

Capitalism Russian-Style

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Can Russia ever achieve a functioning market economy?
Why not? It already has a malfunctioning market economy.
Boris Fedorov, former Russian finance minister¹, 1992

In September 1991 it seemed to us that it would take only
a year or two at the most to build a new economic system
in Russia. But as you know miracles occur only in fairy
tales. Sergei Stepashin, former Russian prime minister, 1999²

Prologue

Arkhangel'sk, January 1992:

The man was so drunk he could hardly stand. After three tries he hauled himself slowly into the bus, dragging a huge dried fish behind him. An overpowering smell of fish, vodka, bad tobacco, and sweat filled the air. "Those *bliadi* (whores) haven't paid us in six months," he railed. "What the hell do they expect us to do? Starve to death?" He kicked the dirty snow from his boots.

"He's one of the oil geologists from Narian-Mar, up on the Arctic Sea coast," my host whispered to me. The drunk went on, his voice mounting, every third word unprintable. "I've got a wife and children down in Zhitomir. My savings are all gone. And there are sixty thousand of us up there, all like me. What do we do now?" The other passengers stared out the window, hardly paying attention. They had obviously heard the same story from many others. The drunk exhaled and closed his eyes.

Moscow, December 1996:

The young bank president had agreed to meet me for dinner on the corner of Kamergerskaia ulitsa. I was suddenly surrounded by bodyguards as the bank president emerged from a parked car across the street. Without a word he led me into an unmarked doorway and down a dark shabby hallway. There were more guards everywhere, and nobody was leaving us out of sight. Down a flight of stairs, we emerged into a palatial dining room. Waiters bustled about, wearing smart uniforms with gold filigree monograms on their jacket pockets. The maitre d'hotel ushered us to our seats with practiced deference. "This is Klub Sergei," the bank president explained as he unfolded a linen napkin. "It's where politicians and bankers go when they want a quiet place to discuss a deal." He smiled smoothly. "I've bought many a deputy here."

¹ Quoted in Daniel Yergin and Thane Gustafson, *Russia 2010 and What it Means for the World* (New York: Random House, 1993), p. 6.

² Sergei Stepashin, speech at the US-Russia Business Council, Washington, D.C., July 26 1999.

Capitalism Russian-style: introducing the book

On August 17, 1998, a pale-faced Sergei Kiriyenko, Russia's thirty-five-year-old prime minister, stepped up to the microphones of a crowded press conference. It was almost exactly six years since the failed coup against Mikhail Gorbachev had led to the disappearance of the Soviet Union. The Russian Federation was its main successor state, and during all the years since, Boris Yeltsin had been its president. Kiriyenko, however, was Yeltsin's third prime minister, having just taken the position just five months earlier. His appointment had been hailed as a sign that further reforms were to come.

But that was not Kiriyenko's message on August 17. His announcement was terse: the Russian government had declared a moratorium on its debts and would no longer defend the ruble.³ The prime minister assured his listeners that the government would stand by its obligations, but no one could mistake the announcement's real meaning. The Russian government had effectively declared bankruptcy.

The announcement ripped like a bomb through the Russian economy. Especially hard-hit was the new private sector that in the space of one decade had grown to supply over half of Russian economic output. The top twenty commercial banks were gutted overnight; bank transfers and settlements froze; transfers of taxes and pension funds halted. In the weeks that followed, credit disappeared and imports plummeted. Russia's GDP, which after a decade of decline had finally shown signs of bottoming out, began falling again. By the end of the year, the ruble had lost over two-thirds of its value against the dollar, and inflation, which had been subdued in the previous three years, had returned in force. A blizzard of dismissal notices blanketed Moscow, as banks, brokerages, and private businesses of all kinds laid off tens of thousands of young employees, who only days before had been the stars of the new Russian market economy.

As dazed Russians set about picking up the pieces, the prospects were grimmer than at any time since the Soviet collapse in 1991. They faced years of work simply to regain the lost ground, and in a much less favorable environment. World commodities prices, which had sustained the Russian economy throughout much of the 1990s, had dropped to record low levels. Foreign investors, badly burned by the Russian default, had withdrawn from Russia, and the country's international credit was at rock bottom. But the most discouraging knowledge was that the decade-long

³ "Zaiavlenie pravitel'stva RF i Tsentral'nogo Banka RF." The text of the official announcement can be found on the Internet at the web site of the National News Service, <http://www.nns.ru>) Excerpts from the prime minister's press conference will be found on the NNS's web site under the rubric "Biznes-novosti."

effort to build the institutions of a new market-based economy – banks, insurance and pension funds, brokerages, private companies, commercial courts, regulatory agencies – had gone disastrously wrong.

Yet as the months went by after the crash, a kind of normalcy settled back over Russia. Beneath the devastated top tier of the largest banks, a second layer of several hundred smaller ones had survived in good shape. The export sector, which had carried the Russian economy through much of the 1990s, continued to ship oil and gas and other commodities and to bring in essential hard-currency revenue. Imported goods reappeared in Moscow shops, alongside new items from Russian producers, for whom a devalued ruble spelled an opportunity to regain markets lost to foreign competitors. As a result, industrial production recovered quickly. Outside Moscow, where the market had penetrated less deeply to begin with, most people were less affected by the crash than the capital. Their lives were depressed before, and so they remained. Despite a blow that would have crushed a normal market economy, Russia somehow resumed muddling along, under a succession of caretaker governments whose main virtue was that they did little to rock the boat, while the country waited for new elections and whatever a new leadership would bring. As former prime minