOVIET ECONOMIC SYSTEM AND ITS DISTORTIONS IN THE ECONOMIC LIFE

As mentioned in the introduction part, if Russia is, today in severe economic and political difficulties, its root causes lie in the Stalinist model to a considerable extent. From this point of view, it is important to grasp its features not only to understand the current economic chaos but also to see how western commentators failed in their proposals concerning the amelioration of the economic conditions in Russia.

Soon after Stalin took over from Lenin, Stalin decided to embark on a program of a rapid industrialization. For ideological reasons he decided to do away with the profit and the market system. Therefore he decided on a new approach. Rather than take the time that would be necessary to build up light industry in order to stimulate heavy industry, Stalin concluded that if he first concentrated on heavy industry, in the long run he would be able to build up a much larger productive capacity. It was with such ends in the mind; Stalin sought build up the country's heavy industry as quickly as possible. However to obtain the capital he needed for the heavy industrial sector, he had to cut back sharply on the resources which would go to agriculture, light industry and the consumer. Agriculture and peasantry were forced to finance the bulk of the accumulation needed for industrialization. In short, through the course of forced collectivisation of agriculture, Stalin aimed at accumulation of the necessary capital that would fund the rapid industrialization.

The most important institutions of the new Soviet economic system were state ownership of the means of the production and central planning. Nearly the entire productive capital and institutions were owned by the state. A highly centralized, hierarchical form of economic planning coordinated the system. At the top of the planning system was the agency called Gosplan, which had the difficult role of developing internally consistent economic plan for the vast country. Below Gosplan, there were government ministries for the major sectors of the economy, which broke down the plan into more narrowly defined product targets for their area of specialization. Actual production took place at enterprises, each of which was under the authority of a particular ministry. At the enterprise level, the plan specified quantities of outputs, as well as the inputs to be provided. Gossnab, the supply agency, managed supply relations among enterprises.[1]

Under the new soviet economic system, the factory managers judged according to how much more they produced in the current year as compared to the year before. A good worker and manager was one who produced more tons and meters the current year compared the year before. Then larger the percentage-increase in production, the higher the wage bonus would be. In contrast, to the manager in a capitalist economy, quantities, rather than profits and return on investment, have been the major considerations to a manager in the USSR. The system stressed production for the production's sake. As a consequence, there has been little concern in the Soviet economy about what was produced and very little regard for the quality and product variety. The workers' and managers' salaries generally have not been affected by such considerations.

Because the quantity-type of success indicators were essential in assigning the bonus to the enterprises and the premiums to the managers, such a system led to enormous waste and distortions. The classic example is the nail producer whose target was spelled out in terms of tons of production per month. He concludes he can most easily fulfil his production target by producing one large nail. When the planners try to correct for this specifying the target in numbers of nail produced rather than tons, the nail manufacturer simply switches his production to producing numerous tiny nails. Thus the heavier product, the more gross ruble-

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[1] Alec Nove, **The Soviet Economic System**, (Boston:Allen and Unwin, 1986)

value the enterprise will be able to claim, and the quicker the firm will be able to fulfil its plan and collect bonus.[2]

The Soviet planning system stressed not only intermediate production targets but also performance and service. These are also measured against some quantitative target. For example, geologists who were assigned to drill for oil were rewarded with premiums if they managed to drill a specified number of meters each month. As a result, as Marshal Goldman pointed out, "there were geological expeditions in the Republic of Kazakhstan that had not discovered a valuable deposits for many years but were counted among the most successful expeditions because they have fulfilled their assignment in terms of meters."[3]

Money and finance played a strictly secondary role in the Soviet economic system. Once enterprises received its production assignment, the state banking provided it with the necessary financing to enable it to pay for the labour and material inputs specified in the economic plan. It was the plan's production orders, which set economic activity in motion, not the possession of money and credit. Such type of financing the enterprises and industries led to enormous distortions in the Soviet economy. For example this was evident in the construction industry. Once the construction industry provided with the necessary capital, there was no need to complete the construction, As a consequence, Soviet leaders periodically called for a moratorium on new construction in order to finish up the old construction. One another related problem with finance, the Ministry and Gosplan officials id not deal with banktrupcy. It was easier to authorize a subsidy and thus avoid a shut down of facilities.

The Stalinist model of economic development served effectively to build up a massive industrial and military infrastructure. All economic decisions were made to grow at a rapid rate while simultaneously reducing rewards allocated to the consumer. There was an

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[2] Marshal Goldman, **USSR in Crisis: The Failure of an Economic System**, (New York: WW. Norton Company,1983), p.46
[3] ibid.

overemphasis on heavy industry at the expense of light industry that would serve the consumer needs.

In the Soviet economic system markets played a secondary role. Consumer goods were partly distributed through retail stores at which consumer could buy from what was available, at prices regulated by the state. Since consumers' needs have traditionally held the lowest priority, there was a shortage problem with regard to basic items such as food, soap, matches, socks and so on. This economic condition, built up over the years, was reflected in the precedent increase in the disposable income by Soviet consumers. The increase in the total savings deposits in the Soviet banks increased faster than the increase in the retail sales. It also served the birth and grow up of a black market and second economy.

One another shortcoming of the Soviet economic model that hinders the development was its ability to do away with old and obsolete technology. For example, they could not produce certain advanced products even after they had become obsolete in the West. Their ineptitude with computers and computer software was particularly striking in the 1980s. Managers were unlikely to be concerned about obsolescence or innovations since their premiums were primarily dependent on increasing production. Since factory managers did not have to concern themselves with the sales or market trends, they were under no pressure to do away with the obsolete. At the same time, the Soviet incentive system did not provide for any substantial increases in bonuses for the production of new goods. The Soviet planners were always reluctant to allocate money to such purpose of innovating new technologies.

The Soviets were able to innovate when it comes to producing military hardware. It was a matter of priority that was given to military sector at the expense of other sectors. Only the military industry was provided with necessary funds and flexibilities for the purpose of innovating new military technologies.[4]

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[4] Joseph S. Berliner, **The Innovation Decision Industry**, (Cambridge, Mass.: The MIT Press, 1976)

1.1. The Soviet Nomenklatura

In order to understand why post-Soviet Russia's economic reform policies failed to reach at its goals, one has to grasp the nature and the place of the Soviet nomenklatura in this rigid centralized economic and political structure as well. In the post-communist Russia, the term 'nomenkalatura' is often identified with corruption and self-enrichment at the expense of people. The term 'nomenklatura' is often used to mean everyone in authority or enjoying privileges in the Soviet times. The most important feature of the Soviet system was the monopolization of the economic and political powers by the party and state officials. They sought to control virtually every aspect of public life together with the political and economic life. As Alec Nove pointed out, "the multitude of administrative units and the overlapping of responsibilities created a phenomenon aptly described as 'bureaucratic pluralism' in which various agencies sought to defend their own interests."[5]

The material privileges accorded to the Soviet elite ran counter to the egalitarian ethic of socialism. The Soviet elite was provided with the special access to consumer goods. There were special stores, open only to the elite, which carried high quality goods for the elite. At food processing plants, for example, there was always a workshop producing higher quality foodstuffs for the elite. Special construction enterprises built fine apartments for the elite. Factory managers in the Soviet Union were paid substantially more than ordinary workers. Privileges were strictly according to rank, and each rank in the nomenklatura ladder had its own list of benefits. They enjoy benefits associated with being part of the nomenklatura.In addition, there was a system of special nomenklatura education. The higher schools were generally concerned with training of local and regional level nomenklatura members. The

[5] John L.H Keep, Last of Empires: A History of the Soviet Union: 1945-1991, (Oxford University Press,1996), p.210

Moscow Party School, the Academy of Sciences and Academy of the National Economy were the institutions where nomenklatura children had a special position to be recruited.[6]

1.2. The Shadow Economy

The 'second or shadow economy' refers to the economic activities that escape control by the state. The scale of the second economy was generally thought to have accounted for at least 10 per cent, and perhaps as much as 20-25 per cent of GNP –and as much as 30 to 40 per cent of total income.[7]

The basic reason for these activities was the shortage of essential consumer goods, which resulted from the over centralized system of economic management and distribution. The criminal mafias in line with political officials were principal actors in this arena. They operated in both consumer and producer goods. In the Soviet economic system, there was bartering of materials between enterprises to help each other to fulfil the plan. Such informal transactions was subject to exchange of favours, with or without payment, between those who had access to scarce commodities or services.[8]

The Black market was particularly important in both obtaining goods which are in short supply and illegally produced, imported (smuggled) or stolen goods. Black market operators were also in contact with the state officials especially in their transactions with regard to export the stolen commodities, import and smuggling. For example, in 1982, Deputy Minister of Culture Nikholai Mokhov was arrested for smuggling diamonds into the Soviet Union while about at the same time, Vladamir Rytov, the Deputy Minister of Fisheries was executed and two other employees of the Ministries of Fisheries were arrested for smuggling millions of dollar worth of caviar out of the Soviet Union.[9]

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[6] Olga Khyrshtanovskaya and Stephen White, "From Soviet Nomenklatura to Russian Elite", **Europe-Asia Studies**, Jun 96, Vol.48, Issue 5, pp.3-4
[7] L.H Keep, **op.cit.**, p.219
[8] ibid., p.218
[9] Goldman, **op.cit.**, p.98

Black market operators were also the important actors in alcoholic beverages because of the shortages in state stores. One another arena that black market was active, was motor vehicles. Many vehicles were sold through unauthorized channels. In this sector official corruption was prominent, for example, workmen at Gorky motor works smuggled out vehicle parts.[10]

The high prices that prevailed on the collective farm markets where supply and demand more properly match, was another sign of the shortage of food supplies.[11] It was another area that was filled by both black market and second economy operators. Because the Soviet system put enormous emphasis on the heavy industry at the expense of the light industry, the Soviet consumers had an increasing saving amount in their deposits. Since there was an enormous shortage in terms of basic foods and other items, the Soviet consumers' deposits could not find its way back to the economy. This situation, in turn, served the acceleration of the second economy and black market throughout economy. The Soviet citizens, who were facing difficulty in finding what they want in state shops or collective markets, have made the second economy a basic part of their lives since they were loaded with large disposable sum of their money in their hands.

1.3. Mafia

Manchur Olson argues that it is small groups with a great deal at stake that are most likely to be well organized and effective defenders of their interests.[12] It was the members of the organized crime and the ex-Soviet nomenklatura, who were to be well organized and were the principal winners in terms of material and political privileges throughout the transition period at the expense of people in Russia.

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[10] Keep, op.cit., p.220

[11] Lazar Volin, **A Century of Russian Agriculture: From Alexander II to Khrusshchev**,(Harvard University Press, 1970)

[12] Manchur Olson, **The Logic of Collective Action: Public Goods and the Theory of Groups**, (Cambridge, Massashussets: Harvard University Press, 1971)

Organized crime was the most explosive force from the collapse of the Soviet Union. Throughout the transition period, the Russian mafia proved itself to be corporate power. The Russian mafia throughout the privatisation period together with nomenklatura purchased a majority of sate owned assets such as enterprises, banks and so on. On February 17, 1994 the Economist reported that private enterprises were forced to pay 10 to 20 percent of their earnings to criminal gangs, and that 150 such gangs controlled some 40,000 private and state-run companies and most of the country's 1,800 commercial banks.[13]

The formation of a criminal underworld in the Soviet era began in1917 as an expression of a political rejection of Bolshevik victory. Criminal activity took the form of counter-revolutionary banditry carried out by association of former capitalists and aristocrats, White sympathizers, and disillusioned revolutionaries who operated outside the new formal hierarchies. Their criminal activities were attacks on public enterprises and individuals. In 1930s, the first informal set of rules governing the underground appeared among individuals calling themselves thieves bound by rules. Their ideological point was the total rejection of the formal Soviet economic system. However, up until WWII, they neither threatened statusquo nor were any potential benefits to the formal hierarchies. Therefore, the formal hierarchies had no incentive to commit resources for their elimination or to engage with them in any compromise.

The post-war criminal actors were product of a devastated economy and turned into crime for economic opportunity and pure material gain. They started to establish connection with formal hierarchies. Their illegal activities ranged from theft, burglary, drug traffic and bank fraud to prostitution. At this stage of the development of organized crime, the relationship between the formal hierarchies and organized crime was restricted to bribes.

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[13] **Economist**, 17 February 1994

One important development in Stalin's era was the emergence of an informal system of management whereby managers turned into entrepreneurs. When the formal channels through which inputs were to be converted into out put failed to deliver products on time to meet the strict quotas of the central planners, channels of delivery had to be opened through informal arrangements that included reciprocal payoffs. Members of formal hierarchies who managed state enterprise developed entrepreneurial skills and established informal networks to ensure the provisions of supplies from other state-owned enterprises.[14] This aspect of the Soviet economy prepared the grounds for organized crime members to infiltrate into the Soviet economy and to accelerate the developing connections with the formal hierarchies within the Soviet economy.

Throughout the Soviet economy, there were incentives for the formal hierarchies to cooperate with the organized crime members, laid at the core of distribution system. In the Soviet economic system the prices were set administratively and especially for the tradable commodities, the prices were highly below the international levels and market values within the country. The resulting differences between market values and administrative ones led to development of an underground economy whereby commodities were reserved by the members of the formal hierarchies and diverted to informal or foreign markets where they could be sold at higher prices.

During the Brezhnev era (1964-82) the informal underground economy developed enormously.[15] Underground factories and organized crime groups supplied what the formal economy failed to supply with the cooperation of the highest level of the formal hierarchies.[16] Theses informal activities cultivated a class of entrepreneurs who were in a position to amass wealth.

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[14] Thomas Mark, "Mafianomics: How Did Mob Entrepreneurs Infiltrate and Dominate the Russian Economy" **Journal Economic Issues**, June 98, Vol.32, Issue 2, p.567

[15] See for a detailed account, Arkady Vaksberg, **The Soviet Mafia**, (St. Martin's Press, New York, 1991)

[16] Thomas Mark, **op.cit**., p.568

Gregory Grossman of the University of California at Berkeley described the major form of illegal activities in the Soviet Union. He mentioned that stealing from state enterprises including collective farms was practiced "by virtually everyone," providing extra income to employees and "an important, often indispensable, basis for the second economy." Grossman cited that peasants were stealing fodder, workers were stealing tools and materials, physicians were stealing medicines, drivers were stealing gasoline, truck drivers were diverting freight, and enterprise managers were diverting goods either to black market or into barter channels for needed supplies.[17]

The old communist system was really a kleptocracy. The 1970s and 1980s, for instance witnessed the upcoming scandals such as Cotton Affair in which party bosses in Uzbekhstan earned huge profits by falsifying the production reports. 1970s and 1980s were the years in which many large criminal organizations began to emerge and many mob leaders began to cooperate in tandem with the government officials. Russian began to use the word "Mafia" in these decades to describe the vast networks lurking inside regional central ministries.

Gifts or bribes to state and communist party officials accompanied all this illegal activity. There were close connections political administrative authority and second economy operators. Gregory Grossman pointed out that the process of bribery and graft was very institutionalized in the Soviet economic structure.

1.4. The Origins of Gorbachev's Perestroika

The Soviet economy was beset by some nagging problems. While the quantity of goods produced increased rapidly, their quality was very low. Some products were high quality such as weapons, aircraft, metals, spacecraft, and so on. Many Soviet products particularly consumer goods not only were low quality such as televisions, private motor

[17] Gregory Grossman, " The Second Economy of the USSR ", **Problems of Communism**, 26 (September-October 1977): pp.25-40

vehicles, refrigerators and washing machines but also their spare parts and repair facilities were notoriously short.

Consumers faced with a retail distribution system, which did not cater to their needs. As a result, annual consumption started to decline throughout 1970s. According to Western estimates annual consumption grew on average by 2.9 per cent per annum during 1950s and 1960s but fell to 2.2 per cent in the 1970s an to about 1 per cent in 1982. Since the Soviet economy operated with a perpetual shortage of goods, the result was an increase in the saving of Soviet citizens especially in the late 1960s and onward. The deposits grew by annual average of 19.9 per cent in 1966-70 and 14.3 per cent in 1971-75.[18]

Increasing shortages of goods and services widened the difference between official and black market prices The Soviet economy operated with a perpetual shortage of goods which led to an increase in the saving of Soviet citizen especially in the late 1960s and onward while creating enormous incentives for enterprise managers to divert goods to black market. The diversion of goods from government shops worsened the shortages and eventually led to breakdown of the retail distribution system.

Enterprises failed to use inputs efficiently. Fearing that essential raw materials or components would be unavailable, enterprises started to accumulate large stockpiles. The inflexibility of the Soviet planning system forced many enterprises to barter goods among themselves to fulfil the planned output levels.

Agriculture remained as a perennial problem throughout the 1960s, 1970s and onward. It was partly due to climatic conditions in the Soviet Union. However the nature was not only the cause. Despite pouring large inputs of labour and capital goods into agriculture in the post war years, the Soviet authorities had faced with difficulty in delivering a high quality and appealing diet to the citizenry.

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[18] Keep, __op.cit__.,p.228

1.4.1. Stagnation

It was inevitable that the extremely rapid growth rate which the Soviet Union achieved started to slower throughout 1970s. A sharp breakdown started to reveal in key sectors of the Soviet economic performance. The years between 1975 and 1985 were called 'stagnation' period. However one thing has to be taken into consideration that in between these years the Soviet economy did no actually did not stop growing, but rather its growing rate started to fell down. The sudden worsening Soviet economic growth was not limited to economic growth. There was also a slowdown in technological innovation around 1970s. Around 1970s, it appeared that the technological gap between the USSR and the West began to widen. It was one another dimension of the decline in the economic growth.[19]

1.4.2. Reasons of Stagnation

There were many reasons, which led to the Soviet stagnation. Among reasons these were prominent. 1-Structural problems such as increasing difficulty in carrying out central planning effectively, a reduction in labour discipline and a decreasing rate in technological innovations. 2-Policy errors such as decision by the planning authorities to deliberately reduce the economic growth rate after 1975 and bottleneck that arose in key sectors of the economy, particularly rail transportation and oil production. 3-Uncontrollable developments such as unfavourable demographic trends and unfavourable weather conditions. 4- the large Soviet military burden especially after 1980 to maintain military competition with the USA, under the Reagan administration.[20]

There was an also increasing corruption and cynicism throughout the institutions of Soviet society. There was also growing sense of alienation, aimlessness and alcoholism was on the rise among the Soviet people. The weakening of observance of law and the growth of

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[19] Vladamir Kontorovich, "Economic Fallacy", **The National Interest**, (special edition, 31, 1993), pp.35-45

[20] Edward A.Hewet, **Reforming the Soviet Economy: Equality Versus Efficiancy**, (Washington DC: The Brooking Institutions, 1988), pp.51-78

corruption, both of which started in the economic sphere, gradually spread to all society. The last years of the Brezhnev leadership was marked by an increasing irresponsibility, lawlessness, bribery, protection rackets and growing protests. Thus the Soviet leadership that took power in 1985 was faced with declining rate of economic growth and increasing social tensions.[21]

1.5. Gorbachev Era

After the short reign of Konstantin Chernenko and Yuri Andropov, Mikhail Gorbachev became general secretary of the Communist Party of the Soviet Union in 1985. Why did Gorbachev start Perestroika? The rapid US arms build up under Reagan administration posed a serious challenge to the Soviet Union. Gorbachev speeches reveal out this fact. Gorbachev's first pragmatic speech reveals this fact "only intensive, high developed economy can safeguard a reinforcement of our country's position on the international stage and allow her to enter the new millennium with dignity as a great and flourishing power."[22]

This was a recognition that the USSR was losing out in the arms race because of insufficient economic strength. According to Gorbachev, there were three major reasons for the declining economic growth rate: faltering efficiency, technological development and quality:

> "The economic growth-rates fell to a level, which actually approached economic stagnation. We started evidently falling behind in one way after the other. The gap in the efficiency of production, quality of products and scientific-technical progress began to widen in relation to the most developed countries and not to our benefit." [23]

Gorbachev stressed two specific flaws in the traditional Soviet model, which caused the economic decline. One concerned the means of coordination of the various parts of the economic system. This flaw was the 'rigid centralism' of the system with its tradition of 'command' from the center. The second flaw was the absence of the effective work

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[21] Padma Desai, **Perestroika in Perspective: The Design and Dilemmas of Soviet reform**, (Princeton University Press, 1989), pp. 3-25
[22] Anders Aslund, Gorbachev's Economic Struggle for Economic Reform: The Soviet Reform Process, 1985-1988, (London: Pinters Publisher, 1989), p.13

motivation, -the lack of work discipline. Based on these assumptions, Gorbachev proposed solutions that entailed the radical restructuring of the Soviet economic system.

Gorbachev argued that the problems that the Soviet economy had faced could be overcome by setting higher targets for economic growth (acceleration) combined with a crash investment program to modernize and raise the technical level of industry, and by campaigns directed at increasing the labour productivity by increasing the factory discipline. The Gorbachev policy of acceleration based on a programme that aimed at increasing the rate of investment and economic growth. This was to be achieved by the more intensive use of energy, labour and raw materials. In practice, acceleration meant that enterprises were required to achieve higher gross output targets with a supply of inputs.[24] The increased investment, however, was largely financed by the state that in turn undermined the financial stability of the Soviet economy throughout the Gorbachev era. Between 1985-87 the deficit increased from 1 per cent to 7 percent of GNP.[25]

Gorbachev government first effort was based on the campaigns against lax work efforts, corruption and drunkenness. One part of these efforts was the anti-alcohol campaign. Drunkenness was viewed as the major cause of the poor worker discipline. To combat with this problem, state productions of alcoholic beverages were sharply curtailed. This measure was largely unsuccessful partly because it led to illegal private production but also because the authorities failed to provide alternative consumption items to absorb the displaced purchasing power. Consequently, the campaign removed a major source of budget revenue; an estimated 20 billion rubles in tax revenues were lost and increased excess demand in retail markets.

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[23] ibid., p.15

[24] Alan Smith, **Russia and World Economy: Problems of Integration**, (London-New York: Routledge, 1993), p.103

[25] Peter Mieszkowski and Ronald Sligo, "Economic Change in Russia: 1985-1995", **Problems of Post-Communism**, May/June 1996, Vol.43, Issue 3, p.2

To aid in modernizing the capital stock, twenty-three new scientific technical research complexes were established in 1986 87 to develop new technologies. The rate of growth in the production of new machines and other capital goods increased to double the level of the preceding decade (1975-85) during 1985-87. In terms of quality control, Gospriemka (the State Quality Control Board) was established in 1986 and was charged of bringing 95 per cent of Soviet manufactured goods up to world quality standards. Quality controllers inspected goods in the factories and accepted only those, which met the state quality standards. Managers and workers were held accountable on the basis that their premium and bonuses would not be paid if their products were to be below the state standards.

In the autumn of 1986, the Gorbachev initiated a wage reform which reversed the levelling tendencies of the industrial wage policies by increasing pay differentials between skill levels and raising the salaries of specialist and managers at higher rates than blue-collar wages. The resolution 'On Improving the Wage System in Production Branches of the National Economy' mandated an average wage increase of 20%-25% for engineers for workers, 30%-35% for specialists and 35%-40% for engineers. The reform would in principle raise wages for all categories of workers and the raises were to be financed by the enterprises rather than by the state budget.[26]

The second phase of the Gorbachev reform process is normally considered to have started when Gorbachev gave a speech to a Central Committee plenum, which convened to discuss the progress of economic reforms in June 1987. The most important development that was reached at the plenum in 1987 was the adoption of 'Law on State Enterprises', which would be effective in 1988. The basic provisions of the law were to make enterprises operating according to the principles of self-accounting, self-management and self-financing. Self-management meant that enterprises would become autonomous financial institutions, which would be expected to cover their variable costs from their revenues from the sale of output. Under this law, the investment would no longer to be provided as a free gift from the state. Rather, it would be financed by repayable bank loans. The most radical element of the law concerned the self-management. Enterprise managers and directors were supposed to be elected by their workers, who would also elect a work council that would confirm enterprise's plans.[27]

Enterprise autonomy meant abandoning the system of central determination of a detailed plan of inputs and input for each enterprise. Instead the center would issue 'on-binding control figures' giving a target for the value each enterprise's output and for other indicators of enterprise performance. There would also be mandatory 'state orders' for part of the enterprise's output. The remainder of enterprise output would be sold through 'wholesale trade.' This meant that enterprise would become relatively free to determine what they would produce and to whom they would sell their products.

The Gorbachev leadership both understand and insisted that price was critical to the overall project of perestroika. The 1987 plenum proposed that a radical reform of the whole system of wholesale and retail price system. The reform was to include higher industrial wholesale prices for fuel and raw materials, a large reduction in retail price subsidies and some decentralization of pricing quality. This recognition was important not only bring prices into line with production costs in order to allow introduction of self-financing but also to stop the existing system of price formation which had resulted in distortions, irrationalities. However, the leadership was cautious on this issue since it could lead to deterioration in working people's living standards. In an attempt to ease the tensions, Gorbachev promised that living standards and purchasing power would be preserved by the payment of equivalent increase in the level of wages. Under the conditions of excess consumer demand, since this

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[26] Linda J. Cook "Social Contract and Gorbachev Reforms", **Soviet Studies**, 1992, Vol.44, p.6
[27] ibid.

commitment required payment from the central budget, it led to fear among the reformers that the price reform policies could result in inflationary pressures. During these years, there was a heated debates on whether prices should be initially increased from one level to another to eliminate subsidies and to reduce wasteful consumption or whether an entirely flexible price system to bring supply and demand into a balance.

Beginning in the autumn of 1988, the state consumer sector was beset by rising prices, the disappearances of common, inexpensive goods and severe supply disruptions. Over the following year the situation grew worse. In this period, enterprises in the consumer good sector, which had been transferred to self-financing, often responded by raising prices for their goods. They also increased profits by phasing out inexpensive product lines, including many everyday items, which had been produced at low prices. Many enterprises used their limited autonomy to put into effect wage increases, which were not backed by productivity increases. These occurrences contributed to the acceleration of inflation and shortages.

By early 1989 the reformers had neither price stability nor a comprehensive price reform. Moreover, consumers who were already confronting inflation and shortages were no longer in support of the reforms, which in turn led to additional state-planned price increases and subsidy cuts. Price reform economically was necessary but politically risky, that's why, reformers retreated, postponed the price reform and moving back to strengthened administrative control over prices in late 1989.

Another important economic reform that took place during Gorbachev era was the realization of 'Law on Cooperatives' in May 1988. The measures of the law intended to allow and encourage private business activity. According to this law, the cooperative enterprises were supposed to be established by a group of workers who would use their labor and property to produce good or services or sales to the public. Cooperatives were allowed to operate restaurants, repair businesses, retail stores, wholesale trading company, bank or small consumer goods manufacturing businesses. The idea behind permitting such small private business was the recognition that the state-run economy had been poor at providing the kinds of services and small-scale manufacturing. Throughout 1989 the number of cooperatives increased rapidly and by July 1989 there were an estimated 2.9 million people working in 133,000 cooperatives. Operating mainly in trade and finance some of these firms were able to take advantage of the rigidities and controlled prices of the Soviet System to make a great deal of money. Trading firms bought scare materials and resold them at much higher prices in world markets.[28] The Law on Cooperatives of 1988 significantly affected the underground economy. Some of the cooperatives were former underground enterprises that became legal.[29] Corruption increased immensely, for example, bribery was necessary to obtain office space in Moscow.[30]

The opportunities to make a great deal of money in private business improved greatly after a decree was passed by the Council of Ministers in December 1988, called 'On the Foreign Trade Activity of State, Cooperative and other Enterprises.' Previously all foreign trade had been under firm control of the state. This decree allowed both state and private firms to trade directly with foreign entities. Restriction on foreign trade remained, one of which was that export and import licences from the Ministry of Foreign Economic Relations were required for many products. The decree on foreign trade of 1988 opened an important means for those people who wanted to become rich. The state-controlled prices made many Soviet goods especially oil and metals prepared the opportunities to be grasped by those people who wanted to become rich at the expense of the bulk of the population. After this decree opened up foreign trade to private firms, import-export companies were formed in the legal form of Cooperatives, which began to operate partly legal to grasp above-mentioned opportunities.

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[28] Kotz and Fred, op.cit., p.93

[29] Anthony Jones and William Moskoff, **The rebirth of Entrepreneurship in the Soviet Union**, (Bloomington: Indiana University Press, 1991), pp.16-17

[30] ibid.,pp.36-38

Over three thousands such firms were formed. Because exporting raw material required a licence from the Ministry of Foreign Economic Relations, the officials began to accept bribes in return for those licences. By 1990-91, a new group private capitalist had developed and was getting rich mainly through connections with the outside world.

The Gorbachev reforms throughout 1987-8 did not eliminate central controls over the economy, but it resulted in the losing of control over the enterprises to a considerable extent. The intention was to gradually replace the strict controls by a news system of democratised and decentralized planning together with a greater role for market relations. However, the design of the reforms carried serious internal flaws. First, it failed to create new institutions to coordinate the behaviour of the newly autonomous enterprises. The shifting of enterprises from state control to relative autonomy over the sales, purchases and financing would require new ways of operational rules. The result of the rapid shift to greater enterprises autonomy was increasing chaos in the enterprises sphere. Second, giving enterprises freedom to determine the allocation of enterprise income produced imbalances in the economy. The enterprises responded to releasing controls over them by increasing employee incomes. That means diversions of the enterprise income from investment to employee pays and benefit, which, in turn, undermined the plans about economic growth. Third, under the old system, the central government had no difficulty in obtaining revenues to finance its expenditures. The Central government's decision to allow autonomy to enterprises led to difficulties in extracting taxes. This, in turn, accelerated budget deficit throughout these years.

1.5.1. Crisis in Consumer Markets

These three problems in the Soviet economy in 1988-9 culminated in crisis in the consumer markets. During those years the Soviet economy experienced increasing shortages. The increase in household income is not equally matched by an equivalent increase in household consumption due to the shortages. Throughout these years private household consumption increased significantly by 3.9 percent in 1988 and 5.3 percent in 1989. Between 1988-89 household incomes grew at an accelerating degree, far beyond the increase in consumer goods available. [31]

To sum up, in the context of regulated prices, the growing consumer demand over goods available caused the shortages and disappearance from normal retail channels that were observed in 1988-9. Another factor behind the worsening shortages was the growing budget deficit due to the decline in tax revenues in these years. Additionally, in 1988-89, the effects of the 1987 Law on Enterprise produced a large budget deficit. This compounded the problem of excess demand for consumer goods, as the state employees were paid partly by means of printing new money. During these years, consumer goods enterprises responded to the excess demand by shifting production toward higher-quality, higher-priced items. Thus, basic goods that the lower income part of the population relied on became ever to find.

While the consumer market was in turmoil in 1988-89, another serious problem was declining net investment in the economy. The year 1989 witnessed a decline in net fixed investment by a 7.4 per cent and 6.7 per cent in 1989. This trend threatened the threatened the future productive capability of the economy.[32]

1.6. Radicalization of the Debate on the Economic Reform

The year 1989 marked a critical turning point in the struggle over the direction of the economic reform in the USSR. The debate over the economic reform evolved in 1989 centered on two key issues. The first was related to the degree of state's role in the economy. The second was related to the desirability of public or private property in the means of production.

As we have seen that Gorbachev 1987 called for an economy that would retain economic planning, but with the decentralization and a significant role for market forces

[31] ibid. p.80

within the planned framework. Starting in 1989 this conception was subject to increasing attacks and the term of 'socialist market economy' came into use. This term implied that the economy should become primarily a market economy with a planning system. In 1990 the term 'regulated market economy' came into use, which was a further step away from the conception of the economy as a socialist one.

The debate on property underwent a similar evolution, beginning in 1989. As we have seen, at first there were calls for a 'mixed economy' in which small-scale individual and cooperative enterprises would exist alongside state enterprises. The next step was the call for 'equal status' of all forms of property. By 1990 the view that state ownership of enterprises was the root of the difficulties of the Soviet economy was openly argued in the press. The superiority of private over public ownership was asserted on the basis that only a private owner would manage enterprises efficiently.

The evolution of the terminology continued and many economists who are participating in the discussions dropped the term 'regulated market economy'. The final step was the call for a 'free market economy'. One example was Oleg T. Bogomolov, the head of the Institute of the Economics of the World Socialist System, began to advocate a free market economy and privatisation by 1990. Another example was Stanislav Shatalin who was the head of the Economics Department of the Academy of Sciences, turned against central control, and upheld the free market and privatisation.

1.6.1. The Abalkin Plan of November 1989

By the middle of 1989 the economic situation deteriorated seriously. There was no clear consensus among economist on the methods of dealing with the crisis. The first sets of proposals were produced by the economist Leonid Abalkin (who in 1989 had been appointed as a deputy minister with responsibility for economic reform). The plan proposed that the

[32] ibid.

reform process was to be divided into three parts. The first, in 1990, was to be a preparatory stage. In the course of this year the requisite market legislation would be prepared. These new laws were to include measures on property, legalising various forms of entrepreneurship, a new tax system and a new banking system. The plan also proposed new measures to reduce budget deficit, limit the growth personal incomes and restrict credit. All loss-making enterprises were to be transferred to lease holding.

The second stage, from 1991 to 1992, was to include the new market mechanism. The share of free trade, that is, products produced above the state orders and sold at unregulated prices was to increase sharply. Wage determination was to be completely decentralized. All of the loss-making collective and state farms were to be closed.

The third stage would include an antimonopoly program and the introduction of a two-tiered banking system. By the end of 1993, 25-30 percent of state enterprises were to be transferred to lease holding, and by the end of 1995 as much as 30-40 percent of state property was to be transformed into joint-stock companies.

The plan was important on the ground that for the first time in the thirty-year history of Soviet reforms, a scheme of sequential changes was proposed. As Petr O. Aven explained "if it had been adopted, the government could have used the program basis for further radical and detailed proposals." [33]

The government of Prime Minister Nikholoi Ryzhkov rejected the Abalkin plan and presented its own program to the Congress of Peoples' Deputies in December 1989. The government plan looked like the Abalkin Plan. The government plan put emphasis on the plan discipline and state orders. For the most industrial products the state orders were to reduce only from 100 per cent to 90 per cent. In addition, the Ryzhkov plan advocated new sanctions for unfulfilment of state orders and also rejected the principle of voluntary acceptance by the enterprises of the state enterprises. The government program also included a two-staged plan for administrative price reform.

The Ryzhkov plan was considerably more conservative than Abalkin's initial plan and placed greater insistence on the rigid state orders. Central controls over prices and wages were to continue while the budget deficit and the growth money supply were to be gradually reduced. Ryzhkov dismissed proposals for the introduction of private property and denationalisation. A stage-by-stage price reform would be introduced in 1991-92.

1.6.2. The Shatalin Plan

In 1990-91, the Soviet economy moved from a condition of severe problems to one of crisis. For the first time, the Soviet economy contracted, with the GNP falling by 2.4 percent in 1990 and about 13 percent in 1991. Net fixed investment declined at the outstanding rate of 21 percent in 1991 and an estimated 25 percent in 1991.[34] The money income of the population together with the budget deficit continued to increase throughout these years.

In August 1990, Gorbachev and Boris Yeltsin who was the chairman of Russian Supreme Soviet, jointly named a team of economist to come up with a new economic reform plan. It was headed by Gorbachev advisor Stanislav Shatalin and Yeltsin advisor Grigory Yavlinsky was also in that group for the formation of the reform program. In early September the team reported the famous 500-plan.

The plan contained a timetable for the transition to a market economy. The Shatalin plan proposed that measures for privatisation and liberalization would be introduced, which would contribute to micro economic stabilization. The first hundred days of the programme were to be devoted to enacting legislation for reform about small-scale privatisation of smaller businesses retail outlets, cafes, restaurant, hotels, etc., which would in return absorb the

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[33] Thomas J.Richardson and Merton J.Peck, **What is To be Done?: Proposals for the Soviet Transition to the Market**, (Yale University Press, 1991), p.167
[34] Kotz and Weir, **op.cit.**, p.91

monetary overhang and create immediate improvements in supplies. The program of micro economic stabilisation would be completed in the first 250 days. There would be no growth of the money supply in 1991 and the budget deficit would be reduced to 2.5 percent of GDP in 1980 and eliminated in 1991, which would be achieved by the elimination of virtually all enterprise subsidies and by major cuts in government expenditures on foreign aid, defence and the KGB and cuts in investment. There would be a rapid liberalization of wholesale prices (except fuel and raw materials) and state retail prices for 75.80 percent of household goods (except basic necessities) would be liberalised by the end of 1991. Rapid privatisation of large-scale industry would be concentrated in the 250.500-day period, so that 70 percent of large scale industry would have been privatised by day 500.

The most radical feature of the Shatalin plan was given role to be played by the Soviet Union itself. Under this plan an economic union of independent republics with common external tariffs and customs would maintain a single currency and the two tier banking system within an independent central bank. The republics were assumed to have the sole authority to raise taxes and would decide on allocating revenues to the central budget to finance defence policy, state-wide social welfare programs and so on. Republican authorities would control their own mineral wealth and resources and property privatisation. Republican law would take precedents over Soviet role. The strength of this plan made it obvious that the Union had already been in disintegration.

In the end Gorbachev rejected the program, although Yeltsin obtained its approval by the parliament of the Russian Republic. In October 1990 Gorbachev submitted a compromise plan to the Soviet Parliament. This plan, known as the `Presidential Plan', retained the goals and brought features of the 500-day plan such as the eventual phasing out of most price controls, privatisation of industry, and the creation of a market type system. It eliminated the 500-day timetable, called for a more gradual transition.

In June 1991 Grigory Yavlinsky together with a group of Harvard University economists proposed another plan for speeding up the transition to free markets and private business. In the media, it was called as 'the Grand Bargain' because of the commitment that the West would provide Russia with $100 billion in economic aid if the plan was adopted. In July 1991 the process of dismantling economic planning reached at its climax when the agencies of Gosplan and Gossnab were abolished. No new effective ones were developed in their place. Later that month, Gorbachev shocked the world by applying for Soviet membership in the IMF and the World Bank, which were two pillars of capitalism. The intention to integrate the Soviet economy in the world capitalist system was now clear.

1.7. An Evaluation of Gorbachev Era

1.7.1. Communists Became Capitalists

During the period of Gorbachev's rule, as we have seen, Soviet legislation banning private business activity was gradually loosened. In the Gorbachev era, many of the party-state elite, gradually, came to support the transition to market economy. By 1990 many capitalist enterprises were operating in the USSR. There was an increase not only in capitalist firms but also capitalists. Some were technical specialists-scientist, engineers, technicians, who were operating out of the state-run system. In these years the success in business required not only technical knowledge but also connection in their ability quickly seize opportunities when they arose. Connections were necessary because the rules for private business necessitated powerful friends in the position of authority. Connections were also only the way to get financing, in the contexts of the absence of private banks. The opportunities that were faced by them in the Soviet Union in 1987-91 were not primarily in production of useful goods. To do that, an entrepreneur would have to compete with state enterprises, which sold at low controlled prices. The potential profit was in two areas. One was trade, both domestic and international. With growing shortages and controlled prices an operator could buy goods from state enterprises and resell them in the domestic market at much higher prices. One another larger profit could be made by getting cheap Soviet materials and exporting them at world market prices.

The new private businessmen came largely from the group that had the best connection and could clearly see the growing opportunities in trade and finance-the party-state elite. Russian sociologist Olga Khrhostanoskaya who studied the Russian elite for many years made a research on the most influential entrepreneurs during 1992-3. The findings of this research are significant in terms of showing the choice of ex-Soviet nomenklatura for capitalism. In her research, she displayed that 62 percent of the most influential entrepreneurs came from Komsomol, industrialists, bankers, and elite families -represent the parts of part-state elite. Scientists or technicians were only 15 percent and another 5 percent were others. 18 percent were coming from the group of those people who are engaged in criminal activities.[35]

Khrstonavskaya's research team also studied the new political leadership of the independent Russia. They found that 75 percent of the leadership circle around President Yeltsin came from the former Soviet elite. Yeltsin's government was made up of 75 percent from the Soviet elite.[36]

The findings of the research are important in that it showed why the transition to capitalism in Russia was bloodless. As it could be seen the ex-Soviet nomenklatura had made their choice in favour of capitalism. The reason why the members of the party state elite favoured such a choice lies in their pragmatic approach rather than ideological. The great majority of the Soviet elite had joined the Communist Party because it was necessary to advance their career. Their presence in the Soviet administrative structure was important for pursuing of material privilege and power. The careerists who made up the great majority of

[35] ibid., p.118
[36] ibid., p.126

the Soviet party state elite in 1980s had seen the possible direction of change in the USSR. As we have seen, Gorbachev and his allies wanted to democratise and decentralize the Soviet system. Workers were supposed to become masters of their enterprises and the public would have political sovereignty over the state. This direction of change threatened to reduce the power and material privileges of the party state elite. That is why in the early years of reform process they resisted change. The members of the party state did have significant material privileges that flow to them by virtue of their membership in that elite. They had high salaries. Through their job they had the use of luxury automobiles. They had access to better housing. They could obtain better quality food, drinks and other consumer goods through special arrangements for the elite. However the subsequent reforms such as the Law on Enterprises, the Law on Cooperatives and the reforms concerning the foreign trade provided them with better opportunies in terms of material and political advantage and they began to rally around Yeltsin's pro-capitalist group.

Throughout the Gorbachev era the command economy was gradually replaced by a `bargaining economy.' Enterprise managers were increasingly able to use their informational advantage to bargain with central planners over output targets sand input allocations, which led to soft budget constraints. The center's dependence on firm-supplied information and the development of bargaining gave rise to branch lobbies that used their power to obtain greater resource allocations for their constituency. Weakened control led to more corruption, appropriation of state property for private use and widespread inefficiency, particularly in the use of investment resources.

Economic reforms promulgated by the Gorbachev government followed a pattern that aimed at attempts to improve the existing system. As a result of decentralized economic decision-making and loosening control over enterprise income, enterprises granted workers wage increases that exceeded productivity. By 1991 real wages had increased 80 per cent compared to 1985 levels. Since output prices were held constant, enterprise profit declined and increasing firm losses were financed by bank credits or direct subsidies from the central government. The central government increased wholesale prices in 1989 but was reluctant to pass theses increases on to the customers. This action further increased the budget deficit of the central government since subsidies were necessary to compensate firms widening gap between their output and input prices.

The increase in nominal wages without a corresponding increase in the supply of fixed consumer goods led to problem of excess demand. Increasing shortages of goods and services widened the difference between official and black market prices, creating enormous incentives for enterprise managers and local officials to divert goods to black market. As goods disappeared from government shops, shortages worsened and eventually the retail distribution broke down.

Declines in energy production and exports combined with deterioration in the credit worthiness of the USSR to produce a balance of payment crisis in 1991. The1991 collapse of trade among countries of the Council of Economic Assistance (CMEA) further disrupted by the supply links for the Soviet enterprises and worsened the payment crisis. The Soviet Union subsequently defaulted on its foreign debt. As result of these factors, Soviet imports dropped from $83 billion in 1990 to $45 billion in 1991. Because some imports were essential as productive inputs, the decline of foreign creditworthiness affected both the production and import of consumer goods.[37]

By 1991 the economy was in a severe state of crisis. Industrial output had fallen 8 per cent compared to 1990 levels. The budget deficit of the central government had risen to 30 per cent of GNP. Shortages were rampant. The monetary overhang was on the scene. There was a

[37] Peter Mieszkowski and Ronald Sligo, "Economic Change in Russia:1985-1995", **Problems of Post-Communism**, May/June 1996, Vol.43, Issue 3, p.3

collapse of the soviet monetary system and economic agents increasingly resorted to bartering and hoarding. [38]

With the decline of in the internal convertibility of the ruble for consumer goods, barter trade was increasing. Consumers were exchanging goods and services with one another. Barter trade was also common among enterprises throughout the Gorbachev years. Many enterprise managers were offering their output for materials to keep their enterprises running. Barter trade extended beyond enterprises and consumers to include republics and local governments. With the breakdown of distribution, heads of government have acted aggressively to protect their residents and local enterprises. They have taken control of local production and then concluded agreements with other localities to exchange that production for materials and consumer goods. One example, the mayor of Leningrad traded textiles for milk with the head of the Estonian Republic.[39]

Another important development that has taken place throughout the Gorbachev period was the immense increase in political and economic corruption. There were many reasons that led to that immense increase in political and economic corruption. The main reason was the reform attempts' fruits such as growing shortages, increasing nominal incomes of the Soviet incomes and so on. One another prominent reason was the decline of Soviet institutions. The destruction of the Communist Party's monopoly on executive, legislative and judicial power and the new legality of private economic activity provided an opportunity for the protective services of organized crime. The decline of the Soviet government as coercive power to maintain order created a power vacuum, which was tried to be filled criminal elements in the society.

From 1977 to 1993 reported crimes increased by over 339 percent; since the start of perestroika in 1985 to the end of 1993, the rate of increase was staggering 300 percent. The

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[38] ibid.

[39] Richardson and Peck, **op.cit.**,p.2

number of `organized groups' who engaged in criminal activity increased from 775 in 1990 to 4352 in 1992 and nearly 5700 by the end of 1994. The Russian Mafia, named as the 'vorovskoi mir' in the ex-Soviet era, controlled many transactions such as transactions in spare parts, timber and gems, which were equivalent to a value of 110 billion rubles ($60.5 billion) in 1992.[40]

What make Soviet type organized crime groups extremely menacing is their political connections with the bureaucracy and politicians. Fearing the loss of their privileges, the formal hierarchies called for laws that would allow them to legal private access to state enterprises by participating in the cooperatives and enterprises. They are, in turn, began to cooperate with the informal hierarchies and organized crime groups who had the necessary capital necessary to transfer of private property.

Typically, in the West organized crime groups operate in the area of controlling markets for illegal goods and services such as prostitution, gambling, and drugs and the extortion of legitimate businesses. However, today, in Russia today starting from the late Soviet times, the organized crime groups controlled not only the export natural resources, the smuggling of nuclear and non-nuclear weapons but also controlled and managed the privatisation process, banking sector and another related economic spheres.

As Marshal Goldman pointed out "as Gorbachev began to permit cooperatives and other private activity in 1986 and 1987 in order to protect the state sector from total collapse, he limited who was permitted to participate. Others, those who became the mafia exploited these limitations for their own benefit and succeeded in gaining control of an estimated 70 to 80 percent of the private sector."[41] The entire reform process since 1986 has in many ways succeeded in legitimizing the 'shadow economy.' Those who were previously black marketers became legitimate businesspersons and earned huge profits especially by exporting

[40] Cameron Half, "The Russian Mafia: The Challenge of Reform", **Harvard International Review**, Summer

goods that are so cheap when compared to international prices. The 1987 Law on Enterprises gave independence to state enterprises and allowed joint ventures. This in turn led to an immense increase in connections between the formal hierarchies and organized crime groups. Soon after, the 1988 Law of Cooperatives lifted restrictions on types of activities of companies, profit, size and pricing. This allowed cooperatives to establish joint ventures with foreign firms, which in turn opened legal passages to Western banks, through which laundered money could find its way back to the economy.[42] The combination of new laws, access to foreign capital and infiltration of organized crime groups into the economy gave rise to a formation of elite entrepreneurs. These elite groups operated the major enterprises and together with the organized crime groups prepared for the struggle to gain ownership of the enterprises in the post-Soviet era especially through the privatisation of enterprises.

As we shall see, on the basis of the lack of legal reforms, these groups would face immense opportunities to gain the control over the economy. In post-Soviet Russia, the lack of legal reform such as on the property rights would make it impossible the business life to operate in a legal context. Business would operate in between legality and illegality and in many cases the existing laws would contradict each other. As a result, for example, as we will see criminal groups would take the advantage of the situation in many occasions. Without a clear legal framework, the concept of free enterprise would serve as an incentive for the development of criminal activity.

The existence and the growth of organized crime groups would put a constraint on economic growth since the money that they extracted from the irregularities of the existing order would not find its way back to the economy, rather flows abroad. Since enterprises would pay up to 30 percent of their profits to the criminal groups as protection money, they

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1997, Vol.19, pp.52-57
[41] ibid.,p.56
[42] Mark, **op.cit.**, p.4

would show their economic far below the true levels to the officials. This situation, in turn, would mean declining tax revenues of the state, contributing to the budget deficit.

By the end of 1991, after the attempted coup and the break up of the Soviet Union, the government of Russia and other republics had to struggle with severe repressed inflation, a breakdown in the economic coordinating mechanism, a disruption of interrepublic trade, weaker central political control and widespread corruption and theft of the state property.

CHAPTER II-THE DEBATE IN THE WESTERN WORLD ON THE RUSSIAN ECONOMIC TRANSFORMATION

2.1. Contending Reform Ideas on the Russian Economy

The economists and other intellectuals produced enormous literature on how to convert centrally planned socialist economies into capitalist market economies in 1990s. As to the necessary economic reform policies to replace the commanded economic structure with a market economy, a broad consensus prevailed among Western, East European and Soviet economists. First, transition must be achieved rapidly if it is to stand a chance of success. Second, the transition must imply a comprehensive switch to a fully-fledged market economy with a strict macroeconomic stabilization policy, together with a comprehensive domestic and external liberalization. The domestic liberalization should compromise the freedom of entrepreneurship, production, sales purchases and pricing. Foreign trade needs to be liberalized which requires a unified exchange rate. Differences remain on whether the exchange rate should remain floating or be fixed in order to serve as an anchor for the stabilization. [1] Some other issues such as privatization were also subjected to extensive dispute.

There was a little disagreement among writers on transition policy about the need to move quickly to a market economy. The critical question was the sequencing and the speed of the transition. Socialist economies had so many problems, and they were so interconnected, that reformers were unsure where to begin. Should they start with the budget, with privatization, with property reforms, with capital markets, with reducing subsidies, with freeing the ruble, or what? Should reform begin with budget reform so as to prevent a price-wage-price spiral when prices are decontrolled? Or should price inflation and wage controls be used to reduce real aggregate demand? Should there be a first step to get prices close to the

[1] Anders Aslund, **The Past Soviet Economy: Soviet and Western Perspectives**, (London: Punters Publisher, 1992), p.168

market before letting prices go? Or is it hopeless to try to guess the "right" market price? Should prices be decontrolled now, so that incentives to production are enhanced? Or should the monopolies be broken up first to prevent the exercise of monopoly power? Should governments avoid political peril by postponing an increase in the prices of necessities (housing, food, and energy)? If so, will the resulting queues and inefficiencies restrict labor mobility, impede adjustments, and reduce incentives to work and bear risk? This list could be multiplied indefinitely.

In western world, two opposing approaches to economic reform in socialist economies have developed in the 1990s. These were shock therapy (big bang), and an evolutionary approach. Shock therapy as a standard approach to economic reform in socialist economies developed in 1990s, on the basis of both experience, especially in Poland, and analysis.[2]

2.1.1. The Case for Gradual Transition

Evolutionists such as Peter Murrel (1993) were skeptical of top-down reforms and emphasized the limited ability of economists or government officials to know the final shape of institutions that would be appropriate for any economy or the policies to get there. Policy and institutions should evolve as the economy transforms.[3]

Supporters of gradual transition were more sympathetic to an extended period of state intervention. This could take the form of price and wage controls, fixed exchange rates, delayed privatization, or state-sponsored construction and nurturing of market institutions. Gradualists, who on the whole tended to focus more on institutional context as opposed to analysis based purely on a historical, orthodox economic theory, contended that the post-World War II recovery of Europe and the early development of capitalism in the West were

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[2] David Lipton, and Jeffrey D.Sachs, " Creating a Market Economy in Eastern Europe: The Case of Poland," in **Brooking Papers on Economic Activity**, 1990, (1), 75-13. See also, Alan Gelb, "The Process of Socialist Economic Transformation," **Journal of Economic Perspectives**, Fall 1991,5, 91-106

[3] Peter Murrel,.1993. "What is Shock Therapy" What did it Do in Poland and Russia? **Post Soviet Affairs** 9 No: 2, 1993, pp.111-40

the result of gradual processes, and that inertia would mitigate against the effectiveness of any too-rapid transformation process.[4]

For some in the gradualist school, rapid reform would be impractical to implement. Simple economics dictates the ineffectiveness of shock therapy. Liberalization of exchange rates will lead to price increases for imports, which is a problem due to the lack of potential exports for transitional economies. Freed interest rates will lead to decreased investment at a time when human and physical capital improvements are necessary. And if wages are allowed to climb, unionized labor will be too expensive for international competitiveness; non-unionized wages will be too low to provide adequate levels of aggregate demand. [5]

Gradualists argued that a dismantling of the old system before enough of a new one is in place would lead to chaos and uncontrollable disruptions. Gradualist argued that popular support of social groups is the only way to ensure the long-term success of transformation. "It is a genuine task of a post-communist State to organize social consensus which aims at broad social cooperation in the process of socio-economic reconstruction."[6] Gradualists argue that the big bang's enactment in both Poland and Russia "was a radical departure from a natural progression."[7]

2.1.2. The Case for Shock Therapy

The shock therapy strategy of economic transformation, which Poland and independent Russia adopted, is often identified with a trilogy of specific economic policies: liberalization (that is, freeing) of prices, stabilization of the economy through monetary and fiscal policies, and privatization of state enterprises. Shock therapy 's name derives partly

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[4] Thomas W. Hall, and John E. Elliot, "Poland and Russia one Decade After Shock Therapy," **Journal of Economic Issues**, June 99, Vol.33 Issue2, p.305

[5] ibid, p.306, See also, Islam Shafigul, "Russia's Rough Road to Capitalism: Metamorphis of an Old Debate," **Foreign Affairs**, Spring 1993, Vol.72, Issue 2, pp.57-63

[6] ibid, p.307

from one of its most important features: the call for a rapid transformation of the economy. The huge job of transforming the state socialist system into a capitalist market system was to be carried out as rapidly as possible-within few years.[8]

Shock therapy advocates differ in several major ways from gradualists: intellectual genealogy, policy recommendations, views regarding the role of politics, and assumptions about the nature of the state.[9]

The intellectual antecedents of shock therapy include neo-liberal thinkers such as James Buchanan, Milton Friedman, and Friedrich Hayek. This perspective is based on an uncompromising defense of market economy and private property relations combined with a "repudiation of the liberal-democratic welfare, regulatory, and interventionist state."[10] For the shock therapists, state activity is generally considered to be predatory-government interference in markets and is often associated with rent-seeking and other economically deleterious acts.

The shock therapy approach is based upon the premise that spontaneous generation of markets and market institutions will occur (and will do so rapidly), given the absence of state interference. The state, which was much too large (and too interventionist) during the era of state socialism, should essentially exit the economic arena. The government's basic contribution was to abolish the old central planning system, privatize its assets, and draft a new legal framework appropriate to markets and private property. It was left to private initiative to create the new market relations and restructure existing businesses, with little government guidance or regulation of the process. This feature of shock therapy was based on the belief that a market economy will spring up more or less automatically if the state simply

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[7] Murrel, **op.cit.**, p.130
[8] David M. Kotz and Fred Weir,(1997), **Revolution From Above: The Demise of the Soviet System**, (London: Routledge, 1997), p.161
[9] Hall and Elliot, **op.cit.**, p.305

goes away. Liberalization will lead to the development of market allocation of resources-capitalism-and thereafter to rapid economic growth. "Economic problems solve themselves: markets spring up as soon as central planning bureaucrats vacate the field."[11]

Among shock therapists there was a surprising amount of agreement as to what should be done. The standard reform prescription can be summarized in five basis recommendations:

1. Price liberalization
2. Corporatization or Privatization of State enterprises
3. Macroeconomic Stabilization
   - Reduction of government spending to achieve balanced budget
   - Strict limits on the growth of money and credit

4-Removal of barriers to free international trade and investment

5-Moderating social cost of unemployment

These measures were presented as a comprehensive program. As Merton J.Peck emphasized “we consider these five steps the minimal conditions necessary for creating an effective market economy. The success of each depends on the others. If adopted singly or over time, they are likely to fail; if adopted promptly and introduced simultaneously on what we call D-day (D for deregulation), they promise a resolution of the present crisis.”[13]

The main differences of opinion within this camp concern timing. Should these reforms be implemented simultaneously in the form of a big bang[14] or in some more gradual

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[10] ibid
[11] Jeffrey D.Sachs, **Poland's Jump to the Market Economy**. (Cambridge, Mass.: MIT Press.1993), p.13
[13]Merton J.Peck and Thomas J.Richardson, **What is To Be Done? Proposals for the Soviet Transition to the Market**, (Yale University Press, New Haven and London, 1992), p.9
[14] Sachs, **op.cit.**, See also Oliver Blanchard, **Reform in Eastern Europe**, (Cambridge: MIT Press, 1991)

sequence?[15] The major disagreements are whether governments should reduce budget deficits and stabilize the economy before decontrolling prices and liberalizing the economy, and issues of privatizating the larger state-owned enterprises. There was little disagreement that small-scale firms, especially retail and service firms, should be privatized quickly. As to privatization, there came out two basic issues here: First, should state-owned enterprises be sold to private investors or distributed to the population at a nominal, if any, price? Second, should privatization of the large state owned enterprises occur early in the reform plan or should firms be restructured before disposal? Gradualists emphasized the revenue aspects of privatization and favoured the restructuring of firms before they are privatized.[16]

2.2. Individual Components of Shock Therapy

2.2.1. Price Liberalization

The Soviet governments had tried to increase both wholesale and retail the prices through administrative means. According to shock therapists, administrative reform attempts were a complete failure on the grounds that: first, administrative reforms typically failed to raise prices to market clearing levels. As a result, consumers were not compensated for increased prices by goods becoming plentiful on the shelves. Second, it was simply impossible to calculate the correct set of relative prices for several thousand commodities; economic conditions simply changed too often, and in unpredictable ways, for a correct administrative reform to be possible. Third, administrative reform resulted in a succession of price jumps; before each jump, which would be much discussed in the parliament and media, consumers would anticipate the price increases by hoarding. The result would be periodic shortages that would further strain the public's patience. In contrast, freeing market prices

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[15] Ronald McKinnon, " Financial Control in the Transition from Classical Socialism to a Market Economy." **Journal of Economic Perspectives** 5: 1991, pp.107-22. See also Janos Kornai, " Transformation Recession: The Main Causes." **Journal of Comparative Economics** 19: 1994, pp.39-63, and William Nordhaus, " Soviet Economic Reform." **Brooking Papers on Economic Activity** 1: 1990, pp.287-318

would result in thousands of frequent and small price adjustments that consumer and producers would not anticipate with extensive hoarding.[17]

2.2.1.1. Recommendations

The first item on the list, price liberalization meant the freeing of both wholesale and retail prices from state control, leaving their determination to the interaction of supply and demand in markets. Thus freeing prices means goods in the shops, albeit at higher prices. It also means sellers will set prices that will cover their costs, so that they will no longer require state subsidies to operate.[18]

As Alfred E. Kahn and Merton J. Peck pointed out the intention behind price deregulation was that "sellers throughout the economy, with the limited number of exceptions, be allowed to set their prices wherever they choose –or wherever the market will permit –free of direct state control. Along with our corporatization proposal –that is, simultaneously converting the present state enterprises into financially and managerially independent organizations – we would expect the liberated enterprises to be guided, in setting prices, by the profits they would be expected to produce: ideally, their goal should be to maximize profits."[19]

2.2.1.2.The Benefits of Deregulation

According to Shock therapists, comprehensive price liberalization was very important on many grounds. First and foremost, by freeing prices to equate the supply and demand, liberalization would mean that people's rubles would be able to buy things. Free prices would make the ruble once again convertible into domestic goods.

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[16] Peter Mieszkowski and Ronald Soligo, "Economic Change in Russia: 1985-95", **Problems of Post-Communism**, May/Jun 96, Vol. 43 Issue 3, p.26
[17] Peck and Richardson, **op.cit.**, p.22
[18] ibid., p.21
[19] ibid.,p.38

Second, liberalization would make an important contribution to stabilization. Stabilization required reducing the growth of money incomes. That required first reducing the government deficit that is financed by printing more rubles. On this ground, price liberalization would eliminate or reduce the need for subsidies for enterprises, which made up a large part of government expenditures. Finally, price liberalization would set the stage for greater economic efficiency, by giving enterprises the incentive to serve the consumers, on whom they will be totally dependent. They would no longer need to obey the Ministries who provided their subsidies and who paid for whatever they produced. Competition among enterprises would begin top develop, leading to improved productivity.

According to shock therapists, price deregulation was very important and necessary condition to pursue all the other reforms, which in turn were necessary to make the price deregulation effective.

2.3. Corporatization and Privatization of State Enterprises

Item 2, the privatization blank, called for immediately turning enterprises into private businesses. The privatization reform was subjected to great debate among Western intellectuals and institutions, such as IMF and World Bank experts. In 1990 the IMF experts had proposed 'commercialization" that is, "the establishment of the enterprise without necessarily implying private ownership.[20]

As mentioned above, there was a little disagreement that small-scale firms, especially retail and service firms, should be privatized quickly. The experience of Eastern Europe had showed that small firms, especially in retailing and services, could be privatized very rapidly. There were two basic issues: First, should the larger state-owned enterprises be sold to private investors or distributed to the population at a nominal price? Second, should privatization of the large state-owned enterprises occur early in the reform plan or should these firms be restructured before disposal? As to the second aspect of the issue, for example, Alice Amsden and Joseph S. Berliner argued that restructuring Russia's enterprises, rather than quickly privatizing them, would be a wiser policy.[22]

Privatization was seen as an essential policy that would be very crucial to the development of capitalism in Russia.Throughout Gorbachev period, many control rights over the assets of state enterprises have been transferred to their managers. In many cases, these managers enjoyed their new power and independence, and were in no rush to privatize. When they considered privatization, they favored spontaneous privatization, since it would provide them with more power than before. In addition, political pressures led to a transfer control over privatization of many enterprises to the local governments. Many of the local administrators view this control as the right to manage the state enterprises rather than privatize them. Russia was in grave danger that firms would move toward local administrative control rather private ownership. The first essential step to prevent this development was mandatory commercialization (or corporatization) of all the enterprises.[23]

It was a necessary condition for liberalization of prices that requires enterprises be converted into independent, self-financing and profit-maximizing organizations. Once state enterprises are corporatized, they would no longer be under the direction of the Ministries or dependent on the government budget for subsidies and investment funds.[24]

In short, the aim was to make enterprise to stand on their own feet, financially making profit or failing to do so on the basis of their own success in satisfying market demand. While a tax on corporate profits would be a uniform rate across enterprises, non-negotiable with tax authorities and would be set at levels that would leave a significant reward for success. In

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[20] ibid.,p.59

[22] Alice Amsden, Jacek Kochanowicz, and Lance Taylor, (1989) **The Market Meets Its Match: Restructuring the Economies of Eastern Europe**, (Cambridge, Mass.: Harvard University Press, 1989). p.5

[23] Oliver Blanchard,; Maxim Boycko,; Marek Dabrowski,; Dornbusch,; Layard Richard; Shleifer, Andrei.1993, **Post-Communist Reform: Pain and Progress**, Cambridge: MIT Press, p.53

[24] ibid

policy prescriptions shock therapists also assumed that the managers would know that unprofitability would result in bankruptcy for their enterprises and economic ruin for themselves. On this ground, they believed that the possibility of bankruptcy would make enterprises efficient. That's why; they firmly insisted that bankruptcy laws must be enacted in the transitional period in Russia.

To sum up, corporatization would require the elimination of both government subsidies and differential taxes. The former was an extremely important component of any program of overall economic stabilization

2.3.1. Preconditions for Corporatization

Several additional measures would be required if the newly created joint-stock companies were to play their proper role in a market economy. As to this important fact, shock therapists proposed a list of recommendations. These were:

1- Government must enact and enforce laws of property and must respect property rights in their own actions. The legitimizations of private ownership and rules providing for its transfer are necessary if capital markets are to develop; legal methods must be provided for the enforcement of contracts, including obligations of debtors to creditors, voluntarily entered upon.[25]
2- Rule must be promulgated for the treatment of enterprises that go bankrupt – for the orderly settling of creditors' claims, either by restructuring those obligations to permit the firm to continue to operate, if there is reasonable prospect of its being able to do so successfully, or for the distribution of its assets, if there is no such reasonable prospect.[26]
3- Banks must be available to provide credit, but only on commercial grounds: specifically, they must refuse to issue credit to enterprises that are not financially viable, in their strict commercial judgment, unlikely to be able to repay.[27]
4- Governments -at the union, republic, and local levels –must cease to subsidize the enterprises, whether with direct subsidies or soft credits, except as part of limited and targeted programs, such as we have already described, to protect low-income families and ease the transition to a market economy.[28]
5- 30 to 40 percent of total industrial output in the USSR was accounted by products for which there were a single manufacturer.[29] This fact put an undeniable dilemma for market economy advocates in their advocacy of comprehensive and immediate decontrol of most prices, because it meant that such a policy would open the door to a considerable amount of monopoly exploitation. The IIASA economists had proposed that "demonopolazation should precede privatization, since otherwise shareholders in firms

[25] Peck and Richardson, **op.cit.,** p.26
[26] ibid.
[27] ibid.
[28] ibid., p.59-60
[29] ibid.,p.65

with undue market power will attempt to block procompetitive policies. Moreover, the privatization process itself will be hampered by uncertainty over an anticipated antimonopoly program.[30]

6- A bankruptcy law must accompany the privatization process. With the establishment of the principle that the enterprises must cover their costs by the revenue from their operations, there is no reason to allow enterprises that are losing money to survive. Provisions for enforcing contracts and providing damages in the event of nonperformance must also accompany privatization.[31]

The purpose of all these measures was to place the enterprises under stringent budget constraints.

2.3.2. The methods of Privatization

There was an extensive debate on the methods of privatization. During that time, Poland, the Czech and Slovak Federal republic, and Bulgaria were moving towards free distribution of shares to the general public, whereas Hungary and the former German Democratic Republic favored selling shares.

In selling the stock, the primary device would be the public auction. Stock would go to the highest bidder. Anyone could buy- individuals, foreign investors, other Soviet enterprises, managers and workers in the enterprise, and banks and financial institutions. Auctions must be widely publicized in advance, and the publicity must provide the necessary financial information to stop doubt on the fairness of the process. [32]

Another method is to issue public vouchers representing potential claims on the shares of enterprises to be privatized. Foreign bankers or mutual fund managers would be invited to bid for the public vouchers. The public would then trade their vouchers in return for shares in the mutual funds that appealed to them. [33]

As a second alternative to auctions, the IIASA economists proposed worker and management ownership. They argued that partial ownership of enterprises by either group could be valuable in promoting identification with the long-run success of the firm. They proposed that workers could be given 10 percent of the shares. Regarding managers they

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[30] ibid., p.152
[31] ibid
[32] Blanchard, Boycko, Dabrowski, Dornbusch, Layard, and Shleifer, <u>op.cit.</u>, p.63
[33] Charles Wolf, Jr, Getting to Market, **The National Interest**, Spring 1991, p.45

proposed that management could be given even more priority in distributing shares in order to give them some of the incentives of owners. [34]

This might be done by making shares available to managers only after the enterprise proved successful, after three years, as an addition to their salaries. The knowledge that these shares will be available could strongly encourage managers to make the economically profitable decisions that shareholders would have made; in other words, the interest of managers and shareholders would be somewhat the same."[35]

Although they said much for the partial ownership by workers and managers, they stressed the strong case that either of them could pursue their own self-interests.

> "Workers have their greater interest in wages, and thus prefer immediate wage increases over the long-term commitment of funds to capital formation and research and development. Thus worker control has proved largely failure as the dominant form of ownership in such countries as Yugoslavia. Management likewise has a greater interest in their immediate salaries and bonuses than in the long-term success of the firm."[36]

The IIASA economists argued against management and workers becoming the dominant power.

> "To assign property rights over all such past investment to those who happen to be the present managers or workers ignores the Soviet citizen as a whole have made in their industry. It would particularly favour those who happened to be employed in the profitable sectors at the time of privatization. A related problem has arisen in Poland and Hungary, where the manager of state firms have contrived to sell their enterprises either to foreigners or to themselves as private owners. This spontaneous privatization has proven to be extremely unpopular and has been referred to as *nomenkaltura* capitalism, reflecting the relatively privileged political status of these managers under the old socialist system. To permit this sort of asset transfer would mean effectively assigning initial ownership rights to the old management, and for reasons of equity and efficiency we strongly oppose it."[37]

2.3.3. The Monopoly Problem

Many of the Russian state enterprises were monopolies. Freeing them from government restraint, the combination of corporatization and price decontrol would create the possibility of monopolistic behavior and monopoly prices. The western analysers produced

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[34] Peck and Richardson, **op.cit.**, p.160
[35] ibid, p-159
[36] ibid.
[37] ibid.

set of policies to prevent such outcomes in the economic sphere. One remedy was encouragement of competition itself. The most crucial element of such policy was to ensure legally free entry of enterprises into whatever markets they wish to enter. It was argued that introduction of foreign competition will be the most effective and immediately available method of restraining the exercise of monopoly power for tradable goods. One another policy recommendation was the introduction of laws like American antitrust laws, prohibiting enterprises from combining or agreeing among themselves to limit competition.[38] Anti-monopoly enforcement agencies were assumed to be established to foster competition as well.

2.4. Stabilize Government Spending and Restrict Credit

2.4.1. The problem

In addition to the microeconomic issues of pricing, Russia faced a huge and growing budget deficit, the acceleration in the growth of incomes, a continued deterioration in the growth of output, and, a flight from ruble. Since most retail prices were fixed in the Soviet Union, the increased demand had manifested itself in barer and barer shelves in state stores and lines that got longer and longer. Under these circumstances, black market prices had risen so sharply and second economy operators became very influential in Russian economic life. The Communist regime left behind an enormous financial chaos when the Soviet Union disintegrated at the end of 1991. The Russian government inherited a disastrous legacy.

2.4.2. General Policy Considerations

Shock therapists, in designing their recommendations for economic stabilization, they acknowledged the fact that the major threat to economic stability would be the threat of a severe inflation when prices were liberalized. In addition, they talked about a period in which there would be irreducible frictional unemployment would take place as people were deployed from their jobs.

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[38] ibid., p.27

The program that they designed aimed at ameliorating the chances of hyperinflation. Item 3 in the list, macroeconomic stabilization, was aimed at curtailing inflation. It had two main parts, one involving the government budget and the second the money and credit policy of the central bank. Large reductions were called for in virtually every category of public spending, including military spending, subsidies to state enterprises, social programs, education, and public investment. The second part of the stabilization policy called for the central bank to sharply reduce the growth of money and credit, so the central bank was in a position to directly restrict credit availability to enterprises simply by curtailing its loans to the banks.[38]

2.4.3. Fiscal Policies

Regarding fiscal policies that the first priority was to reduce the budget deficit. A balanced budget would effectively control the growth of incomes. If the budget was not controlled, incomes would continue to rise, and price-wage spiral might begin. The most important action in the short-run would be to liberalize prices and remove subsidies.[39]

More generally, shock therapy advocates focused on spending reductions and tax increases. As Anders Aslund pointed out: "in more general terms, public expenditures (around 50 percent of GDP in the USSR) could be substantially reduced, because the state functioned poorly and used funds inefficiently. Furthermore, public expenditures were quite high given the actual level of Russian economic development. On the revenue side, substantial changes were required. First, the individualized turnover tax would have to be either evened out or replaced by a value-added tax (VAT). Foreign trade taxes would then need to be changed to ordinary, limited fixed tariffs."[40] This step would prevent the erosion of real taxes as price rise.

[38] Anders Aslund, **How Russia Became a Market economy**, (The Brooking Institution Press, Washington, D.C, 1995), pp.180-81
[39] ibid.
[40] ibid, p.182

2.4.4. Monetary Policies

Reform advocates believed that a substantial tightening of credit was essential to subject enterprises to hard budget constraints. In their view, it was neither possible nor necessary in the short-run to privatize the banking system in order to have credit policies. In the long run, however, creating a banking system was presumed. In the near term, they assumed Gosbank to make enterprises financially independent by extending credit only to firms that could repay; this implied curbing credits to unprofitable enterprises. In addition, the banking system must place overall credit limits on the enterprise sector. They envisioned that banks would charge high interest rates to enterprises under a regime tight credit. In the period surrounding liberalization, real interest rates (equal to money interest rates less the rate of inflation) must be positive.

International financing was also necessary for the implementation of macroeconomic policies. As Anders Aslund pointed out, "first, Russia had run out of international reserves; international credits could replenish them, giving Russia an opportunity to build reserves in an orderly fashion. Foreign credits were also needed to finance any possible budget deficit, to stabilize the domestic price level. Russia also craved balance of payments support to rise its collapsed imports to a reasonable level once again, thus salvaging falling production and reducing the social cost of the collapse of communism. Furthermore, the conditional nature of an international agreement on stabilization would be an important lever for the Russian reform government to use in defending its reform domestically."[41] The International Monetary Fund and the World Bank were seen as principal actors to provide Russia with stabilization funds, which would be necessary to stabilize the Russian economy in the transition period.

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[41] ibid.

2.4.5. Creating a Banking System For a Market Economy

In a market economy, the banking system is the key institution for providing credit to enterprises and achieving macroeconomic equilibrium. These two roles are assigned to different entities in market economies, creating what is termed a two-tier banking system. The central bank would set monetary policy through its controls over the commercial banks; the commercial banks would collect deposits from individuals and enterprises and would make loans, primarily to enterprises.

The Soviet system had consisted of Gosbank, the major institution, and set of specialized banks serving with loans and deposits to the specific sectors indicated by their titles. These specialized banks were: the Industrial Construction Bank (Promstroibank), the Social Housing Bank(Zhilsotsbank), the Agricultural Bank(Agrobank), the Bank for Foreign Economic Relations(Vneshekonombank), and the Saving Bank (Sberbank).

Gosbank, the existing State Bank, was proposed as the most obvious candidate for the role of central bank. The specialized banks were assumed to be the best candidate to become commercial banks.

One recurring issue in the Soviet Union was whether each of the fifteen republics should have its own central bank. Regarding this aspect of the issue, the IIASA had put forward the following statements.

> "The Federal Reserve System, the central bank for the United States, has twelve separate banks. Monetary policy, however, is set largely by what is called the Open Market Committee whose members are seven Federal Reserve governors in Washington and five members chosen from the heads of the twelve separate banks. The system operates as a single central bank. There can be only one monetary policy with a single currency. Monetary policy can be set centrally or with the participation of the central banks in the republics, but there must be a single currency. To maintain a single currency the Soviet Union must have a single monetary policy and hence a single, coordinated central banking system."[42]

Reform advocates, especially shock therapists strongly opposed to any idea that would support each republics to have its own central bank. When the Common Wealth of

[42] Peck and Richardson, **op.cit.**, p.166

Independent States formally succeeded the USSR, there had arisen much confusion over the economic implications of the collapse of the Soviet Union. One important confusion point was over the issue of currency area and monetary authority within the Common Wealth of Independent States.

As Anders Aslund pointed out: "the heart of the problem in trying to form a new relationship between the former Soviet Republics was an inconsistency between currency area and monetary authority. The only remaining Soviet institution was the Soviet ruble, which was used in fifteen different republics. However, the State Bank of the USSR was dissolved at the end of 1991 and divided into fifteen new central banks. Each central bank could expand the money supply by issuing ruble credits. But only the Central Bank of Russia could issue cash all of the printing press for Soviet rubles was in the Russian Federation. Nevertheless, credits were also money. This lack of unified responsibility over monetary policy made Russian Federation to impossible to begin with monetary stabilization. Either the ruble zone had to be broken up, with one monetary authority in each currency area, or the central banks would have to merge into a single monetary authority."[43]

The IMF advocated the maintenance of the ruble zone and threatened that countries that launched their own currencies would not receive any IMF support. IMF experts believed that this was the necessary condition to implement a single monetary policy and to sustain trade among former Soviet republics.[44]

One another important issue was independence of the Russian Central Bank. The Central Bank of Russia was under the control of the Russian parliament. The chairman of the CBR was appointed by the parliament and CBR policies were subject to approval by the parliament. History shows clearly that the legal arrangements surrounding a central bank play a critical role in determining central bank policies. The independence of the German,

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[43] Aslund op.cit., p.110
[44] ibid., pp.110-111

Bundesbank from direct political interference, for example, has been a central reason why the deutsche mark has consistently been a stable currency. That is why, it was proposed that Russian Central Bank should be independent.

2.5. OPENING THE ECONOMY INTERNATIONALLY

Foreign trade was also formidable area of discussion. The IIASA economists had assumed that the Soviet Union would continue as a free-trade area and as a currency area within roughly its present boundaries. From an economic point of view, maintaining free trade among the different regions would contribute to an efficient division of labor and use of resources. As an example, the existence of the USA as a continental free trade zone and the EU attempts at a free-trade region were put forward. They had not addressed the pressing political question of the sovereignty of the republics within the Soviet Union, some of which raised the possibility of instituting separate currencies and establishing restrictions on intraunion trade.[45]

By the opening of the economy, it was meant allowing the sale of foreign goods and services within the Soviet Union, later in Russia promoting exports to the rest of world, and encouraging foreign firms and individuals to invest in Russia Federation. The lack of currency convertibility was a major factor contributing to the failure of Gorbachev's attempts to open economy to foreign investment and to decentralize foreign trade rights to enterprises and cooperatives. The absence of external convertibility meant that the ruble outside the Soviet Union and foreign trade activities had to be conducted either in convertible currencies or on the basis of bilateral agreements. Foreign investors had no incentive to produce for the Soviet market, as ruble earnings could not be converted into hard currency to pay for imported capital and inputs, or for the repatriation of profits. Domestic producers could not exercise their legal rights to import equipment and materials because of their lack of access to hard currency to pay for them.

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[45] Peck and Richardson, op.cit., p.168

The Russian government inherited a complicated mixture of multiple exchange rates, imports and exports licenses and quotas, differentiated retention quotas, and limited foreign currency reserves to defend a convertible currency. Since major exports items, such as oil, cost less than 1 percent of the world market price, the state tried to control exports through licensing. First the Ministry of Foreign economic Relations would issue quotas for the export of particular goods. Then exporter would conclude a contract with a foreign partner and the Ministry of Foreign Economic Relations would issue an export license, essentially to check that price was correct. The state tried to control exports through licensing, but export licenses were easily acquired through bribery.[46]

Retention quotas, which required exporting enterprises to surrender a proportion of their hard currency earning (normally 40 percent) to the central authorities at the official exchange rate, contributed to capital flight by giving exporters an incentive (illegally) keep hard currency earnings overseas or to fail to declare hard currency earnings. Similarly, ban was imposed on barter trade, which was used by enterprises to avoid retention quotas, or to avoid restrictions on exports of subsidized or underpriced scarce goods.[47]

Imports were controlled through the centralized allocation of hard currency at an unrealistic exchange rate of rate of 1,6 rubles per dollar, or 1 percent of the market price. Essentially, the government bought goods on the world market and sold them to a Russian enterprise at a small fraction of world market price. The Russian, in turn, sold the merchandise at domestic price, pocketing most of the subsidy and using the rest for bribes. In 1992, 45 percent of Russian imports were centralized and thus subsidized. According to IMF figures, total imports subsidies correspond to a 17 percent of Russia's GDP in1992.[48]

The USSR had no unified exchange rate but hundreds of currency coefficients. When the USSR disintegrated, Russia inherited a disastrous legacy. The recommendation was,

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[46] Aslund, **op.cit.**, p.146
[47] ibid.
[48] ibid.

moving to a convertible currency, removing import and export restrictions, and introducing convertibility. Opening the economy would provide consumer goods, would speed the introduction of foreign technology, would ensure that prices reflect competitive market prices and would restrain monopolistic forces inside the country.

2.5.1. Concrete Steps

The commentators on the Russian economy economists proposed that the ruble should become freely convertible into other currencies for all transactions. By convertibility they meant that all Soviet enterprises and households would have access to foreign exchange for the purchase of foreign goods or services, but not for the purpose of buying assets abroad or holding foreign currency. One interesting approach was that they talked about a system of monitoring, which would be required to assure that foreign currency was used for permitted purposes. As Richard N. Copper pointed out:

> "In practice, this is likely to require a limit on the amount of foreign exchange that Soviet citizens can require for foreign travel. It also implies a need for Soviet residents to be authorized to open limited foreign currency deposits. It will be necessary, however, to have some procedure for Soviet enterprises to invest abroad in distribution and servicing channels for the sake of promoting exports."[49]

As to fixed versus flexible exchange rates, the commentators pointed out:

> "In the long run, it would be desirable to have fixed exchange rate for Western currencies. In the near term, this will not be feasible, because of the prospect of severe inflation. It is therefore recommended the ruble be allowed to float, although the government will want to intervene to prevent excessive short-term exchange-rate fluctuations. A freely floating ruble will initially move to a level between the official rate and the black-market rate. Thus depreciation upon floating is both inevitable and desirable. A lower exchange rate will balance supply and demand for foreign exchange; will ensure that enterprises can buy foreign goods and services to consumers."[50]

They warned against an overvalued exchange rate.

> "It would be better to have the ruble priced too low than too high. An undervalued ruble ensures that doing business in Russia would become a bargain, and foreign firms and technology would be attracted to set up production there."[51]

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[49] Peck and Richardson, **op.cit.**, p.118

[50] ibid., pp.35-36

[51] ibid

2.5.2. Commercial Policy

As to the formulation of commercial policy, the proposition was a trade policy, which would involve a uniform tariff duty covering all imports. They recommended replacing all quantitative restrictions on imports with a uniform tariff .[52] They emphasized that tariffs were more evenhanded than quotas as a way of protecting domestic industry. In addition, tariffs could provide a source of valuable government revenue.

They envisaged the possibility that a few items might bear higher tariffs for the sake of additional revenue, or to discourage consumption. In particular, when the aim was to discourage the consumption of luxury goods, excise taxes that would apply to all luxury items, whether imported or domestically produced, should be applied rather than tariffs. The excise taxes would penalize both domestic production and importation of the goods whose consumption was to be discouraged and single out goods whose consumption can be taxed to raise substantial revenue.

They also emphasized the importance of transitional tariffs for those products, which would live a sudden shock of competition:

> "We can envision transitional tariffs higher than the uniform rate to avoid a sudden shock of competition to enterprises that are not initially competitive at the chosen exchange rate but have a prospect of becoming competitive in the long run. These transitional tariffs on products should be fixed at 20, 40, and 60 percent, depending on the calculation of initial competitiveness of enterprises by product and should decline over a period of five to seven years to the long-run uniform tariff."[53]

Since most international trade takes place in intermediate products, raising the price of imports through tariffs also raises costs to domestic enterprises that purchase them. To avoid blunting the incentive to export at the new exchange, the formulated proposition was a system of import drawbacks should be introduced, whereby the tariff was rebated when a product containing an imported input was exported.

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[52] ibid., p.123
[53] ibid.,p.124

There were two other areas, however, where special attention should be paid to the impact of the currency devaluation on domestic prices. The first concerned oil and gas, the second grain and vegetable oils. The Soviet Union, later Russian Federation was a large exporter of the former and large importer of the latter. Regarding this aspect of the issue, the suggestion was:

> "It may be desirable to subsidize importation as well as domestic production of some of food products, such as bread and vegetable oils, which are exceptionally important to households. Energy exports, particularly oil and gas, may need to have a temporary export tax to cushion domestic consumers from large price increases, although permitting domestic energy prices eventually to increase to world levels- which we strongly recommended- will free up resources for exports and generate an important source of export earnings."[54]

It was estimated that when markets linked through trade to foreign markets and domestic prices determined by supply and demand, the domestic price of energy would rise to the world price. The magnitude of the increase implied in their proposal, however would be a major shock to energy-consuming enterprises. In order to spread this shock over time, they proposed the introduction of a duty on export of crude oil, gas, and petroleum products. The export duty would raise revenue for the government, again facilitating stabilization.[55]

2.6. The Role of the West

The Western commentators highly believed that Western financial assistance can probably play an important role in raising the chances for successful transformation. The G-7 countries put the IMF in the lead in coordinating the Western assistance. The IMF was given to main tasks in Russia: to provide technical assistance; and to help mobilize international financial assistance, conditional on the implementation of reform measures. Unfortunately, it has done poorly on each task, and thereby contributed to the current Russian economic failure.

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[54] ibid,p.127
[55] ibid.,p.36

The World Bank was proposed that it should help to mobilize funds for significant restructuring of the key sectors of the economy, including military conversion, financial services, and communications and transport.

At the same time, the EBRD was given the task to support the rapid development of the private sector. As Jeffrey Sachs pointed out:

> "One promising model is the US enterprise funds that have been established for Czechoslovakia, Hungary, and Poland. These funds capitalized by a budgetary appropriation and managed by private US firms, spur private-sector activity in the three Central European countries by making large numbers of small-scale loans and taking direct equity positions in local, private start-up firms. In addition, the enterprise funds work with relevant governmental structures to help an adequate level environment for the growth of the private sector. The EBRD could establish similar operations in Russia and other states of the former Soviet Union."[57]

2.7. Moderate the Social Cost of Unemployment

The common expectation about the most adverse consequence of the essential reforms among Western advisers on Russian economic transformation would be a sharp increase in open unemployment. As a solution to this problem, they proposed unemployment compensation system. Such a system would provide workers who are laid off with temporary support. However, that support must be substantially below the wages of those who continue to work and should decrease with the length of unemployment, in order to preserve incentives for workers to relocate, retrain, and accept alternative employment.[58]

2.8. How Russia Came to Adopt Shock Therapy

The pro-capitalist coalition, which developed in the Soviet Union during 1989-1991, was determined to bring capitalism to the country. But the problem was no one was sure exactly how to do it. Should it be done gradually, or would a rapid transformation be better? Advocates of the rapid transformation had been frustrated by the Gorbachev attempts at a gradual transformation.

[57] Lipton and Sachs, **op.cit.**, p.213
[58] ibid, p.5

By 1991 the Soviet economy was rapidly contracting, under the impact of the dismantling of central planning and the weakening of interrepublican economic ties. The idea that some drastic action had to be taken quickly acquired great influence. At this point Western economic thought began to play an important role. Harvard professor Jeffrey Sachs had begun advising the new post-communist government of Poland in 1989.A few years earlier Sachs had developed a set of policies to resolve Bolivia's inflation and foreign debt-repayment crisis, and he adapted those same policies for Poland. Thus shock therapy was born. In 1990 shock therapy was applied in Poland and widely publicized as the best way to make the transition from state socialism to capitalism. The IMF began to promote shock therapy as the right solution for the problems of Eastern Europe. It was the Polish experiment that had a significant impact on the economists close to Yeltsin.

After the failed coup of August 1991, Yeltsin faced a great opportunity to implement his own ideas for Russia. During that time Yeltsin was looking for a new government and encouraged the competition over the reform programs.

In the fall of 1991, Yeltsin aide Gennady Burbulis introduced Yegor Gaidar to Yeltsin. While other leading liberal economists in the Soviet Union, such as Grigory Yavlinsky, were hoping to preserve Soviet Union in some form, Gaidar favored a strategy of Russia going it alone. This appealed to Yeltsin and his aide Gennady Burbulis.[59] Gaidar had studied reforms in Eastern Europe in detail and had concluded that the best economic medicine for Russia was shock therapy of Polish type.[60] The liberal team of Yegor Gaidar's was the victorious one among other competing groups..

Anders Aslund, Jeffrey Sachs, and David Lipton, moved to Moscow in the fall of 1991. Later on, they became leading advisers to the Russian government on the

[59] Kotz and Weir, op.cit., p.166
[60] Aslund, op.cit., p.72

implementation of shock therapy. Other Western economists, who were in an advisory capacity, were Marek Dabrowski, Jacek Rostowski, Andrei Shleifer and Richard Layard. As soon as the government was appointed, the IMF started to hold meetings with Gaidar and other Russian government leaders. The IMF officials put emphasize on drastic actions such as rapid full liberalization, stabilization, and privatization. They suggested that Russia should follow Polish type of shock therapy in order to solve the ongoing economic problems.[61]

[61] Kotz and Weir, **op.cit**, p.168

CHAPTER III-THE IMPLEMENTATION OF SHOCK THERAPY

3.1. Price Liberalization

At the beginning of 1992, comprehensive price liberalization took place in Russia. 90 per cent of retail prices and 80 per cent of wholesale prices were freed from state controls. To ease the cost of the transition, few commodities were excluded from price liberalization. These exclusions ranged from producer goods such as energy and transportation prices to consumer goods such as bread, milk, sugar, oil, vodka, medicine and energy, collective transportation, rent, and public utilities. [1]

Price liberalization aimed at rehabilitating ruble by eliminating the huge monetary overhang. Gaidar decided to attack problem through liberalization of prices and economic activity, combined with restrictive monetary and fiscal policy. Russian economics minister Andrei Nechaev warned the IMF visiting team of specialist that the prices might double in the first month or go up more. Thomas Wolf, member of the IMF ream, in turn assuring him that prices would rise by 70 per cent in January.[2]The price jump exceeded not only the IMF's predictions but also the government's predictions. Prices rose by about 250 percent immediately.[3]

When prices were freed from the state controls, shortages started to diminish and many commodities appeared in the shops. Meat, sausages, bananas, fruits, and color televisions appeared. The arrivals of new commodities, however, were slow, since domestic trade remained regulated.

On January 29, 1992, freedom of trade was announced through a presidential decree. According to this decree, enterprises regardless of their ownership, and citizens were allowed

[1] Anders Aslund, (1995), **How Russia Became a Market Economy**, (Washington, D.C.:Brooking Institution, 1995), p.150
[2] David M. Kotz, and Fred Weir,(1997), **Revolution From Above: The Demise of the Soviet System**, (London: Routlage, 1997), p.168
[3] ibid.

to engage in trade. The purpose of the presidential decree was to encourage the trade to overcome the monopolism in the retail trade. Now, anyone could engage in street trade and anything could be bought and sold in the street.

The public reaction to this decree was overwhelming. The central streets and squares in big Russian cities became crowded with street traders. This was the one aspect of the story. Street prices were higher than those of state shops. The street traders were primarily reselling commodities bought in the stale shops. As mentioned above, according to the original December decree, regional authorities and shopkeepers were ordered to impose maximum 25 percent mark-ups for consumer goods. The method was to buy from state shops and resell them at the market at higher prices. Organized crime was very active and acquired complete control in this trade as well. For instance, they were very active in subway stations. They were not only selling the items that they took from state shops but also high value added items, such as alcohol and foreign cigarettes.

According to the December 1991 decree, the government ordered the shopkeepers, who have no experience of market, to take a fixed mark-up of 25 percent of wholesale prices.[4] This decree also granted regional authorities the right to regulate the prices primarily of food in their region. These regulations became a source of corruption and led to the strengthening of local mafia. Here, the trick was to gain access to these commodities and selling them at high prices in the market.

> "Even in Moscow, gasoline prices remained under local control, prompting hour-long queues outside gas stations, even in 1994. This led to a highly criminalized black market for gasoline."[5]

At this stage of the reform, and during the meetings between IMF officials and Russian reformers, some differences revealed out on the implementation of price liberalization. For example, Gaidar refused the IMF objections to include the oil in the price liberalization of January 1992. Gaidar reportedly agreed that freeing all prices reasonable but

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[4] **Economist**, 8 January 1992

warned that if oil prices were freed from immediately, political pressures force the government to provide enormous subsidies for agriculture and urban households to cover the greatly increased cost of tractor fuel and home heating oil, which would break the stabilization objectives of the shock therapy program.[6]

3.1.1. Energy Prices

From the beginning of reform, liberalization of the energy prices was a formidable area of discussion. The problem was that Russian energy prices were enormously low –less than 1 percent of the world market prices. Energy was perceived as a price standard. State industry leaders as well as the general public believed that energy prices determined the rate of inflation. The government also feared that if energy prices were liberalized this would further disrupt production. Therefore, they advocated regulated prices. One another reason why energy prices were not liberalized fully was the facts that the energy industry was a strong lobby within the state.

On February 27, 1992, the Russian government and central bank, working with IMF specialists, issued a policy statement called the Memorandum of Economic Policies, which embodied the entire shock therapy program. It envisioned freeing nearly all remaining controlled prices, achieving a zero-budget deficit by the end of year, a sharp reduction of subsidies to enterprise, tight credit, commercialization followed by privatization of state enterprises, elimination of state orders, and commitment to a convertible ruble.[7] However, this program was far from being followed. Soon after this Memorandum was on the agenda, they started to criticize the government extensively. Extensive criticism from state managers convinced the President Yeltsin not to allow any liberalization of prices. Although the

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[5] Aslund, **op.cit.**, p.150
[6] Kotz and Weir, **op.cit.**, p.168
[7] **New York Times**, 3 April 1992

Russian government committed itself to liberalizing domestic prices of fuel and energy before 20 April, the government because of President Yeltsin's opposition took no action.[8]

The energy lobby only wanted cheap credits and tax exemptions. It was conservative and rent-seeking. Low domestic prices required strong export controls. However, such controls were far from being implemented. This situation not only led to enormous fortunes for corrupt officials but also torpedoed the government's efforts on a balanced budget.

Their extensive criticism gave its fruit in April 1992. Boris Yeltsin sacked Gaidar's reformist minister of fuel and energy, Vladamir Lopukhin, because he advocated free energy prices. Instead, the former Soviet minister of gas industry, Viktor Chernomyrdin, joined the government as deputy prime minister of energy.[9]

When Chernomyrdin was appointed as deputy prime minister for energy, his first task was to create a huge gas monopoly. All enterprises dealing with natural gas were incorporated into one big concern, called Russian joint stock company Gazprom. Because gas production remained high, Gazprom kept gas prices so low in order to sell its all output. Even Gasprom kept up its deliveries to customers in Russia and CIS although they failed to pay back. As Anders Aslund pointed out: " Presumably, the management of Gazprom was convinced that Chernomyrdin would guarantee them state subsidies for their deliveries."[10]

The Russian gas industry, Gazprom received not only subsidies but also exempted from many taxes. Gazprom enjoyed production, gas pipeline, and export monopolies. Its exports were subject to licenses, quotas, but Gasprom itself was exempt from export tax, some import tariffs, and VAT. Investment in the gas industry was financed through tax exemption of gas exports, which worth $4 billion in 1993.[11]As a result, Gazprom became one of the most influential rent-seeker in Russia. As Anders Aslund pointed out:

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[8] **Financial Times**, 26 March 1992
[9] Aslund, **op.cit.**, p158
[10] ibid., p.159
[11] ibid.

> "Conversely, the thoroughly monopolized gas industry has insisted on keeping the lowest prices. It might appear strange that the energy industry was not in the least enthusiastic about price hikes. However, because it was rent seeking and not profit-seeking, it focused on exacting rents from the state, not on making profits. Moreover, the managers were in charge of the enterprises and were probably able to channel more rents profits into their own pockets, considering that rent-seeking minimized transparency."[12]

When Boris Federov took charge of the energy prices in 1993, Russian energy policy changed considerably. Through the excise taxes on energy, he tried to increase state revenues. He threatened the CIS countries that if they do not pay for deliveries in time, the deliveries would be cut off. After the winter in 1993, Boris Federov tried to raise energy prices. The price of gasoline was liberalized on May 25, 1993, but local prices regulations remained common. In the summer of 1993, the price of natural gas was raised by 123 percent.[13]

The liberalization of coal industry was another problematic area. The major customer of the coal industry was metallurgy industry. The coal industry feared that if the prices were to be liberalized, the demand for their product would fall. The result would be increasing arrears between enterprises. Both industries threatened the government that if the prices were liberalized, they would call for strikes. The government gave in to these demands and continued to subsidize them. In 1993, however, the government implemented price liberalization on coal industry. This deregulation led to great differention in coal prices between different coalfields and breaking up the alliance of the entire industry. The coal monopoly was crushed and the prices of coal started to rise.

Although the Russian government tried to liberalize energy prices, their efforts doomed to failure. The government was only able to increase energy prices through administrative methods. The prices, however, were far below world market prices. Failure to liberalize the energy prices at the beginning of the reform process was an important failure. Politically it costed the reformers a great deal. Anti-reformists used the energy price policies to consolidate their political power to shaken the government's efforts on liberalization.

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[12] ibid., p.161
[13] ibid., p.160

3.1.2. Monopoly Problem

As mentioned before, the Western observers perceived that antimonopoly monopoly policy was very crucial for the sake of economic transformation in Russia. In October 1991, this Antimonopoly Committee was ordered to establish a register on monopolistic enterprises and then regulate them. Antimonopoly Committee set up many sub branches in each region and localities. Antimonopoly Committee and its sub branches have not worked as it was presumed. They did not only break the up the enterprises but also play a regulatory role.

Concerning the monopolies, the Presidential decree on price liberalization in December 1991 included also regulatory provisions, which were reflecting ex-Soviet type of administrative measures.

> "The presidential decree on price liberalization in December instructed the Russian government to regulate the prices of product from monopoly enterprises. Subsequently, sets of legal guidelines were issued on the regulation on monopolies, focusing on old administrative measures such as compulsory deliveries. However, the essence of antimonopoly regulation became price control, including fixed prices, maximum prices, maximum rates of profits, and notification of free prices. In practice, indirect price deregulation came the fore. The markup allowed suspected monopolists were restricted, usually to 25 percent. Regional and Local Antimonopoly Committees could rule arbitrarily. They tended to control prices with food industry for the dubious benefit of the Russian people. In many regions, price regulations (enforced primarily at the regional level) harmed the development of a national market, reinforced regional market segmentation, and incited officials to extortion. The "antimonopoly" policy was in fact an antimarket policy, and its price deregulation was used by conservatives to impede reform."[14]

Although the old Gossnap structures were split up, several wholesale organizations started and continued to fight to maintain their monopolies. Their managers insisted on price deregulations, which was very important to exact subsidies from the state and for the enrichment of themselves.[15]

As to the natural monopolies, although their price remained regulated officially, there were also some monopolistic prices. For example, a ride on metro, Moscow's subway system, which cost 5 kopeks (0.005 roubles) in 1991 had risen to 400 rubles by June 1995.[16]

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[14] ibid.
[15] ibid., pp.153-161
[16] Kotz and Weir, op.cit., p.177

In Russia, the elements of continuity from the old system were carried out through price liberalization efforts. The above-mentioned regulations constituted one undeniable such continuity in the old Soviet-style. Another institutional example was the old State Price Committee. Although it was scaled down, it was not abolished. In the pursuance of the price liberalization, this committee created many troubles.[17]

Freedom of enterprise was also one another problematic area. The local authorities interfered improperly with the emerging new private enterprises. The local authorities officially demanded licensing in order to impose order. In reality, this demand was for the sake of exacting more bribes. On May 27, 1993, the government issued a decree, which provided the local authorities with the right to license all kinds of activity. This decree not only violated the freedom of enterprise but also provided the local authorities with immense opportunities to exact more bribes from the newly emerging private enterprises.

3.1.3. Liberalization of Foreign Trade

In 1992, the foreign trade crisis constituted a major place in the Russian economic crisis. Foreign trade liberalization was a formidable area of discussion when the reform government came to power in 1992. Variety of groups played immense role in the making of foreign trade policies. Domestically, there were few main producers of main of vital export items, such as oil, natural gas, and metals. That is why; they possessed a strong bargaining power.

The Russian export policy was far-complicated story. In the sphere of foreign trade, the problem lied in the fact that the prices of many Russian export product, such as oil, natural gas, coals, metals, fertilizers, certain other chemical products and timber was very low when compared to the world prices of such products. This difference between domestic price and the world price was the area of contention. When the government tried to introduce taxes on

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[17] Aslund, **op.cit.**, p.144

the export of such products, the government met with vehement criticism. As Anders Aslund pointed out:

> "A novelty for 1992, however, was that exporters of regulated items had to pay export tariffs, which were set in the European Currency Units (ECU). The export tariffs were supposed to tax most of the difference between the domestic price and the world price, but these tariffs met with vehement opposition. Exporters were so powerful that they could blackmail the government into exempting them from export taxes by threatening to stop exporting. The government tried to improve its monitoring by introducing a category of "special exporters" restricting the right to export strategic goods to a limited group, but this device did not work either. The MVES was bogged down because of pressure from enterprises demanding to become special exporters, and their numbers multiplied quickly. Leading special exporters also exploited their clout by lobbying members of government for tax exemption."[18]

The only solution to these entire problems was to liberalize the domestic prices of export goods. However, such policy was far from being implemented, since government lacked the necessary credibility and power to implement such policies. As a result, tariff policies adjusted five times in 1992. Export quotas were only in the interest of small group who were granted them, because resistance from the corrupt beneficiaries of the old nontransparent system has hindered them from being effective. Since 1994, export quotas have been limited to oil and oil products, natural gas, coal electricity, nonferrous metals, cellulose, wheat, liquor, fish, and timber. However these products accounted for 70 percent of Russia's exports.[19]

In the sphere of foreign trade, tax evasion also became a problem. The numbers of controllers were small and thus easily bribed. To sum up, the preconditions for bribery in the sphere of foreign trade were excellent and the opportunities utilized very well.

In January 1992, substantial liberalization took place in the foreign trade arena. Although, all enterprises were given the right to engage in foreign trade, the government did not move to the currency convertibility until July 1992. The reason behind this inaction was the fear that hard currency earning of the Russian exporters would be kept abroad. It was a serious problem, since Russia's reserves of foreign currency were depleted.

[18] ibid.
[19] ibid.

During the first half of 1992, Russia had no import quotas or tariffs. This situation led to awakening of protectionist pressures from some domestic producers. Especially, IMF forced the Russian government to implement tariff policies for the sake of fiscal policies. In July 1992, Russia introduced a low unified import tariff, which rose to 15 percent in September. When Sergei Glaz'ev succeeded Petr Aven, as minister of foreign economic relations from December 1992 to September 1993, he attempted to implement more protectionist policies, under the influence of various lobbies.

The subsidized centralized imports were the major problem. In 1992, 45 percent of Russian imports were centralized and thus subsidized. According to IMF figures, total import subsidies corresponded to an extraordinary 17.5 percent of Russia's GDP in 1992. Most of this was not budgeted but financed (and in fact caused) by 12.5 billion in commodity credits and exports extended by Western countries to benefit their own farm lobbies.[20] These credits and import subsidies only helped enrichment of a group of people, who in turn justified these subsidies as an important component to reduce the social cost of deregulation.

In the spring of 1993, Boris Fyodorov and IMF joined forces to reduce both the volume and the degree of subsidization of centralized imports to a few percent of GDP in 1993, and to abolish subsidization of such imports in 1994.[21]

3.2. Macroeconomic Stabilization

The Russian reformers regarded the huge inherited budget deficit and its monetary financing as the chief causes of the extreme suppressed inflation and rapid open inflation that they had inherited. They therefore devoted much effort to trying to draw up a balanced budget.[22]Yegor Gaidar focused on two major measures: far reaching liberalization of prices and balancing of the consolidated budget.

[20] ibid., pp.149-152
[21] ibid.
[22] **RFE/RL, Research Report**, Vol.1, No.34, 28 August 1992

The major reductions were in budget expenditures concerned defense, investment, and subsidies of all kinds. Arms procurement was initially cut by 85 percent, while military salaries were kept high. Many subsidies were kept and state investments minimized, but social expenditures were maintained.[23]

On the revenue side, the chief components of the new tax system were introduced. These were, a value-added tax (VAT) at a rate of 28%, excise taxes on a wide range of price inelastic or luxury consumer goods (alcoholic drinks, tobacco, cars, furs, chocolate, and so forth), a progressive personal income tax with a top rate of 60%, a corporation tax with a standard rate of 32%, export tariffs, and a variety of other taxes. In addition, all import taxes were eliminated.[24]

In the first half of 1992, government spending was decreased by some 40 percent, realizing a budget surplus of 0.9 percent of gross domestic product.[25]For the year as whole, government spending fell to 38.7 percent of GDP in 1992, from its estimated rate of 47.9 percent of GDP. The initial price increase was 245 percent. Although it was a highly high rate, the monthly inflation rate started to fall.* The ruble appreciated significantly in real terms, and the exchange rate was relative stable, notwithstanding the high inflation. That is why, the average monthly wage, measured in US dollars, rose from $7 in January to $40 in 1992. However, real wages fell steeply in statistical terms to about two-thirds of their pre-crisis level in the mid-1980s.[26]All bank savings eaten was by inflation, which turned many people, especially those who were elderly against the reform government.

Then Russian central bank's monetary policy was extremely strict at first. While consumer prices jumped highly, the real money supply fell from 77 percent to 25 percent of

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[23] Aslund, op.cit., p.187
[24] ibid.
[25] International Monetary Fund (1993), **Economic Reviews 1993: Russian Federation**, (Washington DC: The International Monetary Fund, 1993), p.93
* 38 percent in February, 30 percent in March, 22 percent in April, 12 percent in May, and finally 9 percent in August, (see Aslund, op.cit. p188)

GDP between December 1991 and January 1992.[27] Economic consequences of this strict monetary policy generated huge discontent among the Russian state enterprise managers. One another source of discontent originated from Supreme Soviet. They, together with the state enterprise managers, increased their criticisms and turned against the reform government. The complaints resulted in a political storm at the sixth Congress of People's Deputies in April 1992. Finally as a concession to the Congress and the industrial lobby, three state enterprise managers were appointed as deputy prime ministers in May and June 1992. These were: Viktor Chernomyrdin – as the minister of energy, Vasily Barschuk –as the minister of finance, Viktor Gerashchenko – as the chairman of the central bank. Thus, the reform government turned into a coalition between economic reformers and state enterprise managers. When subsidies were issued in early April 1992, the government's effort at macroeconomic stabilization began to loose its strength. The government was forced to make compromises with the barons of the agriculture and industry, offering massive subsidized credits.

One another result of the strict monetary policy was increasing arrears among the state enterprises. As Richard Sakwa explained:

> "The major problem, however, was the arrears accumulated by firms that were unable to sell their goods; by June 1992 huge debts had been run up between companies huge debts had been run up between companies, primarily between the old state industries and the military-industrial complex, amounting to the staggering total of more than a trillion rubles (5.5 billion pound). Debt arose because they could not sell goods to consumers, who had no spare cash, and because they had been unwilling to sack workers or to cut down on overheads, but they above all because they in effect gained credit by not paying for goods received."[28]

The state enterprises stopped paying each other, and arrears mounted up. The Russian Union of Industrialists and Entrepreneurs (RUIE)* and parliament insisted that the Central Bank should provide them with credit. The state enterprise managers vehemently started to

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[26] Aslund, **op.cit.**, p.188
[27] ibid.
[28] Richard Sakwa, **Russian politics and Society**, (London: Routledge Press, 1996), p.159
* The RUIE was largely made up of the directors of the large state enterprises who favored a slower pace of reform and more government subsidies. Arkadi Volski headed it. Many of them were monopolies and they took

demand additional credits. Their job was easy to accomplish their goals, since there was no effective threat –neither job loss nor bankruptcy- to use in disciplining managers. As a result, during the second half 1992 money supply started to increase. By May 1992, enterprises started demanding prepayment from each other. Since the legal system was so weak, the only effective collection mechanism was to demand payment before delivery.[29]

The beginning of the stabilization policy was not accompanied by a fixed exchange rate. The reason for this lied in the fact that there was no international financing by the Western countries and institutions. The exchange rate floated but was not subject to any particular policy.[30]

There was also no income policy as well. Shock therapists had argued that an integral part of the macroeconomic stabilization plan was a system of control on wage increases in the state sector. The intention behind such consideration was the fact that wages rose less than prices; hence prevent a wage price spiral. Yegor Gaidar had predicted that it was impossible to control incomes without a fixed exchange rate.[31]In the end, together with the profound economic crisis, the Russian stabilization policy was on a difficult road.

One another problem was interest rates. One of the most important feature of the Polish 1990 stabilization plan was an interest rate policy that was intended to ensure positive real interest rates, thereby preventing from financing cost push inflation and hoarding stocks by cheap banks loan and forcing them to control costs and raise revenues by sales of their in the market to eager customers. Such a policy was not introduced in the first half of 1992, despite the fact that the government recognized the importance of raising real interest rates to a nonnegative level. The reason lied in the fact that the Central Bank of Russia was

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advantage of the liberalization to raise prices and cut production, the opposite of the reform policies were meant to achieve. Some of them also opposed to privatization, since this would deprive them of their power.

[29] Aslund, **op.cit**., p.189

[30] Michael Elman, "Shock Therapy in Russia: Failure or Partial Success?" **RFE/RL Research Report**, Vol.1, No. 34, 28 August 1992, p.50

[31] Aslund, **op.cit**., p.188

responsible to the Supreme Soviet. The central bank had its own policy, which aimed at the stability and survival of both banks and the real economic systems well. Under the conditions prevailing in the first few months of 1992, positive real interest rates (that's interest rates exceeding the rate of inflation) would have generated the viability of a large part of economic activity. Given that the country was already in a deep depression, the central bank considered that a depression accelerating policy would have been completely absurd. [32]

As a result of insufficiently credible stabilization policy in the first half 1992, a number of problems came out. Interenterprise arrears mounted up, and Russia suffered from an acute cash shortage.* Credits to CIS countries and the government's failure to liberalize energy prices undermined the macroeconomic stabilization efforts. As mentioned before, import subsidies was also another concern to be considered as a devastating factor in the macroeconomic stabilization efforts. According to IMF figures, total import subsidies corresponded to an extraordinary 17.5 percent of Russia's GDP in 1992. Most of this was not budgeted but financed (and in fact caused) by 12.5 billion in commodity credits* and exports extended by Western countries to benefit their own farm lobbies.[33] Anders Aslund criticizes these commodity credits as such: "Ironically, the foreign credits designated as humanitarian aid disqualified Russia from IMF support for macroeconomic stabilization.[34] All these

[32] **RFE/RL Research Report**, Vol.1, No. 34, 28 August 1992, p.50

* "Although rapid inflation has reduced the demand for money (that is, increased the velocity of circulation), the growing demand in nominal terms for money resulting from the rapid increase in prices has greatly exceeded the quantities printed. As a result, wages and pensions have often been paid out only many weeks after they were due, which has generated widespread popular discontent and a large number of strikes or threats of strikes. The government has explained that the limited capacity of the printing presses and the delay in introducing new, larger coupon notes are responsible for shortage. Some observers explain the shortage as the result of using a large part of the money-printing capacity to build up stocks of a new currency to be used after a monetary reform." (See, **RFE/RL, Research Report**, Vol.1, No.34, 28 August 1992, p.51)

* These credits were primarily for food imports. These centralized import of grain were subsidized 99 percent; the exchange rate used was just 1 per cent of the market exchange rate, but it was financed by commodity credits. As a consequence, the IMF assessed Russia's "enlarged fiscal deficit" on a cash basis at 25 per cent of GDP during the first quarter of 1992, although the domestic budget showed a surplus. (See Aslund, **op.cit**., p.150)

[33] Aslund, **op.cit**., p.190

[34] ibid.

devastating developments torpedoed the government's effort at macroeconomic stabilization effort in the first half of the 1992.

3.2.1. The Second Half: June-December 1992

In June 1992, the reform government's effort at macroeconomic stabilization came to an end with the flowing of credits to agriculture, industry, and to the former Soviet republics. The domestic budget deficit reached during the third quarter of 1992 at 14.6 percent of GDP on a cash basis. The most important development of this period was the appointment of Viktor Gerashchenko* as the chairman of the Central Bank of Russia by the Supreme Soviet. He insisted on letting the monetary supply explode to revive production. Money supply increased about by 28 percent during the five months from June to October 1992. Thus in 1992, in order to maintain production, state enterprises could regularly borrow at a 20-80 percent annual rate, while inflation was running over 20-25 percent per month. The Russian Central Bank, with the support of a majority in the parliament, maintained this policy to support production and employment.[35]

The loose monetary policies faced with happiness by the industrialists and the other segment of the old elite –nomenklatura. As Anders Aslund pointed out, however, it did not stop the ongoing decline in industrial production. In the third quarter of 1992, the economy was flooded with credits, but industrial production fell by 24.2 percent compared with the already low level in the third quarter of 1991-that is twice as much as in the first half of the 1992.The argument that the economy needed monetary stimulation had been tested, and it did not hold water."[36]

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* Viktor Geraschenko had been the head of the state bank in the Soviet days. His father had been a central banker under Stalin. Gerashchenko was popular among the old elite because he gave everyone the cheap credits they asked for and kept the refinance rate very low. V. Geraschenko saw inflation as the result of price liberalization, not of financial imbalances. That is why; he blamed planned liberalization of energy prices for causing inflation by arousing inflationary expectations. He focused on declining production and neglected finances. He sought to cure the problem through additional credits.

[35] ibid.

[36] Aslund op.cit., p.192

In this period, capital flight gained momentum, because there were few investment opportunities in Russia. A standard estimate is that capital flight amounted to $1 billion a month in 1992. The exchange rate fell from 135 rubles to the dollar on June 30 to 309 rubles to the dollar on October 1,1992. Dollarization gained momentum, as dollar deposits in Russian banks grew from 34 percent of money supply at the end of April to 119 percent of money supply at the end of November 1992. The average wage in US dollars fell from $40 in June to $25 in November 1992.[37]

As a result of the credit expansion from June to October, monthly inflation reached 25 percent during the last quarter of 1992. On October 7, 1992, the president issued a decree on the formation of a Government Commission on Credit Policy. The commission was made up of reformers and aimed at coordinating and control the credits. It was the only positive development that took place in the second half of 1992.

To sum up, in the first half of 1992 the strict monetary policy alienated the powerful sectors of the economy, and it quickly became apparent that the political base to support Gaidar's effort was very weak. Conservative critics of these policies --lobbies representing the military--industrial complex, agriculture, and other industries –quickly organized and were successful in getting Yeltsin to dismiss several reformers from the cabinet as early as May 92 and to appoint new deputy prime ministers. These included Viktor Chernomyrdin, who was head of Gazprom, the huge state gas company, and a strong supporter of the industrialists. In July, Viktor Gerashchenko, was appointed as the head of the Central bank of Russia and reversed the policy of denying easy credits to state enterprises. This policy accelerated the inflation in Russia in the second half of 1992. By October, Yeltsin was forced to fire Gaidar and to replace him with Chernomyrdin, who soon was openly encouraging a policy of easy

[37] ibid.

credits for industry and agriculture. Thus, the monthly inflation rate, which steadily declined about 10 percent by August 1992, began to accelerate once again.

The Central problem confronted the Russian reformers was that they were trying to bring democracy and capitalism to a country with an outdated constitution, governed by an enduring cast of autocrats and communists. In Poland, Hungary and Czechoslovakia, popular movements led by former dissidents overthrew the communist from the center of power. But no such revolution took place in Russia, where the Supreme Soviet (the standing parliament), and the Congress of People's Deputies were still infested with old communist party bosses who continue to fight to preserve their vested interests in the old order.[38]

3.2.2. 1993-95

The situation deteriorated in the first quarter of 1993 as subsidies to incomes and agriculture rose. The deficit of the consolidated budget deficit was about more than 9 percent. At the beginning of the 1993, Russia faced with a risk of hyperinflation.* The reform group regained influence in January 1993 when the leading economic reformers in the government, Anatoly Chubais and Alexander Shokhin managed to convince the president and the prime minister that Boris Federov should be appointed as the minister of finance. In the early 1993, the prime macroeconomic task was to control credits. Firstly, Boris Federov activated and reinforced activated and reinforced the Commission on Credit Policy. According to new measures, the commission had to approve the credit allocation. Federov pushed the Central Bank of Russia to raise its interest rate. Second major concern was extensive cheap to the other CIS countries, which had been distributed by the CBR. Federov succeded in regulating financial relations with other CIS states, and after August 1993, only limited and properly regulated state credits were issued. Thirdly, Federov focused on huge import subsidies.

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[38] Islam Shafigul, "Russia's Rough Road to Capitalism: Metamorphis of an Old Debate," **Foreign Affairs**, Spring 1993, Vol.72, Issue 2, pp.57-63

Federov managed to reduce these subsidies by about half of their volume between 1992 and 1993, and they were to be abolished in 1994. Another important group of macroeconomic measures undertaken by Federov centered on raising energy prices. Petroleum and coal prices were liberalized. The prices of natural gas and electricity were raised in the summer of 1993, and energy taxation through VAT and excise taxes rose.[39]

One another important development in 1993 was the fall in tax revenues. The reason behind such fall was that the VAT had been reduced from 28 percent in 1992 to 20 percent in 1993. Another reason behind such a fall was the tax exemptions that had been awarded to strong industries such as Gasprom. The expansion of private sector also created problems for tax collections.[40]

One important positive development in this period was increase in the both nominal and real exchange rate. The rising interest rate was the main cause of the steadier exchange rate. Real wages averaged slightly.

These efforts, however, did not have the support of the Central Bank or Prime Minister Chernomyrdyn, and as a result, not much progress was made. The Central Bank of Russia under Viktor Geraschenko actively advocated policies leading to macroeconomic stabilization. Geraschenko continued to insist that the issue of large subsidized credits to old-state enterprises and agriculture and other CIS countries would stimulate production. Agriculture continued to resist at any attempt at deregulation or lowering its subsidization. Credit ceilings for the third quarter if 1993 were broken under pressure from the agricultural and other state enterprises. An explosion of interenterprise credits also accompanied this. The inetrenterprise arrears continued rising to over 7 trillion rubles at the end of April 1993, but then fell back to 1.8 trillion rubles due to the tightening of monetary policy, and a growing

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[•] During the week of New Year 1993, the weekly inflation rose to 10 percent since consumer demand for goods - increased. This weekly rate corresponded to a monthly rate of 50 percent. The rate of during January 1993, inflation increased 55 percent at a monthly rate. (See Aslund, **op.cit**., p.193)

[39] Aslund, op.cit., p.196

threat of bankruptcy* proceedings. As a result, in the second half 1993, interenetrprise debt rose again. This period revealed on fact that it was impossible to abolish or diminish subsidized credits.

In September 1993 Gaidar returned to the government as first deputy Prime Minister in charge of the economy, as Yeltsin's confrontation with the parliament was escalating. Gidar appointment was important in tipping the balance within the government in favor of reform. On September 21, 1993, President Yeltsin dissolved the Supreme Soviet and Congress of People's Deputies and called for new election and a referendum on a new constitution. Now, a new period of offensive reform started to take place for a short time.

On September 1993, Gaidar abolished all subsidized credits via government decree. Second, through number of decisions, he succeeded in deregulating agriculture, and the price of bread, grain and baby food was liberalized. The state stopped procuring food, leaving its trade to the market. Federov also reinforced the budgetary policy, keeping the planned budget deficit at a somewhat high 9.5 percent of GDP. He did this refusing to pay out the new expenditures.[41]

The reformers tried to sack the conservative head of the CBR, but Chernomyrdin saved him. Geraschenko, however, under the pressure from the reformists, gave in to the reformist policies. In October 1993, the monthly refinance rate was raised to 17.5 percent. As

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[40] ibid.

* Bankruptcy laws could not be realized effectively in Russia. The industrial lobby put the primary opposition to bankruptcy laws on the ground that they could lead to widespread closing of enterprises. On November 1992, the Supreme Soviet finally adopted the Law on Insolvency (Bankruptcy) of Enterprises. Until March 1994, only about 50 bankruptcy cases went to court and only ten cases were declared bankrupt. A new bankruptcy law went into effect in March 1993, and Ministry of Finance pressured the Russian Central Bank to enforce on those who do not pay their debts. In May and June 1994, the government undertook new efforts to speed bankruptcies. A State Bankruptcy Agency was established. However, the Bankruptcy Agency did not see its role as one promoting bankruptcies, but rather as instructing enterprises, and it became an additional hindrance. As a result, the number of bankruptcies remained small. (See Aslund, **op.cit.**, p.265)

[41] Aslund, **op.cit.**, p.199

a result, in November 1993, it rose above the interbank lending rate for the first time, and Russia experience a positive real interest rate for the first time.[42]

In the third quarter of 1993, significant changes took place in Russia. Aslund Anders evaluates this period as one in which Russia was on the right direction towards free market economy.

> "Monetary policy became major instrument of monetary stabilization. By the end of 1993, Russia was prepared to adopt to adopt a full-fledged stabilization policy. The necessary institutional changes had been undertaken. At long last, Russia's monetary policy had become a responsible one. Russia had positive interest rate and credit ceilings, and the ruble was the national currency. Fiscal controls were in place. For monetary stability, the main remaining task was to reduce budget deficit to 6 percent of GDP."[43]

Anders Aslund emphasized that reducing the budget deficit could be done through targeting three lobbies. One possibility was to abolish the tax exemption granted Gazprom. The second option was to abolish export restrictions for oil. This would lead to a doubling of the oil price, and much of the oil price could be taxed. A third possibility was to eliminate subsidies to agriculture. Anders Aslund estimated that any of these options could reduce the budget deficit by 3 to 4 percent of GDP.

In short the reformers were briefly strengthened in the last quarter of the year as a result of Yeltsin's Sep dismissal of parliament and his call for new elections. Their resurgence came to an end when the reform parties failed to do well in December elections.

In January 1994, following the opposition victory in the December 1993 parliamentary elections, Yeltsin shuffled the government in favor of former industrial managers. Yegor Gaidar again left the government, along with Finance Minister Boris Federov, who had been a leading proponent of strict adherence to the shock therapy guidelines. Former Soviet minister of Metallurgy Oleg Soskovets was named first deputy prime minister, and he took the military-industrial complex under his control. One another figure was Deputy Prime Minister Alexandr Zaveryuha, who had been elected a deputy in the Duma for the pro-communist

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[42] ibid.
[43] ibid.

Agrarian Party. Chernomyrdin, who had served as prime minister since December 1992, appeared to emerge with greatly enhanced power in January 1994. He himself represented the oil and gas lobbies, which were under favorable treatment. The new government looked like a government Russia's strong industrial lobbies.[44]

On January 20 Chernomyrdin gave a widely publicized speech that seemed to signal a sharp change in policy. He announced, " The period of market romantism is over." While staing that " Russia will not return to past " and is not "turning away from a market economy," he observed "the mechanical transfer of Western economic methods to Russian soil has done more harm than good."[45] He promised that an activist policy to combat the collapse in production and living standards.

He advocated nonmonetary measures for fighting inflation, by which he implied wage and price controls, as well as state support for investment. Chernomyrdin insisted on keeping Geraschenko, and appeared supportive of giving huge state subsidies to the agricultural sector.[46]

Although Viktor Chernomyrdyn was viewed as an enemy of the capitalist transformation[47], initially he perpetuated the Federov's policies considerably. He furthered the reduction in state expenditures. Consequently, the budget deficit stayed at 9.5 percent of GDP. In the first quarter of 1994, money supply was expanded by approximately 7 percent a month. The refinance rate remained high, and in March 1994 the real positive annualized interest rate peaked at an incredible 200 percent. The CBR began conducting monthly credit auctions on February 28, 1994.[48]

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[44] ibid., p201
[45] **New York Times**, 22 January 1994
[46] Aslund, **op.cit**., p.201
[47] Yury N. Afanasyev, "Russian Reform is Dead: Back to Central Planning," **Foreign Affairs**, May/Apr94, Vol.73, p21
[48] Aslund, **op.cit**., p.202

As a result, monthly inflation fell from 18 percent in January to a low level of 4.6 percent in August. During the first half of 1994, industrial production fell by 26 percent, twice as much as during the first half of 1992. In this period, as combined result of increased stabilization and successful voucher privatization, foreign portfolio investment began pouring into Russia, peaking in August at an estimated $500 million. These developments which took place in 1994, were seen as an evidence of successful Russian transformation to free market economy by some leading Western commentators in the West.[49]

Especially in the third quarter of 1994 there were, however, some negative developments due to diversion from strict monetary policy. For instance, the real exchange of the ruble did not appreciate, and nominal exchange rate continued to depreciate approximately at pace with inflation. In September 1994, the exchange rate started to fall considerably. Finally, on "black Tuesday", on October 11, the ruble lost over 20 percent its value in one day. It recovered at the following day. Although the CBR announced that the fall was due to insufficient international reserves to support the ruble, there were humors that it was due to the machination by bankers. There were also allegations that the CBR had sold rubles. This exchange rate crisis resulted in political crisis in Russia. In the aftermath of the currency crisis, the government survived a vote of no confidence with a slight margin. However this development was assessed as a positive development in Russia by outside observers. For instance, Anders Aslund pointed out:" That currency crisis could almost bring the government down shows that Russia had really become a market economy."[50]

Although monthly inflation fell 4.6 percent in August 1994, the government did not further squeeze it. As a whole, annual inflation was about 100 percent in Russia in 1994. Consumer prices rose 224 percent in 1994. At the CBR, Viktor Geraschenko continued advocating subsidized credits to industry to revive the production. In the third quarter, the

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[49] Anders Aslund, "Russian Success Story: Chernomyrdin Pull it Off," **Foreign Affairs**, Sep/Oct94, Vol.73, Issue 5, p.58-66

government issued large credits to the agriculture sector and the northern territories. The CBR gradually lowered the high interest rates in April, and by the end of September it approached to zero.[51] Meanwhile, monetary expansion continued to increase and real interest rate became negative in October. As a result of the currency crisis and monetary expansion, monthly inflation rose to 15 percent in October 1994. Foreign portfolio investment fell from $500 million to $100 million from August to November. The dollarization gained momentum.[52]

The subsidies to agriculture increased gradually over the year, and no attempts were made to tax the gas and oil industry effectively. During 1994, there was a huge debate over the liberalization of oil exports. In 1994, the domestic wholesale price of oil had fallen from 42 percent of the world level in the first quarter to 27 percent in the fourth quarter. The domestic market was flooded with oil, while export quotas blocked exports. This continued the immense opportunities for those who could buy oil at domestic prices and export it at world prices. The inability to liberalize the oil prices not only torpedoed the stabilization efforts but also accelerated the further development of criminality and corruption in Russian socioeconomic development. As Anders Aslund pointed out: " If oil export were liberalized, the domestic oil price would probably rise to 80 percent of the world price, because of the transportation costs should warrant a lower oil price in Russia. Much of this price increase could be taxed, and the additional tax revenues could amount to as much as 4 percent of GDP, which would be sufficient to achieve stabilization."[53]

Tax system was another problem. Basic tax rates for ordinary enterprises were quite high. Russian enterprises suffered from the high cost of corruption and extortion. Regional authorities created problems as well. As Anders Aslund pointed out: " For instance, one enterprise reported that it had to pay a basic profit tax of 38 percent. This was in addition to a

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[50] Aslund, **op.cit.1.**, p.205
[51] ibid.
[52] ibid., p206
[53] Aslund, **op.cit.1**., p.207

municipal tax of 1 percent of the profit, 3 percent for garbage collection, 2 percent in property tax, and 10 percent in ecological tax, amounting to a total tax of 54 percent of its profits. In other cases, the basic profit tax could much higher. The taxes were collected by tax inspectors as well as by independent tax police, both of whom worked on the commission. In practice, enterprises found it difficult to defend themselves legally against the tax authorities. As a defense, enterprises increasingly evaded taxes."[54]While state expenditures increasing, the revenues continued to decline. The Federal budget deficit rose from 9.4 percent to an estimated 10 percent of GDP in 1994.

One another important development throughout the early reform years was the situation of republics, and regions of the Russian Federation. Regionalism a political trend gained momentum throughout 1992 and 1993. They demanded local autonomy and certain privileges such as tax exemptions, from the center. For example, in June 1993, Kalingrad oblast suspended federation tax laws as violating the rights of locally declared free-trade zone.[55] The republics of Tatarstan and Sakha (Yakutia) challenged the tax laws and collection procedures as well. By the end of August 1993, thirty regions and republics were withholding taxes.[56]Barter trade among the regions and republics accelerated throughout 1992 and 1993.

Regarding the tax issue, a new kind of fiscal federalism was introduced at the beginning of 1994. Previously, the allocation of taxes revenues had been designed arbitrarily, because of the ongoing strife between the President Yeltsin and the parliament.* As a result of negotiations between the Ministry of Finance and the 88 regions, the new system was formed. As Anders Aslund pointed out:

> "Basically, the new system introduced clear rules. A certain share of taxes was to go to regional authorities and another share to the federal treasury. The responsibility for expenditures for expenditures

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[54] Aslund, **op.cit.1**., p.204
[55] **The Wall Street Journal**, June 25, 1993
[56] **RFE/RL, Daily Report**, 27 and 28 October 1993
* For example, Tatarstan gained more certain privileges from than other republics.

was correspondingly clarified. Transfers from the center to regions in need were supposed to amount to a couple of percentage points of GDP. However, complaints arose that transfers were based more on political considerations than actual needs, and strong regions demanded that taxes be redistributed to their advantage." [57]

3.3. Managing the Ruble Area

When the USSR fell apart, one of the immediate questions was how to find an optimal form to maintain economic relations between the former Soviet Republics. The State bank of the USSR was dissolved at the end of 1991 and divided into fifteen new republican banks. The problem was due to the fact that the only remaining Soviet institution was the Soviet ruble, which was used in fifteen republics. Each central bank could expand the money supply by issuing ruble credits. But only the Central Bank of Russia could issue cash, for the simple reason that all of the printing presses for Soviet rubles were in the Russian Federation.

This issue led to enormous discussions among leading Western economists and institutions. Leading figures of shock therapy, such as Jeffrey Sachs and David Libton emphasized:

"In our view, there is no realistic possibility of controlling credit in a system in which several independent banks each have the independent authority to issue credit. The reason is simple. Pressure is overwhelming in each of the states to "free ride" by issuing ruble credits at the expense of the rest of the system. It is a nearly self-evident proposition that single currency area should have a bank of issue. As Milton Friedman argues that the key feature of a unified currency area is that it has at most one central bank with the power to create money—"at most" because no central bank is needed with a pure commodity currency. The US Federal Reserve System has twelve regional banks, but there is only one central authority (The Open Market Investment Committee) that can create money."[58]

Anders Aslund assumed the credits, which were issued by the other former Soviet Republics, to be money and would destabilize the macroeconomic efforts for a balanced-budget in Russia. He mentioned about two options as a solution to the issue.

"Nonetheless, credits are also money. This lack of unified responsibility over monetary policy made it next to impossible to begin monetary stabilization. Either the ruble zone had to be broken up, with one monetary authority in each currency area, or the Central banks would have to merge into a single monetary authority."[59]

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[57] Aslund., **op.cit.1**., p.199
[58] David Lipton, and Jeffrey Sachs, Prospect For Russia's Economic Reforms, **Brooking Papers on Economic Activity**,1992, p.7
[59] Aslund, **op.cit.1**., p.106

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As mentioned above, the critical danger of a common ruble area was that attempts by the Russian government to implement a tight monetary policy could be nullified by excess credit emission by other republics over which the Russian government over the supply has no de facto or de jure control. Without strict control over the supply of money, a common currency area provides member governments with an incentive to run budget deficit in the expectation that other republics will finance them, which is inherently inflationary. That was the case that happened in the ruble zone throughout 1992.

As Juilet Johnson mentioned, the problem was the lack of coordinated credit creation among the new central bank of the Soviet successor states. Ruble credits issued by one central bank could be used as a means of payment throughout the ruble zone, and enterprises and governments in various republics could count on easy credit. The most troubling news was Ukraine's announcement in June 1992 of its intention to expand credit between R300 billion and R600 billion in order to settle interenterprise arrears. This massive amount of credit threatened to worsen the inflation in Russia. The only viable solution was quick separation of Russian and Ukrainian money.[60]

The principle of a single currency area, which would involve Republics that wanted to join the ruble zone maintaining accounts with the Central Bank of Russia and coordinating their monetary policy, was maintained in Russian Memorandum Economic Policy. As Anders Aslund rightly assessed that:

> "Its core supporters were the industrial lobbies both in Russia and the other former Soviet republics. The industrialists were against arduous restructuring to market conditions. The conservatives, on the contrary, wanted to minimize both systematic and structural changes in inter-FSU trade, in the hope that the fall in the production would be minimized. They also wanted subsidies from the Russian government, which the ruble zone facilitated. Conservative governments in other republics had a double incentive to preserve the ruble zone: Both their country and their state enterprise managers –their key constituency – would money at Russian expense. The old-rent seeking elites, both in Russia and the former Soviet republics, saw the nontransparency of the CIS arrangements as an excellent veil for exacting subsidies from the Russian state." [61]

[60] Mieszowski, Peter;Soligo, Ronald., "Economic Change in Russia: 1985-95," **Problems of Post-Communism**, May/June96, Vol.43 Issue 3, p.27
[61] Aslund, **op.cit.1**., pp.110, 135

One another group was Russian neoimperialists and nationalists, who favored the ruble zone as well. Even the liberal Grigory Yavlinski has consistently favored monetary union. As Anders Aslund rightly assessed that the nostalgia for empire of the old seemed to be in their subconscious.[62]

The IMF also advocated the maintenance of the ruble zone and threatened that countries that launched their own currencies would not receive any IMF support. Convinced at first that the best way to preserve interstate trade was to retain as large a ruble as possible, the IMF early in 1992 urged all independent states to remain in the ruble area. The IMF plan included the following proposals:

> "First, each republican central bank would agree to set limit on the expansion of its net domestic assets. Second, the monetary authorities in all states would agree to set uniform central bank lending rates and reserve requirement; to establish a common, unified exchange system; and to facilitate the settlement and clearance of payments throughout ruble area. Fourth, the CBR will agree to provide enough ruble currency to the central banks of other states in the ruble area to satisfy the demand for currency in these states."[63]

It was not only IMF but the European Commission supported the maintenance of the ruble zone. As Anders Aslund said in his book:

> "The EC ambassador to Moscow, Michael Emerson, drew far-reaching parallels between the CIS and the European Community, arguing in the press: "Economist argue whether a common market really also requires a common currency. I believe it does. A single monetary unit more fully uncovers the advantages of economic integration, according to my view."[64]

The leading figures of the shock therapy criticized the IMF attempts at supporting the ruble zone. For instance, Anders Aslund criticized the IMF proposals in the following right manner: "Under this plan, every central bank would have been permitted to issue rubles, with no effective control on compliance."[65] The result would be an increase in money supply, which in turn would lead to inflationary effect throughout Russia.

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[62] ibid., p.110
[63] ibid.
[64] ibid.
[65] ibid.

Jeffrey Sachs furthered the criticism as such: " When faced with the question of how the ruble area should be managed, IMF has been extremely unhelpful. Once the inadequacy of budget and credit policies in certain states became clear, the IMF worried that the new currencies might be unstable and encouraged the states to delay the introduction of their moneys, ignoring the inescapable implication that macroeconomic policy mismanagement outside of Russia would only to serve to undermine the ruble stabilization effort!"[66]

The main incentive for the non-Russian republics to stay within ruble zone lied in the fact that they could maintain the transfers from Russia; either by importing energy on more favorable terms than could be obtained in trade outside the CIS and/or by effectively forcing the Russian government to subsidize their budget deficit. * Most Former Soviet Republics and Russian state enterprises wanted subsidies from Russia to maintain production. The subsidization took several forms. The main form of subsidization has been the exchange of energy products from Russia for manufactured goods from other republics at terms of trade that substantially underpriced the energy in comparison with world markets. According to IMF calculations, If Russia's interrepublican trade had been valued at world market prices rather than actual domestic prices in 1990; Russia would have gained 37 percent in terms of trade in relation to the other former Soviet republics. A second form of has been the extension of credits to other republics through the banking system to finance chronic budget deficit of many of the other republics. For example, in mid-1992 Russia provided the CIS countries with 650 billion rubles in credits, 250 billion rubles to Ukraine alone. By January 1993, total debt of other CIS countries to Russia exceeded 1.2 trillion rubles and it kept growing in early 1993. A third form of subsidization has been the provision of foreign exchange to other

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[66] Lipton and Sachs, **op.cit.**, p.8

* For instance, under Soviet rule, Kazakhstan and the Central Asian republics received substantial grants from the union budget, on the order of 15 to 20 percent of their GDP. Another financial flow arose from internal Soviet trade. Certain Republics (Azerbaijan, Belarus, Georgia, Russia, and Ukraine) had had persistent trade surpluses within the USSR. This had in turn benefited Kazakhstan and the Central Asian Republics, which had

republic, at a price in terms of rubles far below the market price. Only the third form of subsidization has been eliminates substantially eliminated in 1992.[67]

The general conclusion among the leading shock therapists was that it was vital to break up the monetary area. This would prohibit various other central banks from issuing the same currency, which would thus prevent extreme inflation. As Anders Aslund emphasized:

> "The only sensible alternative to the ruble zone was the introduction of independent national currencies that should be made convertible on current account. Such a solution had all advantages. It would create the basic precondition for macroeconomic stabilization: one monetary authority responsible for monetary policy in each currency area. The financing and liquidity problem for interstate transaction would be solved, because payments could be made in one of the new convertible currencies. The problem of lack of trust could be best handled between enterprises in different states; under convertibility, they would be able to make direct payments to one another. Convertibility would naturally render trade and payments multilateral and was by no means unattainable."[68]

Anders Aslund gave the collapse of the Habsburg Empire after World War I as an example to draw a historical parallel to support his ideas on this issue of monetary stabilization.

> "Only the country that arose from the former Habsburg Empire acted appropriately with regard to national currency policy, namely Czechoslovakia. At the earliest instance, over a two-week period in February and March 1919 while the borders were closed, Czechoslovakia stamped the Austro-Hungarian notes circulating within its borders. Its currency was made fully convertible from the outset, and Czechoslovakia pursued highly conservative fiscal and monetary policies. While hyperinflation erupted in the other states that were formed from Habsburg Empire, Czechoslovakia pursued deflation. Its economy flourished between the world wars, while those of other Central European states foundered. Czechoslovakia was also the only country in the region that maintained full democracy until it was occupied by Germany."[69]

One another significant issue, linked to the break up of the USSR, was both how to conduct the foreign trade between former Soviet Republics and find a suitable exchange rate mechanism. The leading proponent of shock therapy favored free prices and free trade. On this aspect of the issue, Jeffrey Sachs proposed the followings:

> "In our view, each of the independent states should quickly introduce its own currency by substituting new banknotes (or coupons) for the rubles in circulation on the state, and by redenominating bank balances, contracts, wages, and prices in the new currency at a uniform exchange rate between the ruble and the new currency. Trade between the state and Russia could continue to be conducted in Russian rubles, but the state would have to earn the rubles by its own exports or by explicit credits from Russia, or

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total internal trade deficit on the order of 12 percent of their GDP in 1987-89. That is why, Central Asian republics, especially Kazakhstan, were keen on the maintenance of the ruble zone.(ibid., p.10)

[67] Ericson

[68] Aslund, **op.cit.1**., p.114

[69] ibid., p.115

get them by selling foreign exchange for rubles. If the sate wanted to maintain close monetary harmonization with Russia, it could peg its currency to the ruble. Otherwise, the sate could let its currency float against ruble (and perhaps peg it to something else, such as a Western convertible currency.)"[70]

Regarding the trade between former Soviet republics, although there was a broad consensus among the Western economists that free prices and free trade must prevail, there was, however different ideas about currency and payment arrangements. The problem lied in the fact that there was liquidity shortage to encourage payments between former Soviet republics. Regarding this aspect, the payment mechanism, which was another important issue, had to be resolved throughout the former Soviet republics. On this aspect of the issue, a payment union or multilateral clearing was favored, in line with the European Payments Union (EPU), which existed from 1950 to 1958.[71]

As mentioned above, the argument for a payment union lied in the fact that the focus was the shortage of liquidity for foreign trade transactions. According Anders Aslund, the basic problem was different.

> "The basic problem was a lack of trust at all levels: between the FSRs, between enterprises in these states and between the states and enterprises. This lack of trust was compounded by the absence of both transparency and legal sanctions. In addition, very high inflation and minimal interest rates made the incentives to delay payments overwhelming; under these conditions, it was simply irrational for an enterprise to pay a bill."[72]

The idea of payment union was not viewed by the former Soviet republics a viable solution to the payment problems. As Anders Aslund rightly assessed:

> "Although many Western economists favored a payments union, this view found little support in the FSU, which knew how badly multilateral clearing had functioned within the CMEA. Any surplus from one country had been a cheap credit to other countries with deficits. "[73]

Bilateral clearing was never considered a plausible option by anyone. Payments in hard currency were also not a viable solution. Because hard currency was in short supply, there was too little liquidity to encourage such payments. In the absence of other payment

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[70] Lipton and Sachs, **op.cit.**, p.7

[71] The idea was first presented Eastern Europe, when Council for Mutual Economic Assistance (CMEA) trade system collapsed in 1991, and it was even more strongly advocated for the FSU. (For details, see, Aslund, **op.cit.1.**, p.111)

[72] ibid., p.112

mechanism, barter trade within and between the FSRs developed to grow up after the collapse of the old command system throughout 1992. Barter trade facilitated evasion of taxes, thus torpedoed the macroeconomic stabilization efforts in Russia.[74]

The break up of the Soviet Union disrupted the trade relations among the republics. Export barriers were set up by republics and regions partially in response to their policy of continuing to subsidize many commodity prices. Export barriers were set up because many goods were sold domestically at low, fixed, subsidized prices. Barter trade agreements between Russia and the other states were maintained throughout 1992. Russia has continued to oblige its energy producers to deliver oil and gas far below market levels. In some cases, these oil shipments have in fact been reexported to world markets, allowing enterprises in other states to capture enormous rent.[75]

As result, it became appear that the notion of ruble area was far from creating any advantage. It generated irresponsible monetary policies and high inflation. It did not provide a proper payment mechanism. The ruble zone came to an end in July 1993 when the Central Bank of Russia announced that Russian banknotes issued before 1993 would become worthless. Only after than, one of the basic conditions for macroeconomic stabilization started to take place in Russia. This reform extensively covered in the Western press as a positive development in reaching to macroeconomic goals.

> "This had the positive effect of reducing the drain on Russian resources from other CIS states, but at the cost of undermining confidence in the ruble as a store of value and medium of exchange."[76]

3.4. Privatization

The privatization of industries, which created enormous discussion outside and inside of Russia, was one of the important components of the Russian economic transformation. As

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[73] ibid.
[74] ibid, p.113
[75] Lipton and Sachs, op.cit., p.5
[76] The Wall Street of Journal and New York Times, July 25-27, 1993

discussed in the second chapter, the main purpose of the privatization was to break the dependence of enterprises on state budget and to make the market economy irreversible by creating a class of property owners while at the same time making firms more efficient and market oriented.

When the reform government was established in November 1991, the job of designing and implementing the Russian privatization was given to Anatoly B.Chubais. He was appointed as minister of privatization in November 1992. His top aides were Dimitry Vasiliev and Maxim Boycko. Vasiliev served as deputy chairman of the privatization ministry, with responsibility for implementation of the program. Boycko served as the Russain economist working on policy with Chubais's American advisory team, directed by Andrei Shleifer. [77]

During the first half of 1992, an intense debate over privatization was on the agenda in Russia. The primary question was who was going own the enterprises. The debate concentrated on the work collectives: How much should they receive, and should their shares be individual or collective? In his speech of October 28 1991, Yeltsin initially stated that enterprise shares would be divided between the state and work collectives or employees. On December 29, 1991, a presidential decree on "Basic Provisions of a Program of Privatization of State and Municipal Enterprises in the Russian Federation" was adopted. This preliminary privatization program acknowledged the fact that a substantial share of the ownership was to be given to employees in enterprises to facilitate the privatization. As Anatoly Chubais explained: " If we did not accept that the workers collectives would hardly support privatization. But now they have 'suddenly' shown an interest in the law and started to egging on the administration."[78] The shares given to workers would be the individual property. The government hoped that workers would keep illicit privatization* by managers in check. As

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[77] Blasi, Kroumova, and Kruse, **op.cit**., p.35

[78] Aslund, **op.cit.1**., p.230

* In 1991, Gorbachev inadvertently opened the door to one form of hijacking when he removed the power of the big soviet cabinet ministries over the individual general directors of thousands of enterprises. Once Gorbachev

Anders Aslund pointed out: "In some cases this process, this process was used as a means of insider privatization; in other cases the result was the decapitalization of the state firms to the benefit of these insiders. There was a fear among Gaidar team that if privatization were delayed there would be little left to privatize."[79] That is why, to the reform team, the speed at which ownership was transferred was of primary importance.

This issue was expressed in Yeltin's famous reform speech on 28 October 1991: " For impermissibly long, we have discussed whether private is necessary. In the meantime, the party-state elite has actively been engaged in their personal privatization. The scale, the enterprise, and the hypocrisy are staggering. The privatization in Russia had gone on for a long time, but wildly, spontaneously, and criminal basis. Today it is necessary to grasp the initiative, and we are intent on doing so."[80]

Workers opposed to any significant role for domestic or foreign investors because they feared that outsiders would drastically cut employees, and managers feared outside owners would fire them or curtail their power. This was one of the main considerations, prevailed throughout the reform years, got workers and managers together in their struggle for the formation of Russian privatization program.

The top managers wanted to control the enterprises and own a large amount of the shares as well. They wanted the enterprises in their areas of responsibilities to be organized into production associations, holding companies, or financial-industrial groups. The third group of claimants was the regional authorities and the present and former bureaucrats in the ministries wanted to retain the old privileges as much as possible. This situation left a lot of

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removed cabinet supervision from the top managers, they were free to do what they pleased. They started to treat the enterprise as their personal property. This process was called spontaneous privatization. Certainly the gap between domestic prices and world market prices gave them many opportunities. Before a factory privatized, the top managers had started smaller related corporations and joint ventures with foreign or domestic producers. Before they had a board of directors looking over their shoulders, they began to the simple physical transfer of equipment to these daughter companies. They sold them goods or services at low rates and used their financial accounts to transfer funds to them. Managers and their families now own significant parts of these new corporations. (Blasi, Kroumova, Kruse, **op.cit.**, p.30-34)

[79] ibid.

room not only for negotiation and compromise but also for corruption. One another group was the population, which constituted the key group to awaken the general support not only for privatization program but also for general reform as a whole. Not only the foreign observers but also Russian reformers acknowledged this fact in the sense that if these groups were not given a strong incentive to participate, they could stop privatization.[81]

Advocating another approach, liberal Russian economist, Boris Federov, and Grigory Yavlinsky wanted to sell the enterprises to the highest bidders who would bring capital necessary to restructure them. Yavlinsky and some Western economists predicted that any significant role for employee ownership would doom privatization because workers would take over the board of directors, vote for themselves huge wage increases, and never invest profits in the future of the firms. Other economists hoped that foreign investors would be the ones to supply the necessary capital. Some looked to the privatization of Czechoslovakia, in, which vouchers distributed to every citizen. An individual could use the vouchers to purchase a few shares in enterprises or group of citizens could deposit their voucher in mutual funds, which could then buy bigger blocks of shares in companies.

While the reform team assessing these alternatives, the managers and the former and present government bureaucrats were not waiting for the government to take action. As Joseph R. Blasi said:

> "During 1991 and 1992, they tried to get their hands on whatever assets they could or to position themselves for a form of privatization that would favor them. Our evidence indicates that about 8 percent of the companies had negotiated some kind of special deal under Gorbachev or Yeltsin. In most of the cases, the employees were allowed to lease the enterprise with an option to buy it if privatization ever went forward. The general director of a large high technology firm in Southern Russia proudly told visitors that before the official privatization program went into effect he got a decree signed by a high government official allowing him to privatize his company the way he wanted."[82]

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[80] Aslund. **op.cit**., p.35
[81] Blasi, Kroumova, and Kruse, **op.cit**., p.38
[82] ibid.,p.37

The reform team spent 1992 weighing the alternatives. They finally settled the central principles of the privatization to guide the assignment of property rights to the Russian people. The central key principles were:

> "First, privatization had to be proceed quickly, before the window of opportunity closed, the possibility of rapidly separating the economy from the state power disappeared, and the stealing of assets developed from an art into a science. Second, each interest group would be offered enough potential ownership to persuade the Supreme Soviet to pass the privatization law. Third, the privatization process had to be simple, because the state bureaucracy was incapable of managing anything efficiently and there were initially 1,500 enterprises to put on the auction block. "Simple" meant giving incentives to all the participants to implement privatization on their own, without governmental approval. Fourth, privatization would occur only if Russian citizen wanted to do it. No one could force them to take part in it. Russia had no legal regime, no corporate or related law to speak of, no real independent judiciary, no culture of law, and no way for the courts or the police to enforce government orders. Last, most of the shares in the enterprises would have to be given away or sold at very low prices because ordinary citizen would not have enough money to participate otherwise. Citizen would have to be given some type of "currency" that they could use to "buy" their shares."[83]

The decision to sell Russia's large industrial enterprises at low prices to the population became one of the most politically controversial aspects of the program. For the reform team, the speed at which ownership was transferred was very important on the ground that if it was not proceeded quickly, the managerial elite and criminals would increase their advantage with each month passed.

3.4.1. The Privatization Program

On June 11, 1992, the Russian parliament passed the new privatization program and Yeltsin signed it into law. The terms of the privatization program were strongly determined by the need to obtain political support for the reforms from important stakeholders such as managers and workers. The plan was put forward by the reform team was a political compromise. The central aim of the plan was to distribute property rights to most of the big firms in about eighteen months, fro January 1993 to June 1994.

As a starting point, the Russian privatization program divided firms into those that could be sold for cash, and those would go to the mass privatization. Most small shops and smaller enterprises were immediately allocated to the local governments in this way. Indeed, there had been extensive disagreement over how to sell off more than 170,000 small shops and retail outlets. For instance, Larisa Pyashcheva, the head of privatization for the city of Moscow, had argued for turning over all the shops to their workers. In the end it was decided that they would be sold at simple auctions. Revenues from auctions were to be kept by the local authorities that carried out sales. It was the main incentive that led to speedy privatization with regard to small-scale firms and enterprises. Ultimately, the workers and managers were able to win large number of these auctions.[84] As second step, the program divided large firms into five subgroups: those subject to mandatory privatization, those could be privatized on a voluntary basis, those subject to the permission of the Privatization Ministry, those requiring government approval for privatization, and those whose privatization was prohibited. Mandatory privatization included firms in the "light" industries, such as textiles, food processing, furniture and so on. Major firms in most strategic industries, such as natural resources, defense and steel could only be privatized with the agreement of the whole government. As third step, all large and medium-sized firms were to be corporatised. In other words, they were to be registered as joint-stock companies.

At this stage, all of the enterprise's shares were owned by the state. The managers and employees of each state-owned enterprises were required quickly submit papers to turn their enterprise into a corporation with shares owned by the state. The shares of the stock were considered property of the state and were handed over to the Russian Property Fund until they are sold. They calculated the value of all assets aside from the land at book value and divided the sum by 1,000 rubles to arrive at the number of shares in their enterprises. The workers and managers then selected a board of four members: the general director with two votes a representative of employees, and one representative each of the local and federal governments. The corporatization step was designed to bar well-placed members of the

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[83] ibid., p.38
[84] ibid., p.36

Communist Party, enterprise managers and state bureaucrats from interfering with the shares of the companies under their control. Once an enterprise had been corporatised, the ministry in Moscow lost any control over it. The top manager was freed from the ministry's supervision but constrained by the other board members, and found it expedient to cooperate with the workers to buy the enterprise.[85]

3.4.2. How the Program Worked

When a firm was corporatized, its managers and workers were allowed to choose between three privatization options. The first option gave workers 25 percent of the shares of the enterprises for free, made these shares non-voting. The top managers got 5 percent at a nominal price. Additionally, the workers could get another 10 percent of the shares at a 30 percent discount from book value. Option 1 resulted in minority employee ownership. It allowed 40 percent of the shares to be sold to employees, while 60 percent would be sold at auction or held by the state for later sale. The second option gave managers and workers 51 percent of the equity, all-voting. Option 3 was a management buyout by a group that promised to restructure the firm. Indeed, the managerial lobby in the parliament imposed this option, allowed the managers to buy up to 40 percent of the shares at very low prices if they promised not to go bankrupt.

The principal method in which the sales of the rest of shares took place was either through the auctions of shares for voucher, or investment tenders or cash auctions later. Every person in Russia was offered a privatization voucher, which had a denomination of 10,000 rubles. It could be traded, but government prohibited the stores from accepting vouchers in exchange for goods and services. In theory, anyone –a rich person, a new business started by a smart entrepreneur, a Mafia organization, a foreign company – could buy vouchers and come

[85] ibid., p.40

to voucher auctions. Citizen had to pay the equivalent of about 8 cents for a voucher. This voucher was the sole means of payment in auctions of shares of privatizing enterprises. The law specified that at least 29 percent of the shares had to be sold to bidders, who could include citizens, companies, and the employees and managers. The auctions often left 10 to 20 percent of the shares in the state's hands to be sold at investment tenders or cash auctions later.[86]As Joseph R. Blasi pointed out, this was the golden share, which was to be sold after the initial privatization program completed in 1994.

The architects of the privatization program wanted to encourage the creation of core shareholders, block holders who would own more than 5 percent of an enterprise's shares. The hope was that theses big investors would take a more serious interest in the enterprise, push to get on the board of directors, and monitor the performance of the old Soviet management closely. In order to start the formation of such blockholders investors, the government licensed voucher investment funds to function like mutual funds. A citizen could hand over a voucher to the fund, and the fund would select the companies and group the shares in order to pressure management for performance and demand board seats. At least 29 percent of every company was supposed to be sold for vouchers to ensure widespread citizen participation and keep the value of the vouchers high.

When this privatization program was accepted, it led to an extensive criticism throughout the transition years in Russia. For example, the economist Tatyana Koryagina, a former colleague of Gaidar who later become a key adviser to Gennady A. Zyuganov, said, "Whether the government likes it or not, the privatization program will be beneficial only to foreign business and domestic shadow business (the Mafia)." *Pravda* called privatization "a crime against nation" and said that it emerged as a result of the Yeltsin government's links to the new rich. *Pravda* accused the government of deliberately impoverishing people. " In a

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[86] ibid., p.42

situation where 80 percent of the citizens do not have enough money to buy meat and butter, it is easy to suggest that the vouchers will end up in the pockets of rich tycoons."[87] A common argument against voucher privatization was that people would not value their vouchers but would sell them too cheaply.

The foreign observers severely criticized the program from their own perspectives. Some viewed that the government should focus on only freeing prices completely, so that state-owned firms could compete with one another; privatization could come later. Andrei Shleifer, who was the foreign adviser to the Russian government on the issues of the privatization, fiercely opposed this view. The privatization experts Roman Frydman and Andrzej Rapaczynski questioned whether giving insiders so much control amounted to real private property ownership. They doubted that workers would be more interested in profits than in safeguarding their employment and wages, and whether a manager would be more interested in restructuring than in continuing the search for subsidies.[88]

Optimist looked to the privatization program as the motor for driving Russia into market economy. For example, Professor Richard Layard of the London School of Economics and an adviser to the Russian government argued that giving shares to the people would build up popular support for the reforms and result in efficiency. Another advisor to the Russian government, Anders Aslund favored the most rapid allocation of state assets to the people in the reform process in the sense that this would not only provide popular support for the economic reforms but also would make the reform irreversible. The American management consultant John Simmons argued that employee ownership would restructure the companies more efficiently. [89]

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[87] ibid,p.48
[88] ibid.
[89] ibid.

3.4.3. Ownership

The objective described in the privatization law was to form a group of owners who would contribute to the mergence of a socially oriented market economy by making the enterprises more efficient and attracting foreign and domestic investment. From this point of view, it is important to assess who owns Russian industry after privatization on the ground that it matters whether the majority of the owners of a privatized company are the employees of the firm, only its managers, or outsiders, or whether the company has no controlling block owners. Since privatization was supposed to distribute property among citizens, it is important to know how much property ordinary citizen got.

The true paradox of privatization was that it allowed the members of the nomenklatura to achieve something they could not have hoped for even under communism.The privatization program placed most state owned enterprises in the hand of their employees and former managers. It was reported that insiders have an average of 65 percent of the shares, with top management owning 8.6 percent. Of the remainder, the government holds 13 percent and outsiders hold 22 percent. Of the shares held by outsiders, 11 percent were held in blocks greater than 5 percent.[90] (See figure 1.1 and 1.2 in appendix A)

From the beginning, it was clear that these insiders would be against outside ownership. They were afraid that outsiders would control their companies. Because their companies were in need of capital and technology, those resources only could come through outsider ownership, namely investment funds, commercial firms, banks or foreign investment. The insiders, namely workers and management were afraid that if outsiders were involved in privatization, the result would be loss of control over their company and massive cuts in employment. This was the fear that insiders got together and severely resisted outsiders ownership. As Joseph R. Blasi said:

[90] ibid., p.193

"Shares prices were so low that many employees had money leftover after paying for their shares, so they went as individuals or in groups to the voucher auctions and bought additional shares with their personal savings, their voucher, and the vouchers of family members, friend, or other sources. One manager told of employees who went to the subway stations and nascent Moscow stock exchanges to buy up vouchers. The general directors of the companies made it clear in interviews that thy opposed to the sale of stock to unknown outsiders, and some top managers admitted they worked closely with local privatization officials to block the participation of outsiders. In fact in the winter of 1994 about fifth of all the firms we visited had no outside ownership whatever."[91]

In a report, which was made Joseph R. Blasi, a manager of automobile plant said:

"About 70 percent of the stock is owned by the employees and I own 5 percent myself. Among the outside owners, two investment funds bought 5 percent of our shares. The activity of this investment company is rather dangerous. In our city, they took over a chemical plant and fired the top management. To prevent this, we set up our trading company that's owned mostly by our company and partly by one individual. This trading house buys employees' shares. It is accumulated about 12 percent of them by now. In Soviet times the state constantly gave us money to develop new products, but now we have only our profit for capital investment. Outside investors are the only other source of capital, but if they come in, they could seize control."[92]

One another highlighting example,

"The manager of a Belgorod trucking company with 600 employees observed, "The psychology of the employees is that they simply cannot understand that they are now the owners of this company. They are afraid the privatization program will stop and it will all be taken away from them. We are doing everything possible to keep control of the shares inside the enterprise. We are afraid that new businessmen who made a lot of money in some commercial deal will try to buy shares from the employees. If that happens, employees will finally understand that it is not good to sell the shares. "[93]

The managers looked for an ownership that made sense to them, provided them the capital they needed to modernize, was nonthreatening. As mentioned in a report, which was made by Joseph R. Blasi, the head of a 1,6000-employee machine building plant in the Bryansk region said:

"We lack cash. There are delays in paying wages. The state owns just over a tenth of our shares. We are looking for a foreign investor to buy it, but if we do not find an investor ourselves, the state will auction the stake and we will lose more control. Our largest outside shareholders are a local bank and a Moscow investment fund. They do not interfere with our life and they are not going top make nay changes here."[94]

Although top management acquired about 9 percent of the shares through mechanism Chubais established, and workers ended up with 56 percent, shortly afterwards managers resorted to a series of measures designed to increase their stakes. They virtually wanted to

[91] ibid., p.54
[92] ibid., p.59
[93] ibid., p.62
[94] ibid., p.104

own most of the shares, if possible, all shares.* They started buying up workers' shares while at the same time preventing workers from selling to outsiders. Those who resisted were threatened with dismissal.

> "The general director of a large plant in Astrakhan region told us that 30 percent of the shares in his firm had been resold by the employees in the last year. When we asked who the main buyer was, he acted confused and avoided a straight answer. Later a local government official told us that his office had received complaints that the general director had bought all the shares himself. Top managers seldom admit to participating in other companies that serve as fronts for their ownership of their own firms."[95]

An employee, who was fired, received nothing. Where do the shares go? Top managers stepped in and bought them. The corporation law had no provisions to protect the shares of those who were fired from their job.

> "The authorities in the Mordovia region tried to establish a committee defend employee shareholders against pressure exerted by general directors to sell their shares to the top management. An employee who resigns is likely to be instructed to sell his or her shares to the boss. Most workers do not know their rights and do as they are told. General directors in this region strongly opposed the creation of such committee, just as some advisers to members of the government with ties to general directors opposed a provision in a draft law on corporations in 1995."[96]

The managers resorted to some methods in their attempts to acquire the shares of the firms. One prominent method was that the managers set up companies, which they or their families controlled, and siphoned them money. Under soft budget constraint, it was easy to get money from the state channels. Because the top management controlled the records of shares, they simply refused to record the share transactions they disapproved. If an outsider they disliked bought shares, they could simply refuse to register the new ownership. An employee, who wanted sell shares had to get management's approval before the transaction could be registered. If an outsider wanted to start accumulating shares with the hope of

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* In February 1993, the managers' frustration took an alarmingly political character. In February 1993, about two hundreds large and mid-sized enterprises had been sold. The managerial lobby in the Supreme Soviet offered an amendment to the privatization program to create an additional option: every enterprise could create close to 100 percent employee ownership by getting a low-interest loan from the Russian government to buy back the share that the privatization program had systematically sold off to outsiders. Since inflation was very high that year, the low interest rate the loan essentially gift. The government, however, managed to defeat the legislation. (See, ibid., p.64)

[95] ibid., p.68

[96] ibid., pp.62-63

gaining control of the company, the general director could simply refuse to reveal the current's owners.[97]

Open trading of stocks allows shareholders to buy and sell shares according to their view of stock's prospects. In Russia, open trading of the shares was far from being a reality. The general directors and their lobbies in the Supreme Soviet and industry associations bitterly opposed to this concept because they realized that even if insiders dominated the initial stage of privatization, outsiders could eventually enter their companies. In addition, they did not provide the outsiders with accurate financial disclosure.* As Joseph R. Blasi mentioned, furthermore, hyperinflation made most companies financial information virtually useless.

> "...the companies could decide themselves which outside shareholders should receive financial information and which ones they wanted to boycott. Furthermore, hyperinflation made most company financial information virtually useless. If in 1992 the inflation rate is 2,323 percent, for example, what is the dollar value of sales of 1 billion rubles in 1992? In 1992 the price of a dollar rose from 198 rubles to 415 rubles. Thus financial information was not only improbable, it was impossible, Since investors could not tell whether a stock was a good deal, only favored investors had much incentive to buy it. I 1993 and 1994, many managers echoed the general director Marina Tikonove: "Our financial statements are our commercial secrets."[98]

Regarding the corporate governance, one problematic area was the area board of directors. Although outsiders owned 21 percent of the stock of the average firm in 1993 and 1994, they were denied on the board of directors. Insiders used their control of a majority of shares to outvote the outsiders.[99] Throughout 1993 and 1994 Russian managers spoke openly about a tactic to thwart outside ownership. The trick was to issue new shares to managers and other employees but charged them only a minimal amount. This tactic effectively reduced the power of the outside shareholders. If a voucher investment fund owns 20 percent of your company and you issue enough new shares to insiders, the fund managers wake up next

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[97] ibid., p.90

* Independent accounting firm did not audit most of the companies, so no one had any means of judging what they did disclose. (ibid., pp.90-91)

[98] ibid., p.62-63

[99] See for futher details, pp.91-92

morning to find that they hold 10 percent of a company that received no money for the shares that reduced the fund's ownership.As an example:

> "In 1994 the first well-publicized serious violation of shareholders' rights in a new issue of stock took place at Komineft, one of largest oil companies. Komineft has reserves of over 2 billion barrels of oil and is the country's thirty-sixth largest company by market value. Without giving adequate notice to its outside shareholders, the company called a meeting, and shareholders present approved a very large issuance of new shares. Several key outside shareholders were not notified of this action and were not allowed to buy the new shares if they did hear about it."[100]

As mentioned by Joseph R. Blasi, there was no law requiring new share offering to be offered equally to all shareholders, not just to insiders, or requiring immediate payment for shares. The solution to the stock buyback trick would be to prohibit a company form using corporate funds for a buyback without the approval of a majority of shareholders or to require insiders to pay a fair market price for any shares they buy. Even if an outsider freely bought shares, somehow gained access to the shareholders register and financial information, and secured a seat on the board of directors could still vote for a share issue or a stock buyback to reduce that outside shareholder's power.[101]

As a result top management moved swiftly gained control over workers votes. Top managers, who were dependent on the general director for senior positions, represented insiders on the board predominantly and top managers took control of register rights. Theoretically, groups of workers and their trade union could have meaningful independent power on the company boards. The Russian trade unions, however, have no tradition of independence; they have always been creatures of the companies, which in turn were once creators of the Party and the state. Now the managers rule supreme.[102]

3.4.4. The Struggle for Ownership

The end of voucher privatization of mid-sized and large firms in July 1994 was not end of privatization. One of the goals of the privatization program was to subsidize the federal and regional government's budget with the proceeds of the sales of shares for cash.

[100] ibid., p.93-94
[101] ibid.

At the end of voucher privatization, some state ownership still remained among the 15,000 companies included in that program. In 1996 the average state ownership among mid-sized and large firms was 9 percent, but it was still more than 20 percent in a quarter of privatized companies and more than 32 percent in a tenth of them. The state ownership in the fifty largest Russian corporations was about 38 percent, and many other firms had not been privatized, because enterprises with more than 10,000 employees could not be privatized without government permission. The government devised special rules for these larger firms. In the oil and gas sector, the government kept 38 percent of the shares for three years and allowed the others to be privatized. It retained majority control over these key strategic firms.[103]

On July 22, 1994, President Yeltsin issued a decree on the second stage of privatization: the remaining state holdings were to be sold for cash at competitive auctions, with part of the proceeds going to the companies as capital for their restructuring and the rest. The land under the privatized enterprises was to be sold to the enterprises. The government hoped to raise many many billions of dollars to finance its budget deficit in a noninflationary way. And it wanted to allow outside investors to build up larger blocks of shares so that they could increase their role in corporate governance.[104]

This second stage of privatization was a failure on many grounds. As Joseph R. Blasi explained:

> "In early November 1994 Yeltsin promoted Anatoly Chubais to the position of first deputy prime minister in charge of overall economic reform. The man Yeltsin chose to replace him at the privatization ministry, Vladimir Polevanov, scared off potential investors with talk of renationalizing companies and criticism of privatization before he was fired. In the first nine months of 1995, 7,000 companies were slated to sell their remaining shares. The government hoped to raise about $2 billion. The procedures for the auctions were issued late. Little information about the enterprises was made available, and few investors were interested in buying shares. Plans to sell the shares through nationwide auctions and the stock market did not live up expectations. By November 1, shares in only about half of the companies had been sold for about $500 million, because of a depressed stock market and opposition from enterprise management and regional government officials to introducing outside owners."[105]

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[102] ibid., p.107
[103] ibid., p.72
[104] ibid., p.72-73
[105] ibid.

In late 1994 and 1995, only 9 percent of the enterprises had investment tenders for their shares and only 24 percent had cash auctions, at which smaller stakes were sold. Commercial firms that had little to invest bought the shares cheaply. Many of these firms promised additional investments that they were not able to deliver. The voucher auctions for these firms were dominated by the insiders.[106]

The Russian government needed seriously to increase revenues from privatization in 1995. On May 11, 1995, President Yeltsin issued a decree that increased the proportion of privatization proceeds that was go to the central government at the expense of the regional governments. For this purpose, the Russian government tried to sell 25 percent of Svazinvest, a holding company that held 38 percent of the stock in the eighty-five regional telecommunication firms across the Russian Federation. The intent was to $1 billion to finance the budget deficit in a non-inflationary way. The Italian state telephone company STET was winner of the auctions.[107]

On of the most controversial aspect of the privatization program, which is loans-for-shares scheme, came to agenda in 1995. The government was looking for revenues from privatization to support the budget deficit in noninflationary way. A consortium of banks suggested that they lend the Russian government funds and take large blocks of shares in the country's giant companies. The banks would manage the shares. The banks also wanted to restrict the involvement of foreign investors in buying up Russia's strategic companies. On August 31, 1995, President Yeltsin accepted a version of the plan that came to be known as the loans-for-shares scheme. Twenty-nine blue-chip companies would be auctioned separately to banks. The auctions would be open to all interested bidders, even to foreigners, and the bank that offered the largest loan to government would win each block of shares. The banks were required to hold the shares until September 1, 1996. After that date they could sell the shares and take a third of the capital gains. The bids of loans to the government appeared to be offers of assistance, but in fact the banks were simply looking for a way to acquire control of some Russia's largest companies.[108]

The implementation of the loans-for-scheme created a public discontent over privatization. The Russian citizens were simply excluded from the auctions. The list of companies participating was shortened, sometimes as a result of political pressure and lawsuits by managers of influential companies who opposed the sale of their shares to either banks or other outsiders. The participation of foreigners was seriously restricted. The banks were allowed to organize the auctions themselves and participate in them as both bidders and depositors for bids. In the end, only twelve companies were auctioned. The first farm auctioned was Surgutneftgas, the eight largest company in Russia, with oil reserves of almost 11 billion barrels. An offer one bidder was disqualified on technicalities and the auction was won by the pension fund of Surgutneftgaz. The LUKoil Group, the largest corporation in the country, joined with Bank Imperial to win its own share auction after excluding foreigners and Russian corporations that cooperated with foreigners. Both deals helped to secure insider control of the companies. Oneximbank organized the auction for Norilsk Nickel, the sixth largest Russian corporation, and won the auction. Its bid of $170.1 million was just $100,000 over the starting price. Oneximbank disqualified a competing bid for $350 million on technicality. Oneximbank then took control of Norilsk Nickel.[109]

As mentioned before, the true paradox of privatization is that it allowed the members of the nomenklatura to achieve something they could not have hoped for even under communism. The best companies of Russia were channeled into the hands of ex-communists. As Roman Frydman, Kenneth Murphy and Andrzej Rapczynski mentioned,

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[106] ibid.
[107] ibid., p.74
[108] ibid.
[109] ibid., p.75

"But, the nomenklatura's rape of those countries cannot compare with that of Russia, whose enormous wealth and natural resources fell prey to a few modern-day robber barons with a party pedigree. In what reportedly began as a conscious Soviet policy of placing various party officials into key economic posts, Mikhail Gorbachev's prime minister, Nikholai Ryzhkov, made a switch "from plan to clan" (to use the phrase of sociologist Davis Stark) and is now chairman of Tveruniversal Bank. Before becoming the president of the Association of Russian Banks, which represents independent commercial banks, Sergei Yegorov was an official in the State Bank, at one time serving as the head of the Russian Republic office of the Bank. Connections to the often-corrupt new authorities can also yield fairly good results. For example, last November Russia's huge Oneksimbank, a firm with close ties to President Yeltsin's security chief and drinking buddy, Aleksandr Korzhakov, was victorious in auctions to control 38 percent of Norilsk Nickel, the world's largest producer of producer of that commodity (as well as of platinum and cobalt). Oneksimbank, which is partly owned by Norilsk Nickel, was named by the government to be its auctioneer. Oneksimbank declared its own $170 million offer to be winning bid, despite the fact that it was only half that offered by a competitor and a mere $100,000 above the minimum bid level that it had set."[110]

In this sense, the situation of the Gazprom is another illuminating case to consider. The assets of the Gazprom alone were valued in the hundred of millions of dollars. Although Gazprom and other large energy companies were excluded from the official privatization program, 60 percent of the stakes in them have ended up in the hands of few insiders, favored politicians, and banks run by the ex-nomenklatura. Among the major shareholders of Gazprom is rumored to be its former boss, Prime Minister Viktor Chernomyrdin. Chernomirdin denies any involvement, but few believe his protestations, particularly as his son is building a lavish mansion within a wooded Gazprom estate.[111]

At the end of the loans-for-shares auctions in which only a handful of bidders participated, Russia's banks were openly struggling with each other to eat more of the cake. The banks that organized the auctions repeatedly disqualified their competitors and won the bids; most bids were fairly low; foreigners were completely excluded; some banks and companies used font companies to bid; and banks that were bidders, auction organizers, and bidding competitors helped each other with loans guarantees. In the end, the government acquired over $1 billion.[112]

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[110] Roman Frydman, Kenneth Murphy, and Andrej Rapaczynski, "Capitalism With a Comrade's Face," **Transition**, 26 January 1996, p.6
[111] ibid.
[112] Blasi, Kroumova, and Kruse, **op.cit**., p.75

This programme, since the government has no money to pay back the loans, has provoked criticism, mainly because the banks selected to arrange the selloffs often end up buying the assets for a fraction of their real value. To Communists and nationalists in the Duma, the loans-for-scheme symbolized the whole privatization program, and they called for for an investigation. For the supporters of shock therapy for Russia, the loans-for-share program was considered as a key event in the insider-outsider struggle. In their words,

> "The loans-for-share program was considered as a key event in the insider-outsider struggle. Despite the low public participation in stock ownership under the loans-for-shares scheme, one new propertied class in Russia, the bankers, had finally succeeding in pushing the government to design a privatization scheme that did not uniformly favour insiders."[113]

3.4.5. How Much Property did Citizen Get?

The proposed aim or the essence of the mass privatization was free distribution of the assets to citizens. In the summer 1992, President Yeltsin decided to make privatization voucher a centerpiece of economic reform. As he mentioned that " we need millions of owners rather than a handful of millionaries."[114] To realize this end, the voucher auctions were to be held. The system was similar to the Czechoslovakian voucher scheme, although it was more populist. The administrative fee was smaller, even children could participate in the Russian scheme, and everyone got one voucher. In both countries, the intention was to let voucher privatization be massive enough to make it worthwhile and to undertake several issues of vouchers. An important difference was that the Russian vouchers were transferable and tradable. This was seen as a matter of freedom of choice. As Yeltsin pointed out: "Everyone will have equal opportunities in this new undertaking, and the rest will depend on ourselves... Each citizen of Russia and each family will have freedom of choice. The privatization voucher is a ticket for each of us to a free economy."[115]

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[113] ibid., p.83
[114] Aslund, op.cit.1., p.235
[115] ibid.

The Russian people, however, had a mixed opinion of privatization vouchers. They did not believe or support the idea of privatization vouchers as a way to free market economy. The attitude of Russian citizens toward voucher privatization was documented by a number of Russian polling organizations throughout the process. Public support for a move away from the Communist was obvious before 1992, but as time went on, Russians increasingly questioned privatization. The negative views were acknowledged in a series of polls conducted from June to September 1992 by the Russian polling organization VSIOM as the details of the voucher privatization plan for larger companies were being aired. Before the program was implemented, 43 percent of the persons polled thought it was a deception that would make some people richer and the rest poorer; 22 percent thought it would not change anything; 8 percent said it was a program to make people owners; 6 percent viewed it as an attempt to provide people with material assistance; and 21 percent had no opinion. It was clear that Russian people had differentiated attitudes toward voucher privatization.[116]

The voucher privatization program began in December 1992. By September 1994, when voucher privatization was half over, 30 percent of respondents thought privatization was necessary at their enterprise; 26 percent thought it was unnecessary; 6 percent were against privatization; and the rest had no opinion. At the same time, 1 percent felt that privatization had improved the economic performance of their enterprise; 20 percent believed it had made the performance worse; 69 percent saw no change; and the rest had no opinion.[117]

This mixed views raises the question how exactly the vouchers were used and who the owners of the enterprises' stocks actually were. As Joseph R. Blasi said in line with the findings of the Russian polling organization –VSIOM,

> "Of the roughly 149 millions citizens, about 12 million, or 8 percent, said they used vouchers to buy shares at their place of work. About 9 million, or 6 percent said they either sold their vouchers or gave

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[116] Blasi, Kroumova, and Kruse, **op.cit.**, p.76

[117] ibid.

them away. And about 45 million, or 30 percent, said they invested their vouchers in voucher investment funds, which then bought shares for them. No information was available on the remaining 17 percent, so these figures must be viewed with caution. What do these figures mean? Employees of the enterprises have reported that they used the enormous advantages offered to insiders the way –according to this poll- 21 million employees of the enterprises say they used their vouchers. They feared a redistribution of ownership to managers."[118]

As Joseph R.Blasi mentioned, despite the great publicity accorded with the voucher program, doubts, lack of information, or cynicism led 58 million people, or almost 40 percent not to participate in the program. What happened to these vouchers? For example, the *New York Times* reported that one investment banker, Boris Jordan, working for CS First Boston in Moscow, acquired 17 million vouchers on the secondary market for various clients.[119] The ordinary Russian people did not know what to do with vouchers. They mostly sold them away. Managers together with other actors such as the mafia members, ex-communist bureaucrats were very influential in collecting the privatization vouchers from people. The managers together with workers bought other peoples' vouchers so that they could increase their ownership in their own firms. The outsiders were excluded by illicit means, primarily through withholding of information about voucher auctions. Voucher auctions were usually local affairs, dominated by employees, related locals and possibly one or two block holders (usually voucher funds).[120] This situation led to enormous opportunities for corruption, namely for bribery.

In the end, employees of the newly privatized enterprise, who made up about 10 to 15 percent of the population, owned 58 percent of the stock of those companies in 1996. All the other Russians got ownership of only 11 percent of the stock, 6 percent as individuals and 5 percent through voucher investment funds. On the other hand, the very small group of citizens who control Russian commercial firms, certainly less than 1 percent of the population, ended up with 11 percent of all the stock by 1996, while Russian bank holding

[118] ibid., pp.77-78
[119] **New York Times**, 15 September 1995
[120] Aslund, **op.cit**.1., p.254

companies and financial-industrial groups have taken substantial stakes in one in ten of all privatized companies.[121]

Although 35 percent of the shares were supposed to be sold for vouchers, an average of about 20 percent was put up for auction. A presidential decree on the rights of citizens to participate in the privatization was issued in 1993. It established that not less than 29 percent of all shares should be sold at voucher auctions within three months after an enterprise had been corporative. However, the share stayed at around 20 percent, because enterprises continued to resist voucher privatization, preferring to keep the stock for their employees. As Anders Aslund pointed out: " notably oil companies released less than 10 percent of their shares for voucher auctions.[122]

The share of property given to citizens in the privatization process must be viewed in the context of the declining living standards of many Russians. In 1992, as the Financial Times reported in March 1996, " the then state-owned Sberbank's 70 million depositors in effect had their life saving wiped out as hyper-inflation destroyed the value of the ruble. The government is working on a plan to compensate these depositors but the sums are colossal."[123] Citizens saw the privatization in the context of all these events. That is why, they were frustrated by the reform attempts in such a way they even did not involve in voucher privatization efficiently. One another important fact that the reformers had not been able to persuade the government to include all companies in the program of rapid privatization, so the program excluded a large number of controversial companies in order to get the process moving. The loans-for-shares scheme demonstrated that the later privatization of these large and valuable companies did not benefit ordinary Russians. This was one reason why the loans-for –shares scheme served as lighting root for public criticism of privatization. In fact, 43 percent of the Russian stock market was accounted for oil and gas giants, 21

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[121] Blasi, Kroumova, and Kruse, **op.cit**., pp.78-79
[122] Aslund, **op.cit**.1., p.255

percent by electric utilities, 13 percent by metals, and 11 percent by telecommunication firms, many of which were held back from voucher privatization. These were the companies constituted the 100 most valuable companies in Russia. [124] These companies were privatized by the loans-for-shares scheme, without citizen privatization.

To sum up, clearly most people realized that they did not benefit much economically from voucher privatization. As we have mentioned above, there were many reasons for this outcome. Most shares had gone to insiders, and many of the most valuable enterprises evaded voucher privatization. The rights of outside owners were weak, and people did not in their rights as shareowners; many people were disappointed that they failed to purchase shares in concrete enterprises.

The proponent of the shock therapy evaluated the voucher privatization as a positive sign on the road to free market in Russia. They believed that voucher privatization was important in the sense that private property was becoming a reality in Russia. For them, the numbers was more important than who were the real actors in acquiring the private property in Russia. They did not pay attention to corruption and growing role of mafia and ex-communist officials in privatization process. The main two proponent of the shock therapy, Anders Aslund and Andrei Shleifer believed that private property was realized truly by the help of voucher privatization.

> "As a result, 14 percent of the population or 21 million Russians enjoyed direct ownership of shares, and an additional 30 percent or 44 million had indirect ownership. These numbers are truly impressive. Although voucher auctions only privatized one-fifth of the shares of 14,000 large and medium-size enterprises, voucher privatization was towering event in the privatization process. The distribution of vouchers attracted extraordinary attention and was the theme of much government propaganda and information. Voucher privation served to redress the imbalance between insiders and outsider in the privatization process. Otherwise, people would have felt excluded from privatization and their dissatisfaction could have blocked the process. Moreover, information about voucher auctions from the privatization authorities and advertisements of voucher funds come to dominate televisions advertising. They helped to explain what privatization meant and brought people into the process. The transparency of the auctions undoubtedly helped to limit corruption, nomenklatura privatization, and public trust."[125]

3.4.6. Small-scale Privatization

[123] Financial Times, 27 March 1996

While citizens got a smaller portion of the assets of large and mid-sized companies, their participation in private ownership of smaller businesses and apartments was large. In 1992 nearly all firms with fewer than 200 employees were slated for privatization. The privatization offices in the country's eight-nine regions held auctions and sold food stores, barbershops, beauty parlors, clothing shops, cafeterias, and bakeries for cash to the highest bidders. Because the local and regional governments got the proceeds from the sale of these shops and stores, they had powerful incentives to complete the sales quickly. Each region was given a monthly quota of enterprises to be sold, and they had to report their progress to Moscow. According to Joseph R.Blasi, small-scale privatization move forward rapidly and many Russian people took advantage of the freer economic climate and founded hundreds of thousands of small businesses each year of the economic reforms. [126]

As Joseph R. Blasi mentioned: " by late 1995, 105,111 retail stores – six of every ten stores throughout the country –had become privately owned. About 1,000 small busineses a month were still being privatized in 1995. Usually the stores' employees bought them, though outsiders gained ownership of some of them.[127]

Small-scale privatization had reached full speed in August 1992, and on average 5,000 to 6,000 enterprises a month were privatized between August 1992 and April 1993. By the end of 1992, 46,815 enterprises had been privatized. By the end of 1993, about 89,000 enterprises had been privatized, including more than 70 percent of all small enterprises. By September 1, 1994, the number of privatized enterprises had risen to 106,000.[128]

Privatization of housing has moved slowly. By early 1995, only a third of apartments had been privatized –about 11 million apartments – and about a half million apartments were still being privatized each quarter of 1995. Citizens must apply to receive title to their

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[124] Blasi, Kroumova, and Kruse, **op.cit**., p.78
[125] Aslund, **op.cit.1**., p.257
[126] Blasi, Kroumova, and Kruse, **op.cit**., p.81
[127] ibid.

apartments. This implied full property rights, including the right to sell, lease and bequeath their flats. Local authorities were in charge of privatizing flats. The cost was negligible. Initially people were hesitant to acquire title to their apartments. Under communism, rents were low, representing a slight percentage of the tenant's monthly income. Utilities were heavily subsidized, and the state paid for insurance on the apartments. The main incentive for ownership was the ability to sell the apartment, turn it to a son or daughter, or rent it.

> "One government study finds that many tenants fear that private ownership will require them to pay heavily for maintenance and insurance and subject them to discriminatory property taxes. Since the typical apartment house still contained unprivatized apartments in 1996, the state continued to pay the building's operating and maintenance costs."[129]

In the end, several million citizen gained ownership in the privatization of small businesses and about 12 million in the privatization of apartments. Again here, it was clear one more time that most of the Western evaluation of the Russian privatization is based on the speed and numbers rather than the form of ownership. The proponent of the shock therapy paid little attention to the growing role of mafia and nomenklatura in the privatization process in Russia.

3.4.7. The Mafia as a Corporate Power

Throughout the transition period, the Russian Mafia proved itself to be a corporate power. The Russian Mafia, throughout the transition period capitalized their assets, converted privileges enjoyed by custom into property defended by right. Together with the nomenklatura, they have purchased a majority of state-owned assets by using the privatization process into their advantage. The Russian government's Analytic Center for Social and Economic Policies reported on January 17, 1994, that gangs controlled about 40,000 businesses, including 2,000 in the state sector.[130] On February 17, 1994 the Economist reported that private enterprises were forced to pay 10 to 20 percent of their

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[128] Aslund, **op.cit**., pp.249-50
[129] Blasi, Kroumova, and Kruse, **op.cit**., p.81
[130] ibid., p.115

earnings to criminal gangs, and that 150 such gangs controlled some 40,000 private and state-run companies and most of the country's 1,800 commercial banks.[131] In 1995 the head of the Academy of Sciences' Institute of Sociology said that the government believed that criminal structures in the state control over 50 percent of all economic entities. The institute reported that 40 percent of all entrepreneurs and 66 percent of all commercial structures were then involved in criminal relations, and that the Mafia had established control over 35,000 economic entities, including 400 banks, 47 currency exchanges, and 1500 enterprises in the state sector. Quoting calculations by the Academy of Sciences' Analytic center, the report stated that the practice of exacting tribute from commercial in the form of stock and transferred 35 percent of all capital and 80 percent of all voting shares into the hands of criminals. The Russian Mafia exports its capital to foreign bank accounts and then reintroduces it into the country as foreign investment in the name of foreign companies.[132]

The report of the Academy of Sciences' Institute of Sociology referred to a finding by the Interior Ministry that 15,00 criminal associations divided the country into sphere of influence, and that the sphere of commercial activity was expanding beyond small time racketeering. The report mentioned that criminal structures involved in some very remunerative spheres of legitimate businesses: finance, export-import operations in the fuel and power complex, etc. The Interior Ministry also reported that 49 criminal gangs, operating, in Moscow, with 4,000 members, 257 bosses, and 7 kingpins; with money invested banking and financial structures they opened stores, restaurants, casinos, and automotive service enterprises. Several of the top 200 companies were reported to rely on criminal elements to prevent the buying of the shares. Several brokers who bought the shares

[131] **Economist**, 17 February 1994
[132] Blasi, Kroumova, and Kruse, **op.cit**., p.115

of one firm were killed. In 1995, the Russian Business Roundtable lost nine of its thirty top officials to assassins. Forty-five business people were assassinated from 1993 to 1996.[133]

These claims on the Russian economy were subject to enormous discussion. Those who have optimist view of the Russian economic transition accepted that Mafia influence was most evident in the small business sector. In their words, "The Mafia is growing. But the influence that has been ascribed to it is in far in excess of the hard evidence."[134] They denied the idea that Russian economy was on the edge of criminality. They accepted the fact that the reports were pointing toward gradual infiltration of large companies but not yet domination of them. Their question was: To what extent these figures refer to the 17, 937 mid-sized and large privatized enterprises that are at the center of Russian economy? They emphasized, "with the exception of the expensive commodity industries, such as metals and oil, where corruption began before privatization, there is little hard evidence that the Mafia owns these companies."[135] They assumed the above-mentioned estimations to be referring to new businesses and places where criminal influence was widespread, such as small retail businesses and hotels. In their words,

> "This estimate then applies primarily to smaller enterprises, and it appeared at a moments when elements in the Academy of Sciences sympathetic to the old Communist order were regularly issuing press releases condemning privatization. The 1994 estimate of 40,000 businesses under criminal control and 2,000 in the state sector must be examined carefully. By January 1994 about 89,000 enterprises had been privatized. More than 90 percent of them were small retail shops. More than half of all-mid-sized and large enterprises had not been privatized by late 1993, when this estimate was prepared. The "40,000 businesses" referred to in 1994 were four times the number of mid-sized and large enterprises were privatized at that time and twice the number of large enterprises in existence. Moreover, our surveys, reports streaming into the privatization ministry from all regions, and press reports indicated that a majority of the shares went to employees initially. If the 40,000 firms cited included most or all of the larger firms that had been privatized, organized crime would have had to take over the entire privatization process in eighty-nine regions; they had to have forced employees to sign their names to documents declaring a preference for majority employee ownership and subscribing for shares in thousands of enterprises with the collusion of Privatization Ministry bureaucrats in all of those regions –all in about eleven months. Clearly the 1994 estimate must refer mainly to small enterprises, and one must pay attention to the actual assertions in the government report cited by the *Economist* that criminal elements "controlled" these businesses and were demanding payments. If these estimates are correct, the reasonable assumption is that the "criminal control" took the form of the gangs' well-documented and widely reported practice of demanding protection money from start-up small businesses and recently

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133 ibid., p.119

134 ibid., p.120

135 ibid., pp.115-116

privatized small shops. Many observers view this practice as a private attempt to offer protection that the police could not provide in a transitional period."[136]

They also did not pay attention to the fact that Mafia was very influential in collecting the shares of the companies, and they asked:

"Can it be true that 80 percent of corporate shares and 30 percent of capital are controlled by criminals? Not likely. Criminal elements are probably influential chiefly in three areas: first, smaller privatized businesses and start-up firms, where a lot of cash changes hands and a small amount of effort in the area of loan sharking and protection can lead to easy profit with little overhead; second, smuggling and metals, and wholesale and retail outlets where products can quickly be turned into cash; and third, some proportion of very profitable large enterprises that produce such commodities or have access to them. But available evidence is simply insufficient to substantiate the assignment of 30 percent or 80 percent or any other figure to this end. It would be bad Mafia businesses for the figure to be very large, because many big privatized firms are unprofitable, and even organized crime wants a risk-adjusted return."[137]

In this respect, they favored the insider privatization in the sense that the privatization program's strong emphasis on insider ownership was an important obstacle to the organized crime members in their attempts at acquiring control over enterprises. In their words,

"It may be true, as police reports indicate, that organized crime criminals want to move their money into legitimate businesses and invest in undervalued Russian stocks, but the privatization strong emphasis on insider ownership and control has made entry to the larger enterprises costly. Indeed, management's maneuvers to keep out outside investors may have served to keep out organized crime in the early stages."[138]

As was clear in the above-mentioned statements, they involved the reliability of the estimations. In their words, "even if the estimate is correct, the numbers do not bear out the charge that the entire privatization process was criminalized."[139] They were not in conscious the fact that the Russian economy was showing the signs of evolution towards Western-style capitalism on the one hand and the consolidation of corporatist, criminal-style capitalism on the other. In the middle of 1990s, the Western conventional wisdom was emphasizing the former and thus was seeing Russia moving steadily toward market economy. They were not even mentioning about the danger of criminality in the small businesses sector.

[136] ibid., pp.116-117
[137] ibid., p.119
[138] ibid., p.120

3.5. Agriculture

The situation in agriculture was more complicated. As Anders Aslund pointed out private ownership of a farm enjoyed a popular approval rating of 75 percent or more.[140] About 50 million Russian families have agricultural plots and enjoying working the land. Family farming had begun as one of the forms of lease under Gorbachev at the beginning of 1990, but scale was limited. At the end of 1990, there were 4,400 private farms.[141] The Russian reformers had emphasized on the land reform at the Russian Congress of People's Deputies, which adopted the Law on the Peasant Farm and the Law on Land Reform as early as November and December 1990. The Law on the Peasant Farm gave individuals the right to leave collective and state farms with their shares of communal land and assets. However, the Russian Congress of People's Deputies refused to adopt the law before it was amended with the stipulations that no land could be resold within ten years. In addition, the farm's general meeting should decide what assets would go to a peasant farm. The number of peasant farms increased by about 45,000in 1991.[142] However, property rights to land remained limited and the RSFSR Constitution did not recognize private ownership of land, although it was accepted in the Law on Land Reform of December 1990.[143]

Real land reform became a main focus by the Russian reformers throughout the transition years in Russia. The agrarian lobby, however, gained support in Congress of People's Deputies. In April 1992, the majority of the Russian People's Deputies voted against allowing private land ownership. This strong opposition made it difficult to change the constitution. In December 1992, the Democratic Russia movement carried out a campaign to gather signatures for a referendum on land reform. The campaign was successful; 1,9 million signatures were collected, although one million more were needed to

[139] ibid., p.117
[140] Aslund, op.cit.1., p.259
[141] ibid.
[142] ibid., p.260

force a referendum. The Congress of People's Deputies was thus forced to give in to the demands. In the end, the Congress of People's Deputies gave limited rights to sell land.[144]

The agrarian reform was complicated more than ever before when Yeltsin assigned the task of carrying out agrarian reform to Vice President Aleksandr Rutskoi from February 1992 to April 1993. Aleksandr Rutskoi gave in to the demands of the agrarian lobby. He soon decided that the country could not afford to set up more family farms. Instead, he preferred the idea of setting up large agroindustrial companies with massive inflows of state subsidies. The agricultural sector continued to be the largest recipient of government subsidies. And the Central Bank continued to believe in credits to enterprises.

Although popular aspirations for agricultural reform were high, the mighty agrarian lobby, which was composed of the heads of some 25,000 *kolkhozy* and *sovkhozy*, countered these aspirations enormously. These agrarian barons had no interest in the privatization of agriculture. On the contrary they wanted to maintain their *kolkhosy* and *sovkhozy*, as well as a maximum of regulations and subsidies.[145]

The difficulty in reaching at true agrarian reform could only be understood in the politics of lobbyism, which gained momentum in 1992. As mentioned before, two former general directors of military-industrial enterprises, Georgy Khizha and Vlademir Schumeiko, became prime ministers. Georgy Khizha was supervising the military industrial complex. Simultaneously, the general director of Gazprom, Viktor Chernomyrdyn, became deputy minister for energy. The agrarian lobbyists were influential in1992 and in the spring of 1993, Aleksandr Zaveryukha, a true agrarian lobbyist, joined government deputy prime minister for agriculture. Khizha, Chernomyrdin, and Zaveryukha all fought for the interest of their lobbies. In addition, the agrarian lobby was tightly organized with the Agrarian Union, which sponsored the Agrarian Party in the parliamentary elections in December 1992. In the end,

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[143] ibid.
[144] ibid., p.261

they fought against all attempts at true agrarian reforms in Russia and they made success to a considerable extent as well.

In the face of all these difficulties, the reform government tried to introduce a law that would allow private ownership of land. The Supreme Soviet, however, opposed it bitterly. On October 27, 1993, Yeltsin finally issued a decree, "On the Regulation of Land Relations and the Development of Agrarian Reform in Russia," which gave full approval of private ownership of land. With the introduction of this law, it became permissible t buy and sell and as well as to use it as collateral. In fact, this decree had been prepared in the sense that it would prepare the road for the to break up of state and collective farms. However, the agrarian lobbyists were far from any such ideas on the disintegration of state and collective farms since they were very vital to their political presence and material well-being. State and collective farms were very unproductive and inefficient. For instance, although private plots comprised very little of the total agricultural land, they were very productive and efficient. At the same time, government supported all attempts at setting up family farms. The expansion of the family farms continued after the disintegration of the USSR. 134,000 new family farms were set up in 1992 and 87,000 in 1993.This expansion started to fall due to the disappearance of the state subsidies in 1993. In the second half of 1993, only 12,000 new family farms were added, and 7,000 in 1994. One another prominent reason behind this fall was state and collective farms, because family farms were highly dependent on them.[146]

The government also supported to use of private plots. New legal provisions were introduced for full private ownership of the plots. Interestingly, although these private plots had comprised 2 percent of agricultural land, they accounted for 24 percent of gross agricultural production. From 1991 to 1993, the area of private plots was increased to 5 percent of agricultural land in 1993 and they accounted for 36 percent of gross agricultural

[145] ibid., p.260
[146] ibid., p.262

product. The owners of private plots reached at total number of 50 million in 1993 and they were very productive. Under the impact of new legal provisions, anyone who desired could have a private plot. Private plots were supposed to be privatized to their tenants.[147]

In the end, in the face great resistance from the agrarian lobbyists, the government failed in breaking up the power of state and collective farms. The situation in the agricultural sector became more and more complex. Although the retail food prices increased rapidly during 1991-94, the financial situation of the agricultural sector deteriorated in this period. Prices of agricultural input increased sharply while procurement prices increased by less. Profitability in agriculture appeared to have declined 40 percent between 1991 and the first half of 1994.[148] However, as Anders Aslund pointed out the agricultural sector received large subsidies and credits, which, because of the high rate of inflation, were virtual gifts. An attempt was made in late 1993 to reform and liberalize agricultural prices, but following the agrarian lobby's gains in the December 1993 parliamentary election, credits were reintroduced. A number of monopolistic, quasi-public agricultural procurement and importing enterprises continued to operate under the cover of price regulations and compulsory food deliveries to the state. Importers of agricultural goods continued to receive large subsidies.

The supporter of the shock therapy severely emphasized the importance of a true agricultural reform in Russia. The true agricultural reform could not be realized in Russia throughout the transition years due to the above-mentioned facts.

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[147] ibid.

[148] Mieszowski, Peter,Soligo, and Ronald, **op.cit.**, p.34

CHAPTER IV: THE RESULTS OF SHOCK THERAPY AND THE WESTERN PERCEPTION OF ECONOMIC CHANGE IN RUSSIA IN 1992-95

Shock therapy was supposed to bring about a rapid transformation of the Russian economy, building an efficient, technologically progressive, consumer-oriented prosperous capitalist market system. What has actually happened in this period? Has shock therapy worked in the manner that its advocates had predicted? Who has gained and who has lost from this policy? These were the questions pervaded the Western world in the early transition years.

As mentioned before Russian economic transformation was fascinating story on many grounds. Russian economic transformation was subject to great debates in the Western world. While some were arguing that Russia was a distorted picture of capitalism with robber barons, mafia, universal theft, economic stagnation and impoverishment for millions of Russian people, others argued that Russia was moving to a normal market economy.

4.1. The Result of the Shock Therapy

Free pricing was supposed to bring an increase output –the expected "supply response." Store shelves in Moscow and St Petersburg rapidly filled up with a rapid wide variety of goods for sale, and this development cited with approval by the Western media. The appearance of small-scale street traders in Moscow was accepted as both sign of private market behavior and the evidence of supply response to the price liberalization.[1] This development was assumed to be the upcoming signs of Russian market behavior.

The critiques of the shock therapy argued that this did not result from any upturn in production. Instead, the only increase in supply came from an influx of previously unavailable imported goods. The sudden surplus in the markets was due, not to increased supply, but to a

[1] **Economist**, 18 January 1992

drastic drop in consumer purchasing power as rising prices placed many goods beyond the reach of many households.[2]

After the shock therapy was introduced, Russia experienced a severe decline in production sphere. It was such a decline that still continuing at the turn of the century. Figure1.1 shows the decline in several indicators of overall economic activity in Russia during 1990-1995. During the four years following the introduction of Western neo-liberal ideas into the Russian economy, GDP fell by 42 per cent and industrial production by 46 per cent. Figure 1.1 shows that agricultural output also declined steadily although not as rapidly as did GDP or industrial production. Investment suffered a total collapse. This was a great problem that threatened the future of the Russian economy.

There was a great fall in each individual sectors and individual products in the Russian economy. Figure 1.2 and 1.3 shows the output performance of the eleven sectors of Russian industrial production. As these figures showed, during the shock therapy period from 1992 through 1995 all of the sectors experienced large declines in output. Only electric power and fuel declined by less than one-third. Light-industry –which includes textiles, clothing, and leather goods –suffered the worst decline of the group. As seen in the figures, the metal and chemical sectors have finally begun to grow and fuel stopped declining in 1995. There was also a decline in other individual sectors of the Russian economy. Figure 1.4 and 1.5 shows the decline in other sectors in the early transformation years.

The price inflation led by shock therapy led to enormous deformities in the Russian economy. Before the introduction of the shock therapy in Russia, there was a hidden or suppressed inflation in Russia. Soviet consumer price inflation was less than 2 per cent per year in the 1980s and 5.6 percent in 1990.[3] After prices were freed in January 1992, consumer

[2] David M. Kotz and Fred Weir, **Revolution From Above: The Demise of the Soviet System**, (London: Routledge, 1997), p.173

[3] International Monetary Fund, **Economic Review: The Economy of the Former USSR in 1991**, (Washington DC: The International Monetary Fund, 1992)

prices rose by 2,500 per cent over the course of 1992 (31.2 per cent per month). Inflation gradually slowed over the following three years, but in the last three months of 1995 consumer prices were still rising at 4.1 per cent per month, or 63 per cent on annual basis.[4](See the figure 1.6)

By the end of 1995, consumer prices had risen by a factor of 1,411 compared to year-end 1991 and by a factor of 3,668 compared to year-end 1990. As mentioned before, a ride on the metro, Moscow's subway system which cost 5 kopeks (0.05) rubles in 1991 had risen to 400 rubles by June of 1995. A kilogram of beef rose from 2 rubles in Moscow shops in January 1991 to 3,187 rubles in June 1994.[5] The persistent rapid inflation undermined the hopes for economic recovery.

The combination of depression and rapid inflation sharply decreased the real incomes of Russian wage earners and pensioners. In the face of rapid price increases, the ruble rate of pay of Russian workers also rose. The average monthly wage and salary earnings in Russia rose from 297 rubles in 1990 to 595,000 rubles by October 1995.[6] While 2,000-fold increase in ruble earnings over five years could not keep up with rising consumer prices. As a result, real earning fell during this period. The figure 1.7 shows, in 1992 average real pay fell 68 per cent of its 1990 level, climbed slightly in 1993, and then fell to 48 per cent of the 1990 level by 1995. The situation of the pensioners got even worse. The minimum pension fell and reached 25 per cent of its 1990 level by 1995.

In this period it became increasingly common for employees, to be paid late or to be paid only a fraction of their official wage. In March 1995 unpaid wages in industry,

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[4] Vincent Koen, **"Measuring the Transition: A User's View on National Accounts in Russia,"** (IMF Working Paper, January 1995)
[5] Kotz and Weir, **op.cit**., p.177
[6]International Monetary Fund, **Economic Reviews 1995: Russian Federation**, (Washington DC: The International Monetary Fund, 1994)

agriculture and construction alone amounted to an estimated 5.3 trillions rubles, which was about 22 per cent of the total wage and salary bill of Russia that month.[7]

The Russian people including employees, workers, pensioners constituted the losing part in the Russian economic transformation. Their situation gets worse and worse each year. In the Western world, many were paying attention to this aspect of the Russian economic change:

> By early 1995 the real earnings of the average Russian worker had fallen by more than 50 per cent. Many people survived by buying only food. Many Russian urban residents spent their weekends cultivating their patotes and other vegetables at their small dacha outside the city, to survive the collapse of their money income. Rents and utilities remained relatively inexpensive. Purchases of clothing were postponed as long as possible, and new household durables became out of reach for the average Russian family.[8]

The interesting development was that huge decline in production did not bring a massive unemployment. The official unemployment rate reached a mere 3.0 per cent of the labor force in June 1995. Together with those who failed to be registered as unemployed, the number of o-unemployed reached to 7.7 per cent by June 1995.[9] The reason is that Russian enterprises, despite many of them were privatized, have not acted in the traditional capitalist behavior. Although the demand for their products has collapsed, enterprise directors have laid off few its workers. Traditional practices do not die easily and long tradition of paternalism towards employees has made Russian enterprises reluctant to cut costs by reducing the work force. The privatization program also was one another reason behind such development in the ground that the Russian managers needed the shares of workers to become leading one in the management of the enterprises. In this respect, it would be unwise to fire workers since they would sell their shares to the outsiders.

In the face of sharp drop in sales, instead of firing workers, some of the Russian enterprises diverted their production into other spheres such as producing for the warehouse.

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[7] International Monetary Fund, **Russian Federation -Statistical Appendix, IMF Staff Country Report**, (Washington DC: International Monetary Fund. 1995)

[8] Kotz and Weir, **op.cit**., p.180

Many observers reported factory warehouses stocked with goods in the early transition years. For example, in 1992, while only 400,000 passenger automobiles were sold in Russia, 1 million were produced in Russia. That same year factories produced 3.2 million refrigerators and freezers despite selling only 1.1 million.[10] This example was important evidence that the inflation had hit the purchasing power of Russian people terribly.

In terms of foreign trade, although Russian foreign trade was about a total collapse at beginnings of 1990s, Russia foreign trade recovered slowly in 1993 and 1994. Exports outside the FSU fell by 40 per cent and imports declined by about 55 per cent in 1990 and 1992. This decline stopped in 1992 as Russian foreign trade regime became more open. In 1991, trade between the former members of the Council for Mutual Assistance (CMEA) collapsed. In 1992 and 1993 the same thing happened to trade between the FSRs. The volume of Russia's trade with FSRs declined by half from 1991 to 1993. Russia was compelled to reduce its exports to other FSRs, because they lacked international financing and were having repayment problems. Russia's recorded trade surplus towards FSRs was 5.3 per cent of GDP in1992. This was reduced to 3.2 percent of GDP IN 1993, when Russia's total exports to the FSRs amounted to less than $14 billion. Russia's total exports were about $57 billion in 1993.Export outside the FSU recovered slowly in 1993 and 1994.Basic export materials were oil and gas. Since their prices were still under regulation, and no real macroeconomic stabilization occurred in Russia, Russian enterprises were forced to export to survive. In this period, Russia's three export markets were Ukraine, Germany, and China.[11](See table 1.8)

Russian import continued to decline in the early transition years. It was about one-third of 1990 level in 1993. As result, Russia gained an impressive trade surplus of $16 billion in 1993 and $12 billion in 1994. This situation made it possible for Russia to build up its

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[9] ibid.
[10]Jery F.Hough, " Russia -On the Road to Thermidor," **Problems of Post Communism**, 41 Fall, 1994, pp.26-32

international reserves in 1993.[12] Foreign trade in Russia was very subject to corruption and criminality. This would be discussed later.

In the Russian economic transformation, not everyone fared badly. There were gainers and losers. The Western media captured this fact in the early transition years. A CBS News poll conducted a in Russia in May 1995 found that, while 66 per cent of the respondents said they were worse off than they had been before perestroika began, 16 percent said they were better off.[13] The top officers of some of the new banks became very wealthy. One study reported that, of the 50 richest and most influential members of the Russian business elite, 25 were bankers.[14] Others were ex-nomenkaltura members who profited the transitional years enormously. As Marshall Goldman pointed out, 60 per cent of the owners of the newly privatized enterprises were Party officials or former factory managers.[15]

The situation of Russian banks was another evidence in terms of showing the way of Russian economic change. As John Lloyd mentioned, " From the beginning the new financial structures grasped their goal –to make money."[16] The new banks made money from money, instead funding the production. The highly inflationary environment of Russia provided them with enormous opportunities. As John Lloyd pointed out,

> "Easiest of all was to take ruble deposits, change them into dollars, then pay back the depositors in deflated rubles which, even with apparently generous interest, left a substantial gain. The explosion of trading in previously scarce or forbidden foreign commodities was among the most popular activities: trade finance was –if carefully done – a virtual guarantee of profit. When they loaned, they did so at very high rates of interest, and for three or four months at the most. Another purpose of the security armies was to ensure that repayments were made promptly and in full (a large cause of assassinations was the failure to make such repayments.)"[17]

The new commercial banks were finance department or channel banks, which were set up by large enterprises to channel state funds and to conduct money operation for them. For

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[11] Anders Aslund, **How Russia Became a Market Economy** Washington, D.C.:Brooking Institution, p281-282
[12] ibid.
[13] Reported by the Associated press, New York, 10 May 1995, (See, Kotz and Weir, **op.cit**., p.181)
[14] **Business World Weekly**, 9 August 1994
[15] **The Wall Street Journal**, 13 February 1996
[16] John Lloyd, **Rebirth of a Nation: An Anatomy of Russia**, (London:Penguin Group, 1998), p.282
[17] ibid p.288

example, Gasprom had three major banks – Imperial, Mosbiznesnank and Gazprom bank. The oil sector has also four different banks, called Tokobank, Neftekhimbank, Zapsibkombank and Yugorsky Bank; the first of these was in the top of the emerging banking houses. Gazprom together with Lukoil established the Imperial Bank. There were also other commercial banks and most of them were accused of being 'mafia' bank. As John Lloyd emphasized they were used to launder money.[18] There were also other accusations about these commercial banks on the ground that they used state credits for their enrichment. As Anders Aslund pointed out:

> "The subsidized credits were primarily directed towards three kind of enterprises: agrarian enterprises, energy enterprises, and enterprises in the northern regions of Russia. However, those credits were channeled through about 10 commercial banks, the so-called court banks, which sat on the credits for a long time and used them for their own profit. That was a major source of enrichment."[19]

In Russia's inflationary atmosphere, the bankers and their banks grew and got very rich. The bank and the new banker involved in the privatization process. They acquired the most valuable enterprises of the Russian economy through loans-for-scheme deal. In the famous "loans for shares" deal of 1995, Boris Yeltsin handed over control of the largest oil companies and the Norilsk nickel consortium at a fraction of their true worth to a small group of people in return for their support in the 1996 presidential elections. This act consolidated the new oligarchs in their effective command of economy and the government.

The new banking elite was originated from the leaders of Komsomol under the Soviet regime. In the perestroika period, they had started to taste the fruits of the capitalism by involving in trade. For example, Vladimir Gusinsky, who established the Most Group, was selling computer equipment during perestroika period. One another example, Mikhael Friedman, who established the Alpha Group, was selling carpets during perestroika period. Some prominent figures of the reform group in the transition years entered the banking sector. Both Pyotr Aven and Konstantin Kagalovsky, members of the rapid reform advocates,

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[18] ibid, p.287

became bankers, in the Alpha and Menatep Groups respectively; Sergei Dubynin, finance minister after Boris Fyodorov, joined Imperial Bank (sat on the Gasprom board) until he was appointed chairman of the Central Bank at the end of 1995.[20] The prominent prime minister of the Gorbachev years, Nikolai Ryzhkov, who had a deep belief in the regulated economy, became chairman of Tveruniversal Bank and got very rich.[21]

In the mid-nineties, the business people of Russia had become a large, powerful group, which has made great wealth for many of its members. They were very influential not only business but also in politics and media. One prominent figure, called Boris Brezovsky became an important actor not only in Russian economy but also in politics. He was the main supporter of Boris Yeltsin in 1996 presidential election. The logovaz under Boris Berezovsky became the force in the Russian market for foreign cars, especially BMWs, Mercedes, and Volvo. He also involved in media by taking 16 per cent of the Ostankino first channel (ORT) and buying *Nezavisimaya Gazeta* in 1995. Vladimir Gusinsky was the most prominent figure in the media. He bought *Sevodnya* and the NTV channel in 1993. He had close relations with Moscow mayor Yury Luzhkov who had enriched himself through property deals in 1994. Gusinsky's the Most group also funded political parties' of both Gaidar and Yavlinsky.[22] In the end, Gaidar received financial and political support from a number of leading bankers. One another prominent figure was Oleg Boyko, the chief executive of Konsern Olbi, a financial holding company, and president of Bank Natsiolni Kredit. Boyko was a key backer of Gaidar who served as deputy chairman and chief financial officer of Gaidar's Russia's Choice political party.[23] This new rich class was the most who profited from the Russian

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[19] Anders Aslund, "Reform Vs. 'Rent- Seeking' In Russia's Economic Transformation," **Transition**, 26 January 1996, p.14
[20] Lloyd, **op.cit**., p.288
[21] Roman Frydman, Kenneth Murphy, and Andrej Rapaczynski, "Capitalism With a Comrade's Face", **Transition**, 26 January 1996, p.5
[22] Lloyd, **op.cit**., pp.289-303
*See the Chapter 3's privatization part to grasp how privatization program led to enrichment of some prominent officials at the expense of Russian people.
[23] **Kommersant Daily**, 14 September 1995

economic transformation and that's why they were great supporter of the ongoing reform policies. In 1995 Grigory Yavlinsky, who was a liberal economist and political leader of Yabloko, criticized the Yeltsin government for its capitulation to a small business elite that was getting rich on its economic policies.[24] The new business people were also highly corrupt figures. For example, the Harvard Russian economy specialist Marshall Goldman accused Vladimir Gusinsky of having mafia connections.[25]

The new rich class got rich through gaining ownership of privatized raw materials firms such as oil, gas and automotive enterprises, or by investment in real estate and housing construction. Meanwhile, as figure 1.1 showed, there happened little productive investment took place in Russia in the early transition years. The true paradox of the privatization was that it allowed the members of the nomenklatura to achieve something they could not have hoped for even under communism. Some other politicians are reputed to have become wealthy, including two successive mayors of Moscow, Gavril Popov and Yury Luzhkov.[26] Not only politicians but also other officials such as ex-KGB'S prominent figures were also in the struggle to become rich. For example, General Oleg Kalugin, Russia's one time dissident KGB general, became one of his country's richest man, trading around the world in scrap steel from decrepit state factories.[27]

It is widely in discussed in the Western Media that the new rich class have sent large amount of money abroad for safekeeping. It was estimated that capital flight probably reached a total $60 billion to $73 billion between 1992 and 1996. Estimates of the capital flight during 1992-1994 range from $50 billion claimed by the Central Bank of Russia to as much as $100 billion.[28] It was interesting in the ground that this capital flight exceeded the combined inflow of Western direct investment and official aid during those years, which

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[24] **New York Times**, 14 September 1995
[25] Lloyd, **op.cit**., p.288
[26] **Wall Street Journal**, 13 February 1994
[27] Frydman, Murphy, and Rapaczynski, **op.cit**., p.7

totaled to $19.4 billion.[29] Those opponents of the shock therapy in the Western media paid attention to this aspect of the Russian economic transformation and argued that shock therapy prompted a capital outflow from Russia instead of the desired capital inflow. The Russian capital was moving to the accounts in Switzerland instead of being invested in the Russian enterprises for restructuring in terms of technology and management.

A growing gap emerged between the majority, whose living standards dropped rapidly, and a minority who have done well under shock therapy. The opponents of the ongoing reform policies criticized the reform policies harshly in the ground that the implementation of the shock therapy not only changed the choices of Russian people but also hit the health of Russian people.

> "Talented young people in Russia started to dream about becoming bankers, not scientists, whose low salaries made it difficult to meet ends to survive. The quality and availability of health care declined sharply as the government subsidy was reduced. Many young doctors sought to emigrate. Public health services also declined. As a consequence, there have been epidemics of diseases rarely seen in Russia in the past. In the summer of 1993 a cholera epidemic hit southern Russia, and 15,210 cases of diphtheria were recorded in Russia in 1993."[30]

Their critics were also pointing to the right things while they were carrying the elements of nostalgia for the past.

> "Russian science one of the most impressive achievements of the old regime, has suffered along with the economy. Russian research institutes had their budget slashed and were told to find projects that could be self-supporting. Some of Russia's world-class research scientists have had to spend their summers, not working on research, but tutoring American high-school students in order to keep groceries on the table.[31] For example, others left science to take accounting of jobs at banks, responding to the financial incentives. In a unique science version of cheap foreign labor, American corporations have hired top-flight Russian scientists to work for them in Russia, at wages that are a small fraction of their of what they would pay for US researchers."[32]

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[28] **OMRI Daily Digest**, Part I, No.122, 23 June 1995

[29] Economic Commission for Europe (1995) **Economic Survey of Europe in 1994-95**, (New York and Geneva: United Nations, 1995)

[30] **New York Times**, 2 October 1994

[31] High school students from New Jersey and Long Island, gearing up for the Westinghouse science competition, were able to pay to spend a summer under the tutelage of some of Russia's top molecular biologists, protein physiologists, and biochemist in Pushchino, Russia. (**New York Times**, 25 July 1995)

[32] In May 1992, Bell Labs paid for two Russian physicists, leading expert in waves and non-linear optics at the huge General Physics Institute, to do research for Bell labs. They were paid 5,000 rubles per month, or $11 at the current exchange rate. In that same month Corning, Inc., hired 115 scientists and technicians from two Russian research institutes. Sun Microsystems has hired large numbers of Russian computer scientists. (**New York Times**, 11 January 1993)

Organized crime in Russia was another favorite media topic in the Western world. A report prepared fro Yeltsin in 1994 found that 70 to 80 per cent of private banks and businesses in major cities were forced to make payments of 10 to 20 per cent of their revenues to organized crime.[33] The head of the Russian Interior Ministry's organized crime section estimated that 20 per cent of Russian bank loans were actually payments to "mafia" organizations.[34] The organized crime was very obvious and violent. As Konstantin Borovoi, chairman of *Russian* Commodities & Raw Materials Exchange and one of *Russia*'s most prominent businessmen, explained: "The mafia is an attempt to imitate the government. It has its own tax system, its own security service and its own administrative system." [35]

Their activities were ranging from the export of natural resources, the smuggling of nuclear and non-nuclear weapons, managing privatization, banking to drug and prostitute traffic. The banking system became a criminal bonanza. Most of the commercial banks were under the control Russian mafia. For organized crime groups banking sector was very crucial in money laundering and to facilitate their money operations. To facilitate money-laundering operations, which permit the disposal of the profits from organized crime, Russian banks established ties to banks in Antiqua, the Cayman Islands. Even, they established banks there.[36] The Russian Interior Ministry officials estimated that $25 billion was transferred from Commonwealth states to Western banks by organized crime structures in 1993.[37]The organized crime members killed 120 bank employees, including 15 directors, in 1993, and bank offices were subjected to 780 arsons, and explosion that year.[38] At the same year, Sergei Yegorov, president of the Association of banks wrote a letter to President Yeltsin complaining "all of society and new financial and entrepreneurial institutions have become

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[33] **New York Times**, 30 January 1994
[34] ibid.
[35] Paul, Klebnikov.,"Joe Stalin's Heirs" **Forbes**, 27 September 1993, Vol 152. Issue 7, p124
[36] http://open.academic. n2k.com/canvas.cgi
[37] Stephen Handelman, "The Russian Mafia: Politics by other Means," **Foreign Affairs**, May/April 94, Vol.73 p.87

the well-organized, well-equipped bandits."[39] At least two members of the Russian parliament were murdered during 1994-1995, with organized crime believed to be responsible.[40]

It was true of evidences that organized crime groups benefited from enormously transitional policies, especially from privatization process. It was reported that some residents of well-allocated Moscow apartments have been murdered in scams aimed at obtaining ownership of the recently privatized apartments.[41]

One another prominent area for organized crime members was smuggling. A large portion of Russia's raw material exports is reported to be illegal. For example, border guards turned Russia's border with Latvia into a sieve, as result, Latvia managed to export 238, 000 tons of nonferrous metals in 1992 although it produces none.[42] Oil smuggling was one another important area that Russian mafia involved in. The mob operators were very influential in Black Sea to transfer oil. Since oil prices remained regulated, they were at a fraction of world market prices. The difference between the domestic prices of oil and world market prices was one very important reason of the oil smuggling.

> The big money is from oil exports, totaling $7 billion to the world market last year and an equal amount to the former Soviet republics, most of which now have to pay world prices. About half the exports have been going through the mafia-infested Spets-Export firms, which can buy oil at the low domestic price and sell at a market price 400% higher. Bribes and threats frequently accompany the granting of oil export quotas. [43]

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[38] **Boston Globe**, 9 May 1994
[39] **New York Times**, 16 August 1993
[40] Russian legislator Andrei Aizderdzi was shot to death at his home after the newspaper he owned printed the names of 266 organized crime figures (**New York Times**, 28 April 1994). Sergei Skorochkin, a businessman and parliamentary deputy, was kidnapped and slain on 1 February 1995. In a pervious incident, Mr. Skorochkin had shot dead a man whom he had identified as mafia agent. (**New York Times**, 3 February 1995)
[41] When Moscow apartments were privatized, they were generally given to their current occupants. Those living in apartments in choice locations have been offered generous cash deals to trade their apartment for one in a less desirable location, along with an offer of transportation to the new apartment. However, they would not arrive at the new home. Moscow police reported the confirmed murder of 32 Muscovites, with an additional 1,750 unaccounted for, in such apartment scams in the first three months of 1994. One police official suggested city officials in charge of apartment registrations were bribed to look the other way in such murderous scams. (**Moscow Times**, 4 June 1994)
[42] Handelman, **op.cit**., p86
[43] Klebnikov, **op.cit**., p.127

Combating export corruption is tough. Last month Foreign Economic Relations Minister Sergei Glaziev withdrew export privileges from all but five of the Spets-Export firms. Four days later he was fired. [44]

It was highly reported that bribery became a common method of doing in Russia. An academic study of business in Moscow in 1993 found 80 per cent reported that bribes were required to do business. One Moscow businessman told in 1995 that he was able to obtain a 30 to 40 per cent discount from state-owned suppliers of building materials in exchange for business.[45]

The opponent of the shock therapy argued that the rise of organized crime after 1991 related to the shock therapy strategy of reforms and turned Russia into a distorted caricature of capitalism. In the western newspapers and journals, there was a great debate on the definition, origin, nature, extent and influences of the Russian mafia on the Russian economy. There were very many interesting and conflicting views of mafia in the Western media. In the early years of transition mafia became one of the most explosive force in Russian economic life. The Western commentators on the Russian economy underestimated and misunderstood the influence of the Russian mafia on the Russian economy. Some commentators believed that this was the price to be paid for transition to free market economy. Some western commentators believed that it was evidence that points to early stage of capitalism. As Stephen Handelman pointed out:

"Many Russian policy makers (and some foreigners) believe that corruption and crime are the price that must be paid for Russia's experiment with free enterprise.[46] The say that a period of lawlessness is part of price every society pays for radical economic change. Pointing to examples of Latin American economies, they suggest that without certain amount of robber-baron-style entrepreneurship, the consumer goods in most Russian cities would disappear."[47]

According to George Melloan said,

"Russia is right now a bit like America west of Dodge City in the mid-1800."[48]

[44] ibid.
[45] Kotz and Weir, op.cit., p.185
[46] Handelman. **op.cit**., p.87
[47] http://andrsn.stanford.edu/Other/redmaf.htm

Michael Scammell, a professor of Russian literature at Cornell, argued,

> "Today's corruption seems to be characteristic of a profound change and upheaval, when Russian society is in the stage (to paraphrase Marx) of the primitive accumulation of capital. The situation of should be compared not with profit-making today's America but with the rough-and-tumble of America of a century ago, and the new entrepreneurs should be compared with the robber batons of those days. "[49]

Some economist argued, " A corrupt market is preferable to no market."[50] There were even some views about positive effects of Russian Mafia on the Russian economy.

> "Corruption is one-way entrepreneurs can bypass cumbersome roadblocks. Similarly, if formal markets are rigid or monopolized by a small group, then a black market could be more efficient and promote growth. Citizens who made antiquated products for official markets could be more productive in a black market that is more responsive to demand. If current policies promote import substitution (and a ration import licenses), bribing an official to get an import license for a good for which your country lacks competitive advantage (and would otherwise produce at higher cost) should be beneficial to the national economy."[51]

There was also enormous discussion about the origins of the Russian mafia. Some argued that it was a result of the western originated transitional policies that mafia became the most explosive force in the transitional years. On the contrary, some argued that mafia was a fact of communist regime and claimed that Gorbachev reforms (Perestroika) accelerated the mafia and corruption by delimitating property rights.[52] Others questioned the transitional policies on the ground that how it led to enormous corruption in Russia. They questioned the privatization program enormously. For example, Thomas E. Weisskopf questioned voucher program enormously, said that voucher privatization program founded not only the cash basis of further corruption in Russia but also legitimized the criminal earnings in Russia. He had warned that voucher program would not result in transfer of property to the people since inflation decreased the real purchasing power of people.[53]

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[48] **Wall Street Journal**, 16 March 1992
[49] **New York Times**, 26 December 1993
[50] Kennedy Scott, "Comrade's Dilemma: Corruption and Growth in Transition Economies," **Problems of Post-Communism**, March /Apr 97, Vol.44 Issue 2, p.33
[51] ibid.
[52] Cameron Half, "The Russian Mafia: The Challenge of Reform," **Harvard International Review**, Summer97, Vol.19, Issue 3, pp.54-56
For a detailed account of discussions, see also, **http://www.cato.org/dailys/1-07-98.html**
[53] Thomas E. Weisskophf, "Russia in Transition: Perils of the Fast Track to Capitalism," **Challenge**, Nov/Dec92, Vol.35 Issue 6, p.32

Indeed, privatization was one of the most controversial aspects of the transitional policies. According to defenders of shock therapy it laid the foundation of institutional change in Russia by giving property to the Russian people. They believed that privatization was one of the most successful aspects of the transition in Russia.[54] The opponent of the transitional policies believed that it was one main reason of corruption in Russia.

> "Control and ownership of state enterprises were handed over to enterprise managers through worker buyouts with funds provided by their allies among informal entrepreneurs and organized crime groups. By 1996, this process of property transfer left the majority of the formal hierarchies in charge of privatized enterprises and left the banking industry almost exclusively in the hands of former informal entrepreneurs and organized crime groups. Organized crime groups that were left out of this transfer infiltrated banking sector through extortion enforced by contract killing of banking managers who refused to compromise. The formal hierarchies also handed over municipal properties to organized crime members at fractions of their values. As state enterprises and properties were almost being given away, competition among organized crime groups to acquire them led to the gang wars of 1991-1992. The wars ended after the triumphant organized crime group bosses defined territorial and functional through informal agreements that guaranteed monopoly fights for each groups."[55]

Commentators on the Russian transition talked about the lack of legal code to prosecute corrupt government officials, define property rights, permit access to bank accounts, regulate banks, prevent money laundering, screen civil service applicants, inspect the source of foreign capital and soon. As Stephen Handelman pointed out:

> "Under the existing system, police may arrest a group of felons caught in a criminal act, but the lack of Western-style conspiracy laws means police cannot prosecute the mastermind if he or she stays off scene. Under Soviet law, "racketeering" was considered a capitalist concept and therefore, inapplicable to Soviet reality. On the other hand, making a profit—"speculation," a serious offense under the old Soviet criminal code—remains an ambiguous area for post-Soviet law enforcement. Provisions for settling disputes between private companies have yet to be clarified, no guidelines yet exist for establishing contracts or declaring bankruptcy. Russia has no independent judiciary and no way of tackling more sophisticated varieties of white-collar crime. Currents laws offer no means of impounding the records of fraudulent companies or checking the criminal provenance of bank accounts. Even if such provisions existed, their enforcement would be doubtful. Russian policeman are so poorly equipped that some pursue criminals by bus and taxi. In such an environment, it is no wonder that crime flourishes."[56]

They presumed that If Russia had copied a Western legal code; it would not have fallen to victims to organized crime groups. Stephen Handelman criticized the Western countries

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[54] Aslund, **op.cit.1**., p.265

[55] Thomass Mark, "Mafianomics: How Did Mob Entrepreneurs Infiltrate and Dominate the Russian Economy?" **Journal of Economic Studies**, June 1998, Vol32 Issue 2, p.567

[56] Handelman, **op.cit**., p.89

and institutions rightly and proposed that Western countries should provide Russia with necessary legal help.

> "Westerners underestimate the extent to which organized crime and corruption have hampered Russian political and economic reforms. Early assumptions that the introduction of free enterprise would smooth the way for democracy failed to take into account the lingering power of the former Soviet establishment. Organized crime has reinforced the old structures in their battle to retain control over key sectors of the economy and strengthened popular hostility toward the free-market democratic policies pursued by pro-Western reformers. The West should take Russian organized crime far more seriously than it has up until now. The current situation poses a double dilemma to policy makers in Western capitals. While internal Russian developments have moved once again to the top of the international agenda, the West has increasingly less influence over Russia's domestic affairs. Western advice and financial assistance, albeit limited have been discredited by Russia's bruising encounter with the chaos of the marketplace. Nationalist and authoritarian remedies are now descendant. But important areas of influence remain unexplored. The first area requires a conceptual change in economic aid policies and in strategies for developing the Russian market. Until recently, the West concentrated on helping Russia meet its international debt load while encouraging it to carry on with austerity policies. Since December elections, opinion shifted toward providing more overt support for social safety net programs as a way of easing economic discontent. But, these policies still do not address the central problem: the legal vacuum at the heart of the Russian economy. Western advice and assistance in creating a commercial structure, including a viable banking system and regulatory agencies, and in developing a legal framework for business activities would go far toward meeting the security concerns of Russian and foreign investors. International assistance in bringing Russia's justice and law enforcement system into modern era is crucial."[57]

As mentioned by Stephen Handelman, the western countries and institutions could grasp the extent and damages of the Russian mafia on the Russian economy. They just focused on providing Russian with IMF funds and necessary social safety programs. They even did not questioned what was happening to the IMF help in Russia. The communist and nationalist trends in Russia were in their concern mostly. Especially after 1993 December parliamentary elections, these fears were on the agenda. The West main concern was to support Yeltsin and his clan in the Kremlin at the expense of everything, since they were seen as the guarantee of the reforms in Russia. The Western countries were not paying attention to the corruption events in Russia at that time.

As a result, organized crime and corruption hit the Russian economy terribly. They controlled major enterprises, evaded taxes and appropriated state subsidies by forming business lobbies that substantially influenced political decisions.[58] Such massive

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[57] ibid. pp.90-91

[58] Peter Rutland, "Business Lobies in Contemporary Russia." **International Spectator** 32, no.1 (1997): p23-37

redistribution of state funds left the rest of population to a predatory taxing system justified by the need to insure the survival of what remained of state institutions. Because of this and ill-defined formal system of property rights, emerging small entrepreneurs were inclined to evade taxes by keeping their business in the shadow economy. Unable to seek legal enforcement of contract, parties with conflicts invited organized crime groups to defend their interests. Under such conditions, organized crime groups offered their services as passive players throughout the post-Soviet states. They provided protection and informal system of dispute settlement in return for significant fees.[59] They forced the new firms to pay 10 to 20 per cent of their profit. They put new commercial banks under their control not only to launder their criminal earnings but also to send their earnings abroad. This capital flight represented another cost of organized crime. While Russian government was looking for Western economic aid to stabilize the economy, billions of dollars were leaving the country. Estimates of capital flight in 1992 in excess of $4 billion, and by 1994 the figure reached $1-2 billion per month.[60] While hyperinflation reduced real incomes of state employees, the decline in state budget left the police with little resources to fight organized crime groups. As a result, corruption plagued the state institutions all over.

4.2. The Debate in Western World on the Russian Economy

In the early transformation years in Russia, there is no evidence that the application of shock therapy that is transforming the Russian economy into an efficient technologically progressive consumer-oriented, prosperous capitalist market system. The immediate effect effects have been plummeting production, rapid inflation, impoverishment of the majority, increased inequality, declining public services and growing crime and corruption. The argument in the Western camp was that transition policies would lead to prosperity after

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[59] Mark, <u>**op.cit**</u>., p.569
[60] Half, <u>**op.cit**</u>., p.57

prolonged hardship. The transition policies would provoke a short-term decline then recovery would replace it. Their arguments, however, could not be realized in Russia.

The proponent of the shock therapy argued that If Russia in an economic recession, this was due to backsliding and inconsistencies in the implementation of the shock therapy in Russia. Each time, they warned Russian officials to implement reform policies consistently and rapidly to reach at true transformation of Russian economic system. They argued that the neo-liberal ideas have not applied truly in Russia. The problems including recession and corruption caused by excessive gradualism in the implementation of shock therapy. To support their assertion, they put forward the following ideas.

> "Liberalization has been too gradual. The intended liberalization of foreign trade did not occur. While imports were liberalized, export regulation on the contrary became more restrictive. They were the greatest impediment to a true liberalization of the economy. The most damaging kind of foreign trade regulations persisted. Their crucial characteristic was that export licenses and quotas were distributed by fiat by central organs. These licenses were of great commercial value. As could be expected, massive corruption evolved around export licenses, since the procedures for the allotment of licenses are not very transparent. A second problem was that energy prices remain regulated and extremely low by international standards. That's why; there happened massive corruption in this sphere. A third problem was that the limited internal liberalization of both prices and trade flows. Up to 40 per cent of inter-enterprise distribution remained subject to centralized allocation and centralized distribution was usually connected with price controls. Fourth, inter-republican trade remained regulated by state orders. Fifth freedom of enterprise was not really established. Sixth, monetary and fiscal policies were not strict and severe. There were no bankruptcy laws and bankruptcy procedures as well."[61]

As the effects of the shock therapy became known, in Eastern and Central Europe as well as the former Soviet Union, a sizeable literature arose critical of shock therapy. The critics of the western neo-liberal ideas, which were directed at transforming Russian economic system into free market, based on the questioning of each component of shock therapy. First and foremost criticism was put forward by David M. Kotz and Fred Weir. They argued that the belief that a rapid transition was necessary to prevent the old Soviet elite from regrouping and stopping the process was based on a false premise – that the party-state elite was opposed to building capitalism. The great majority of that state elite favored capitalism.

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[61] Anders Aslund and Richard Layard,**Changing the Economic System in Russia**, (London, Pinter Publishers Ltd.,1993) pp.20-25, see also, Anders Aslund, "Russia's Collapse: Winners Takes All," **Foreign Affairs**, Sept/Oct 99, Vol.78, Issue 5, pp.64-75

The problem was die to the fact that they wished a capitalism in which they could enrich themselves at the expense of the great majority. Other critics was based on two different explanations. First, it was argued that shock therapy failed to take account of the structure of the pre-existing socioeconomic system that Russia inherited from the Soviet days. Second, the economic theories underlying shock therapy have serious internal flaws.[62]

4.3. The Questioning of the Individual Components of Shock Therapy

4.3.1. Price Liberalization, inflation, and the missing "supply response"

As mentioned at the beginning, the critiques of the shock therapy argued that this did not result from any upturn in production. Instead, the only increase in supply came from an influx of previously unavailable imported goods. The sudden surplus in the markets was due, not to increased supply, but to a drastic drop in consumer purchasing power as rising prices placed many goods beyond the reach of many households.

The rising prices drove the newly freed ruble's value down relative to foreign currencies, sharply raising the ruble cost of imported goods. Thus, enterprises, after, initially raising prices, found their cost sharply rising, as labor, domestic non-labor inputs, and inputs, and imported inputs all became more expensive. The cost squeeze led enterprises to raise prices again and again. The result was cost-price spiral.

The inflation was made worse by the highly monopolized economy, which Russia inherited from the Soviet days. Russia's giant enterprises faced little competition and did not fear inroads into their markets by new rival firms. In the end, they increased prices without restraint.

Rapid inflation unleashed by price liberalization created a poor investment environment, which also worked against any positive supply response. Rapid inflation caused people and institutions that had money on hand to exchange their rapidly depreciating rubles

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[62] Kotz and Weir <u>op.cit</u>., pp.186-87

for assets that were expected to hold their real value, particularly foreign currencies, real estate, and minerals. As those with money to invest poured it into such assets, their prices driven up rapidly. This created opportunities for very high profits from speculation –that is, from buying whatever has a relatively rapidly rising prices and reselling it later. Those positioned to do so made quick fortunes. As a result, little productive investment took place in Russia.

4.3.2. Macroeconomic stabilization

The anti-inflation policy component of shock therapy required the reverse of state spending. As was mentioned in the third chapter, shock therapy's tight fiscal and monetary policies could not stop inflation. Indeed, the tight fiscal and monetary policies could not be applied in Russia. The proponents of the shock therapy argued steadily that inflation was a result of soft monetary policies in Russia. The opponent of the shock therapy's tight and fiscal policies believed argued that shock therapy's tight public spending and monetary policies carry serious long-term cost for Russian economy. They argued that scarce credits are a major obstacle to the much-needed modernization of Russian industry.

> "For example, the automobile enterprise VAZ (Volga Automobile Associated Works) has had success in international markets with its Lada model. But tight monetary policy has blocked the access to credit it needs to raise its product to world standards. A company official remarked bitterly, " The IMF is not interested in Russian car production. Why keep car production going here, when car companies in the United States and Japan can't sell all the cars they make?"[63]

4.3.3. The Problem of Privatization

The Russian government succeeded in privatizing most of Russia's enterprises. This policy, however, did not bring the expected benefits for the Russian economy. The policy of rapid privatization imposed high cost on Russian society. Russia had no pre-existing legitimate wealthy class of people who could buy large state enterprises. Under such

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[63] New York Times, 23 July 1992

conditions, it was inevitable that the nomenklatura and mafia members became influential in the privatization process at the expense of Russian people.

> "For example, Deputy Minister Rem Vyakhirev became second-incommand and replaced Chernomyrdin when he move back to the government as deputy prime minister. Forbes magazine estimates that Vyakhirev's net worth today exceeds $1 billion. Similarly, Vagit Alekperov, the acting minister of the Fuel and Energy Ministry during Soviet days, was also identifiedin Forbes' list of billionaries. Despite the fact that the state retained ownership of sub-soil minerals and most of the land, Alekperov put together a collection of choice properties, including oil fields and refineries, into what in 1991 became Lukoil. Today, it is Russia's largest oil company, producing more than 50 millions tons of crude oil annually."[64]

Privatization together with the other components of shock therapy has been major cause of rapid expansion of organized crime and corruption. Besides members of old elite, the other group in society well positioned to gain control of the newly privatized state assets was organized crime.

Handing over the enterprises to private owners did not assure that they would be operated efficiently. The opponent of the shock therapy argued that the shock therapy's advocates exaggerated the form of ownership. They argued that the advocates of shock therapy did not comprehend how Soviet communism had left a demoralized and dissatisfied work force. They argued that restructuring Russia's enterprises would be wiser policy instead of privatizing them.[65]

4.3.4. The limited impact of free trade and investment

Under the new policies of relatively free trade, foreign products quickly displaced many domestic ones in the main cities. Some commentators on the Russian economy argued that the liberalization of trade and investment had limited effect on the Russian economy. They argued "while this may provided some incentives for Russian industry to produce more efficiently, the peculiar nature of Russian market has limited such effects. The new rich and middle-class are the main market for such surge. They prefer foreign products and do not object to the high prices most imports carry. The majority of Russians, who have been left

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[64] Marshall I. Goldman, "Russia's Energy: A Blessing and A Curse," **Journal of International Affairs**, Fall 99, Vol.53, Issue.1, p.76

with very limited purchasing power, can buy some imported food or small luxuries, but they are largely forced to rely on cheaper domestic goods. Thus, the new imports exert less of the competitive pressure for product improvement or price restraint than had been expected."[66]

They continued to argue that most of Russia's industry could not yet compete with Western products on an equal footing. That is why, turning the country open to relatively free importation is not wise policy. They even proposed protectionist policies to support Russian industries from severe superior foreign competition.

As to foreign direct investment, Russia failed to attract much of it. Total direct investment in Russia during 1992-1994 amounted to $3.9 billion. That averaged about $9 per capita per year for the Russian population.[67] There were foreign direct investment only in the sphere of oil and raw materials. . Russian oil companies were in need of foreign investment not only to stop decline in oil production but also to accumulate capital and modernise the obsolete oil industry. While foreign investors were certainly eager to invest, resistance came from the heads of the various Russian energy companies, as well as other members of the Russia's new rich class. One of the most powerful oligarchs, Boris Brezovski, insisted in January 1998 that it was not Russia's interest to allow foreigners to make strategic investment in energy sector. [68] The Communist party and nationalist camp in the Russian parliament shared similar views. Foreign investment was limited due to lack of legal protection and continuing bureaucratic reasons. Rapid inflation, expanding crime, corruption and hostility against foreign firms constituted other major obstacles. For instance, as to investment in Russian oil and other companies, enterprises, foreign investors had limited

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[65] Kotz and Weir, **op.cit**., p.191
[66] ibid., p.192
[67] Economic Commission for Europe (1995) **Economic Survey of Europe in 1994-95**, (New York and Geneva: United Nations, 1995)
[68] **http://www.rferl.org/newsline/1998/03/200398.html**
*Production-sharing agreements

legal regulations to preserve their share holdings. The attitude of the Russian business community against foreign investment was very hostile as well.

> "The fleecing of Kenneth Dart's investments in several Russian petroleum-operating companies is one of the most notorious examples of what can happen to even the most sophisticated foreign investor. Navaromco, a Cyprus-based company established by Dart, invested substantial sums in two Russian petroleum-producing companies, Samaraneftegaz and Noyabrskneftegaz. Both companies controlled valuable operating oil fields, and investment seemed to be a clever and cheap way to gain access to some of the state-owned petroleum reserves. Yet in both cases, Dart found that he could do no more than stand by helplessly as majority shareholders proceeded to trample on his legal rights as a minority stockholder. In the case of Samaraneftegaz, Dart discovered he had been outmaneuvered by Yukos, the oil company whose majority stockholder was Mikhail Khodorkovsky and his Menatep Bank. Khodorkovsky had borrowed $800 million from Western banks such as Goldman Sachs, Merrill Lynch and Credit Lyonnais. While the loan was not a problem, the collateral Khodorkovsky put up to borrow the money was the stock of Samaraneftegaz. This meant that if Yukos encountered difficulties--as it did due to falling oil prices in late 1998--Dart's investment would simply be wiped out when creditors claimed the collateral. Dart was similarly outmaneuvered in Noyabrskneftegaz by the Siberian oil company Sibneft, in which Boris Berezovsky owned 97 percent of the company's equity Berezovsky's banditry was more complex than Khodorkovsky's. For years Noyabrskneftegaz had sold the oil it produced at a low price to Sibneft, which then resold it at a high price. So Noyabrskneftegaz operated at a loss while Sibneft was extremely profitable. In addition, Noyabrskneftegaz decided to issue shares secretly and then sell them to four investment companies, which by coincidence resold those shares to Sibneft. What upset Dart was that the shares were sold at 50 percent of the market price, and existing stockholders were not given the preemptive right to participate in a similar purchase. As a result, Dart's share of ownership in Noyabrskneftegaz declined from 7.6 percent to 4.4 percent, while Sibneft's share rose from 61 percent to 78 percent. Moreover, the shares that Dart held fell in value by 40 percent." [69]

One another major obstacle was whether Western oil companies could share in production of newly developed fields via production share agreements. As Marshal Goldman pointed out:

> "The struggle to convince the Duma to pass a law formalizing the rules for PSAs* reflects the same concerns. Whenever possible, foreign oil companies have urged the passage of such agreements because it would allow them to act as if they had an equity interest in the fields they are developing--for if production increases, so would their share of the output and revenue. Another benefit of such an agreement is that by agreeing to a fixed tax regime, the state cannot later finagle other means to capture any windfalls or production increases generated by the Western operator. Realizing that a PSA law would attract substantial foreign investment and increase output, President Yeltsin had periodically urged the Duma to pass such legislation. When it refused, he issued a decree authorizing many of the same benefits. After time, however, many Western oil companies became wiser to Russia's ways and refused to invest further."[70]

In 1992, President Boris Yeltsin had decreed that foreigners could only purchase up to 15 per cent of the stock of a Russian oil company. However, as to protection of share

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[69] Mashall I.Goldman, "Russian Energy: A Blessing and A Curse," **Journal of International Affairs**, Fall99, Vol.53 Issue 1, p.78
[70] ibid., p.77

holdings and other legal regulations to facilitate foreign investment, no other regulations took place in the following years. As result, to invest in Russia became a risky business. In response, foreign investors reacted by putting their investment in the non-Russian states surrounding the Caspian Sea. In the early years, there have been 40 joint ventures with the Western companies in the oil business in Russia.[71]

The drop in Russia's energy output continued through the late 1990s and 1990s.By 1996, 293 million tons of petroleum were produced, compared to 536 millions tons in 1985 – a drop of more than 45 percent.[72] In order to offset this decline, President Yeltsin revoked a decree in November 1997 and authorized foreigners to own 100 percent of stock. Finally, in December 1998 the Duma passed the necessary facilitating laws, which were aimed at facilitating production-sharing agreements.[73]

The opponent of the shock therapy assumed the shock therapy's results to be responsible for the failure of direct foreign investment in Russia. They argued "The continuing legal and bureaucratic obstacles faced by foreign investors are undoubtedly part of the reason. But even these problems been solved, the conditions created by shock therapy did not make Russia an attractive location for the kind of foreign investment that was desired. Rapid inflation, falling production, decline in real incomes, and expanding crime and corruption created an environment that is very unstable, both economically and politically. Foreign investors will not make any long-term investments in any country suffering such conditions."[74]

4.4. An Alternative Approach to Rapid Economic Transformation

The opponent of the rapid economic transformation in Russia proposed a different alternative that is based on gradual transformation of the economic system. They argued that

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[71] ibid., p.78
[72] ibid., p.74
[73] ibid., p.76
[74] Kotz and Weir, <u>op.cit</u>., p.192

the designers of shock therapy both showed a deficient understanding of the process by which a capitalist system develops and paid little attention to the features of the pre-existing economic system in Russia. "History shows that gradual economic transformation can indeed work. Capitalism fist arose in Britain very gradually over a period centuries," they argued.[75]Some also found shock therapy's laisesez-faire approach to transforming the economy is unrealistic.

> "Some historians believe that capitalism developed in Britain with little state help, although even that is disputed. But there is no dispute that later transitions to capitalism received major support from the power of government. In the United States the federal and state governments played a critical role in fostering capitalist development in the early and mid-nineteenth century. Government subsidized and built canals and railroads, educated the labor force, and protected manufacturers from superior foreign competition."[76]

They proposed an approach that is called a two-sector strategy. This strategy based on developing a new private alongside the old state sector, rather than converting state sector into a private market sector. By keeping state-produced input cheap and providing low-cost credit for start-up enterprises, favorable conditions could be created for starting new-consumer-goods firms. This was the strategy China has followed since the late 1970s.

4.5. How Shock Therapy Failed to Take Account of the Features of the Pre-existing Economic System in Russia

The advocates of the shock therapy failed to take account of the features of the pre-existing economic and political changes in Russia. That is why, their policies failed in bringing the necessary changes in Russia to reach at free market. From the beginning it was clear that their policies would result in failure.

First, the state socialist system was a very centralized one in which outputs and production processes were closely specified for enterprises all across the Soviet Union from the center in Moscow. In this system, there was logic to building very large enterprises with only one or two sources that are producing each major product. The system was ver

[75] ibid, p.193
[76] ibid, p.194

monopolistic. Second, the system was based on a very high degree of vertical integration. Each enterprise would receive a given input from the same sources. In a sense, individual enterprises were not really separate, independent entities like capitalist firms. The system was a vast, inter-connected, integrated production machine. Third, many towns and cities in Russia dominated by a single enterprise, or a few enterprises. These enterprises were providing cities with not only employment but also with social services. Fourth, since the system worked by direct allocations of gods and services from one another, the financial side of the system remained very underdeveloped and largely passive. Financing was automatically provided for planned activities and played no independent role in directing production. One another feature of the system, it was highly corrupt.

These features of the state socialist system explain why western neo-liberal ideas on the transition of Russian economic system failed to bring prospects for successful transition in Russia. Because the system was highly monopolistic, it was highly difficult to restructure the existing system. By stopping credits, it was hoped that market forces would drive firms that were inefficient or produced unwanted products out of business, while rewarding those that effectively met consumer wishes. But the vertical integration and company- town structure of the inherited Russian economy made this unworkable. As Leijonhuffud, A mentioned, "if one inefficient producer goes bankrupt, it will drag on down many other enterprises, efficient or inefficient, that depend on it for either supplies or markets. And down with bankrupt enterprises go the towns and cities dependent on them for employment, tax employment, tax revenues, and public services. A scheme of market-determined bankruptcy, given this economic structure, is not appropriate. The pressure to keep the pipeline of credits and subsidies open, even if at a reduced rate of flow, was very difficult to resist. The state has little choice but to keep enterprises afloat through direct subsidies and cheap credit. This suggest that it is not possible to turn enterprises into autonomous entities as the privatisation program envisions, as well as rendering tight monetary and fiscal policy ineffective as a means to rein in the inflation." [77]

IMF also played a harmful role in Russia's transition to free market by advocating shock therapy as a mean to Russia's transformation into a free market economy. From the beginning, it was highly clear that shock therapy was not applicable in Russia. In the beginning of 1992, there was a deep belief in the Western economists and IMF specialists that inflation could be stopped in Russia if the ruble is stabilized thorough IMF's stabilization fund. However, IMF failed to bring the $24 billion aid package in 1992. The leading figures of shock therapy such as Jeffrey Sachs and Anders Aslund argued that it was a fatal mistake that the Western countries could not provide the real reform government with the necessary stabilization funds and thus helped growing of conservative elements in Russia.

Western countries had one big chance to make a difference, at the beginning of 1992. The West, especially the United States, enjoyed enormous goodwill and influence in Russia. It should have used his power to push for all the measure necessary for Russia's complete economic reform –liberalization of commodity prices, deregulation of exports, unification of exchange rate, and the establishment of market interest rates – which are standard elements of any International Monetary Fund (IMF) program. President Yeltsin appealed to the West for help, but in vain. The IMF concluded a minor agreement in July 1992, but by then Russia's reformers had been defeated, in part because they had counted on the West's help. Instead, Western countries were preoccupied with securing repayment of the Soviet debt. Rather than providing money for reforms, they gave credits to dubious commodity traders. A remorseful West has repeatedly tried to make amends for its initial lack of action. But its support, primarily through IMF, has gone to far less reformist governments, and the result have been mixed.[78]

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[77] A, Lejonhufvud, **New Left Review**, 199:1993, p.123
[78] Anders Aslund, "Russia's Collapse: Winners Takes All," **Foreign Affairs**, Sep/Oct99, Vol.78, p.69

By supporting the monetary union among former Soviet republics, IMF played a harmful role in Russia. The result of that policy of monetary union became one important reason of the inflation in Russia in the early years of transition. Russia received over $18 billion IMF help until 1996. In each case, IMF demanded that Russia should adopt the necessary reforms. But despite defaulting on its promises, Russia continued to receive financial aid. In other words, the cheap credits allowed Russia to delay its reforms, while the IMF was effectively rewarding Moscow for not reforming.[79]

The IMF and the western countries could not grasp the importance one fact that the post-communist Russia was governed by those many former communist apparatchiks and most of them were at the core of the Yeltsin regime. None of them has an understanding of free market economy and democracy. There was a huge knowledge gap. That's why, the reforms had no sophistication, scope and discipline. That's why, the necessary reforms such as the bankruptcy laws, the rule of law, anti-monopoly mechanisms, shareholder rights and inadequate measures concerning corporate governance could not be followed strictly in Russia. The combining result was an atmosphere in which corruption and crony capitalism of the worst kind flourished.

The macroeconomic policy failure of the West and the IMF was combined with their ignorance in building necessary institutions and providing Russia with necessary legal codes in terms of business for creation of a modern market economy. Furthermore, the West and its institutions such IMF failed to address the huge knowledge gap in Russia. Russian entrepreneurs, politicians and managers severely lacked modern economic and business knowledge. That's why, population resorted Soviet-era of behaviour of stealing from and cheating state. Embezzlement and corruption became rampant. Historic Russian and Soviet-

[79] For a detailed account of discussion, see also,**http://www.heritage.org/insiderrussia/updates/testimony091798.htm**

era business practices caught up with post-communist Russia. The Western countries did not pay attention to these facts.

4.6. Conclusion

The principal sign of the stabilization of a political system is the creation of a new ruling class; the term "new ruling class" in itself implies something distinct from the old class.[80] The post-communist period in Russia in many respects was an incomplete revolution profound continuities and political practices. In contrast to Germany, after the Second World War, where its traditional order had been destroyed by defeat and allied intervention, it was out of the old Soviet order that new Russia was born. As Richard Sakwa pointed out, "the post-communist system emerged out of the old nomenklatura and its way represented the reconstitution of late Soviet forms of rule –but without the CPSU."[81]

The transformation of Politburo member into the President, the oblast Party secretary into the mayor, the criminal entrepreneur into a businessman implied the transformation of a new elite as the formation of old in the post-communist Russia. The new elite dominated many of Russia's regions and republics.

After the coup in 1991, Yeltsin concentrated on economic reform at the expense of democratic renewal and remarkably little decommunization took place. There was remarkably little turnover in the regional and local elites. According to Olga Kryshtanovskaya 75 per cent of the new political elite and 61 per cent of the new business elite came from the old Soviet nomenklatura.[82] Yeltsin regime established a strategic alliance with the old administrative elites by choice to secure a social base to his own rule. Indeed, an important reason why the collapse of communism was so peaceful was that the old elite had split up and the economically oriented part of the old elite opted out of communism.

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[80] Andrei N.Nedishevski, "The Formatioon of a Ruling Class," **Russain Social Science Review**, Sep/Oct97, Vol.38, Issue5, p.51

[81] Richard Sakwa, **Russian Politics and Society**, (London: Routledge Press, 1996), p.159

However, they did not want a competitive market immediately. They preferred an intermediate stage in which they could take more control of the economic assets.

Russia' transition from a command economy to capitalist economy has been a struggle between rent-seekers and those who wanted to apply reforms to consolidate capitalism in Russia. In the early transitional years, the foreign observers misjudged the real threat to economic and political reforms. They firmly focused on nationalism, fascism (the central threat to economic and political reforms), unemployment, starvation and inflation. To a considerable extent, these were threat to market economy and democracy in Russia. Throughout the transition period, inflation turned out to be a major problem, and persistently high inflation brought about a sharp fall in output and in the standards of living of people in Russia. It also led to an increase in wealth differentials among people in Russia.

The central threat to market economy and democracy was the existing and growing rent-seeking sector consisted of economic and political figures. Rent-seeking refers to any activity designed to exploit a monopoly position or to gain access to government subsidies, as opposed profit-seeking in a market with competitive firms.[83] When communism was collapsing, the Soviet Union was a paradise for rent-seekers. The methods of rent-seeking were, arbitrage, import subsidies, subsidized credits and nomenklatura privatisation.

Arbitrage was the fundamental method of rent-seeking: buying cheaply at fixed state prices and selling at high free-market prices. That was the main preoccupation of the cooperatives that mushroomed in the Gorbachev era. In 1988, state managers were allowed to set up private co-operatives for arbitrage with their government- owned businesses. Managers of oil companies bought oil from their enterprises privately, extracted export licences and quotas from corrupt officials, and sold the oil abroad at the market price. In 1992, when Yegor Gaidar tried to end this rampant embezzlement by freeing Russai's

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[82] Olga Kryhshtanovskaya and Stephen White, "From Sovite Nomenklatura to Russain Elite," **Europe-Asia Studies**, Jun 96, Vol.48, Issue 5, pp.3-4

commodity prices and exports. The state energy lobby, led by Chernomyrdin and supported by communists resisted enormously. Eventually, the reformers succeeded in deregulating commodity prices, but only after managers extracted billions of dollars from their enterprises.

A similar source of rents was import subsidies. In the winter of 1992, the fear of famine was real. The reformers thus had no chance to abolish the existing subsidies for food. A food importer paid only one per cent of the going exchange rate when purchasing essential goods from abroad, but could resell them relatively freely on the domestic market and pocket the subsidy. These imports were paid for with Western "humanitarian" export credits that were added to Russia's state debt. Total import subsidies were 17.5 per cent of Russia's GDP in 1992. These profits were highly concentrated, benefiting a limited number of traders in Moscow who operated through the old state agricultural monopolies.[84]

Another form of rent was huge subsidized credits. Business elites had an alternative way of making money in the early 1990s: cheap credits from the Russian Central Bank. Under the Soviet system, interest rates had no economic function. When prices liberalized in January 1992, money became scarce, as the money supply did not rise as fast as prices. The state enterprises urged the government and the Central Bank to replenish their working capital, and unfortunately, the government and Central Bank gave way to those demands to a considerable extent. In 1992, while inflation was 2,500 per cent, the bank issued credits at 10 or 25 per cent a year. Thus, those credits were virtual gifts from the state to the enterprises that received them. The total volume of credits amounted to some 30 per cent of the GDP in 1992. Many bankers became rich enormously.[85] Nomenklatura privatisation was another form of rent, which was discussed, extensively in the third chapter. Nomenklatura privatisation benefited most enterprises, but particularly the managers of energy enterprises.

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[83] Aslund, **op.cit.2**, p.17

[84] Aslund, **op.cit.3**.,

[85] Brigitte Granville, **The Success of Russian Reforms, London**: (The Royal Institute of International Affairs, 1995), p.67

In the end, a relatively group benefited enormously from rent-seeking during the end of communism and the birth of capitalism. The sectors where most rent-seeking occurred were energy, agriculture, trade and banking. The rise of oligarchs was a direct result of slowand partial reforms. As aforementioned, the economically oriented part of the old elite had opted out of communism in the Gorbachev era. However, they did not want a competitive market immediately. They preferred having an intermediate stage in which they could enrich themselves at the expense of people.

The truth about Russia, in the early transitional period, was that it was ruled by a handful of men who were called oligarchs. In 1996, the Yeltsin victory in the presidential election was distinguished by the rise of a new class of oligarchs. After the elections, the bankers, media barons, and the industrialists who had financed Yeltsin's election campaign got rewards they wanted. These rewards were positions in the Kremlin, broadcasting and commercial licences, and access to national resources pile.[86] The new oligarchs were so humiliating to Russians not because they are wealthy but because so little of their wealth found its way back to the Russian economy.[87]

If Russia is in an overall social, economic and political crisis, the nomenklatura revolution gives us the hints. The transition was in many respects was an incomplete revolution with profound political, economic and social continuities. In Russia, pattern of political transition left much of the old system in their place. That's why, Russian economic reforms doomed to failure.

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[86] Grigory Yavlinski, Russia's Phony Capitalism: Oligarchy or Democracy, **Foreign Affairs**, May/June98, Vol.77 Issue3, p.70

[87] ibid.

APPENDICES:

Appendix A. Privatization

	1994	1995	1996	What General Directors wanted
Insiders	65%	55%	58%	69%
Management	25	16	18	44
All the top managers	7	8	10	40
General Director	2	3	4.5	13
Middle and Lower Managers	-	8	8	1
Nonmanagement employees	-	39	40	25
Outsider, Russian	21	32	32	24
Citizen	-	9	6	-
Unrelated commercial firms	-	8	11	-
Suppliers	-	3	2	-
Customers	-	2	1	-
Other firms	-	2	1.3	-
Investment funds	-	6	5	-
Holding companies	-	1	2.6	-
Banks	-	1	1.6	-
Pension funds	-	-	0.02	-
Insurance companies	-	-	-	
Foreign corporations, banks, individual funds	-	1	1.6	-
State	13	13	9	7

Figure 1.1 Inside and outside ownership of enterprises, 1994-1996 (percent)
Source: Russian National Survey, 1994-1996 (See, Joseph R. Blasi, Maya Kroumova, and Douglas Kruse, **The Privatization of the Russian Economy**, (Cornell University Press, Ithaca and London, 1997), p.193)

Majority Owners	1995	1996
Employees	59.0%	64.7%
Rank and file	26.7	30.5
Managers	2.3	4.2
Top Managers	0.4	0.4
General Director	0.4	0.8
No majority insider	29.4	28.8
Nonstate outsiders	17.3	19.8
State	3.1	2.6
None	20.3	12.8

Figure 1.2 Majority owners of private-sector corporations, 1995 and 1996 (percent)
Source: Russian National Survey, 1994-1996 (See, Joseph R. Blasi, Maya Kroumova, and Douglas Kruse, **The Privatization of the Russian Economy**, (Cornell University Press, Ithaca and London, 1997), p.193)

Appendix B. Macroeconomic Indicators on the Russian Economy

	1991	1992	1993	1994	1995	1990-94	1991-94	1990-1995	1991-95
Gross Domestic Product	-9	-19	-12	-15	-4			-47	-42
Industrial Production	-8	-18	-14	-21	-3			-50	-46
Agricultural Product	-5	-9	-4	-12	-11			-35	-32
Investment	-15	-40	-12	-27	- -	-67	-61		

Figure 1.1 Percentage Change in Macroeconomic indicators for Russia
Source: International Monetary Fund, *Russian Federation –Statistical Appendix*, IMF staff Country Report, Washington DC: International Monetary Fund, 1995, p.85

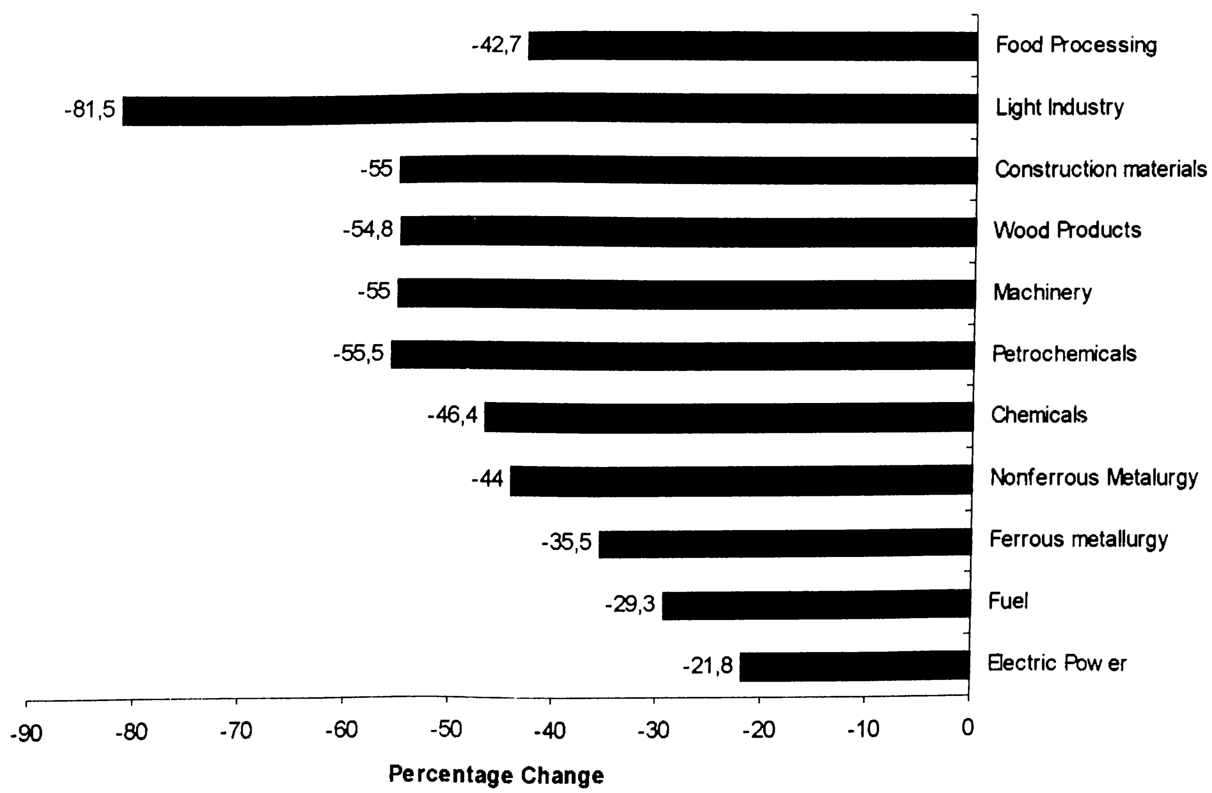

Figure 1.2 Percentage change in real gross industrial output by sector, 1991-95
Source: International Monetary Fund, 1995, *Russian Federation –Statistical Appendix*, IMF staff Country Report, Washington DC: International Monetary Fund, 1995

Sector	1991	1992	1993	1994	1995
Electric power	0.3	-4.7	-5.3	-8.8	-5.0
Fuel	-9.0	-7.0	-15.0	-10.0	-0.6
Ferrous metallurgy	-7.4	-16.4	-16.6	-17.4	+12.0
Nonferrous metallurgy	-8.7	-25.4	-18.1	-9.0	+0.8
Chemicals	-8.3	-22.6	-19.9	-20.0	+8.0
Petrochemicals	-3.0	-19.4	-24.9	-35.0	+13.0
Machinery	-10.0	-16.2	-16.6	-33.0	-4.0
Wood products	-9.0	-14.6	-18.7	-30.0	-7.0
Construction materials	-2.4	-20.4	-17.6	-27.0	-6.0
Light industry	-9.0	-30.0	-23.4	-46.0	-36.0
Food Processing	-9.5	-16.4	-9.2	-17.0	-9.0

Figure1.3 Percentage change in real gross industrial output by sector
Source: International Monetary Fund, 1995, *Russian Federation –Statistical Appendix*, IMF staff Country Report, Washington DC: International Monetary Fund, 1995, p.2

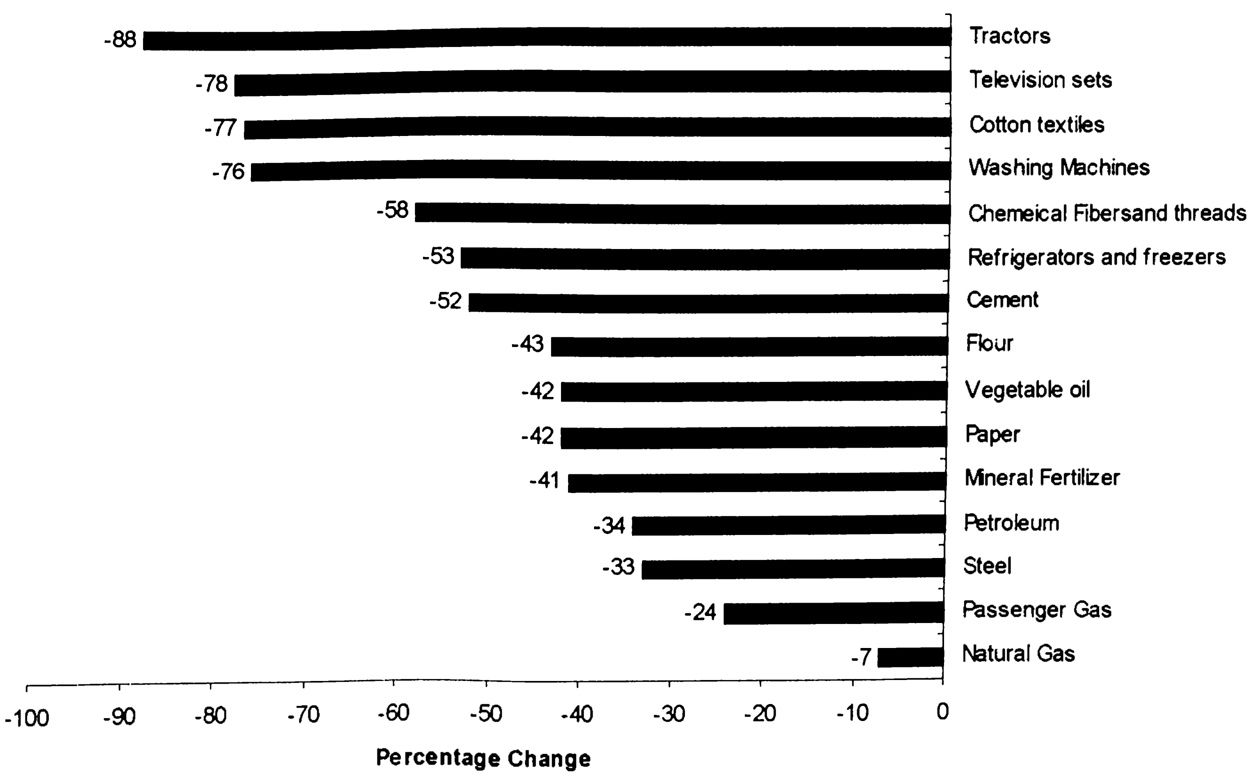

Figure 1.4 Percentage change in output volumes for selected products, 1991-95
Source: International Monetary Fund, *Economic Reviews 1995, Russian Federation*, Washington DC: The International Monetary Fund, 1995, p.66

Sector	1991	1992	1993	1994	1995
Natural gas (billions of cubic meters)	643.4	641.0	618.5	561.1	600.0
Passenger cars (thousands)	1.030	963	956	799	785
Steel (million tons)	77.0	66.9	58.1	48.8	51.6
Petroleum (million tons)	462.3	399.3	353.5	312.7	306.8
Mineral fertilizers (million tons)	15.0	12.3	10.0	7.5	8.9
Paper (thousands tons)	4.765	3.604	2.882	2.214	2.775
Vegetable Oil (thousands tons)	1.165	994	1.137	793	678
Flour (million tons)	20.5	20.4	17.2	12.7	11.6
Cement (million tons)	77.5	61.7	52.2	37.2	36.9
Refrigerators and freezers (thousands)	3.710	3.284	3.485	2.626	1.764
Chemical fibers and threads(thousands tons)	529	474	349	197	220
Washing machines (thousands)	5.541	4.289	3.863	2.100	1.325
Cotton textiles(million square meters)	5.295	3.294	2.324	1.508	1.225
Television sets (thousands)	4.439	3.672	3.975	2.161	979
Tractors (thousands)	178	137	89	29	22

Figure 1.5 Output Volumes for selected products
Source: International Monetary Fund, *Economic Reviews 1995, Russian Federation*, Washington DC: The International Monetary Fund, 1995, p.66

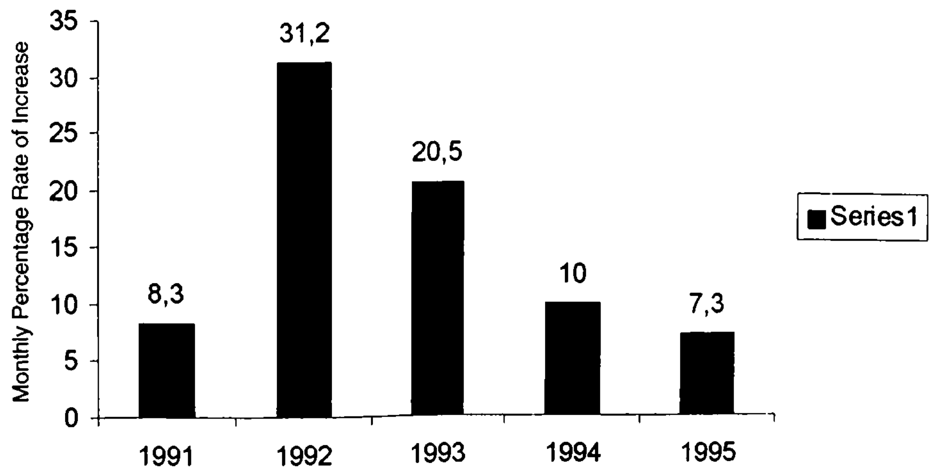

Figure 1.6 Average rate of consumer price increase per month during 1991-95
Source: OECD, *Short-Term Economic Indicators: Transition Economies*, Paris Centre for Co-operation with Economies in Transition, various issues, p.92

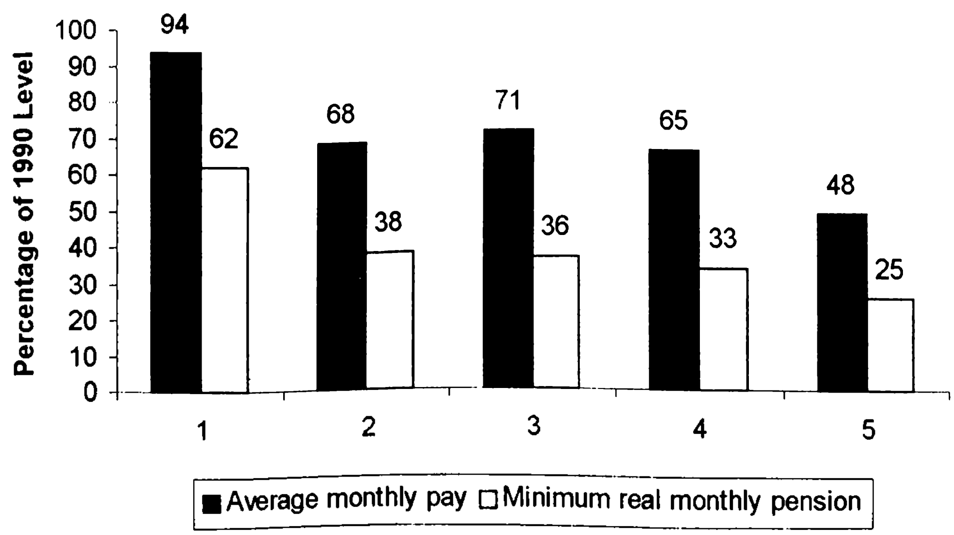

Figure 1.7 Real Pay and pensions

Source: International Monetary Fund, *Economic Reviews 1995, Russian Federation*, Washington DC: The International Monetary Fund, 1995, pp.73, 78

	1990	1991	1992	1993	1994
Exports outside the FSU	71.1	50.9	42.4	43.0	48.0
Imports outside the FSU	81.8	44.5	37.0	27.0	35.7
Trade balance	-10.7	6.4	5.4	16.0	12.3

Figure.1.8 Foreign Trade, 1991-94
Source: Anders Aslund, How Russia Became Market Economy, The Brooking Institution, Washington, D.C., 1995, p.281

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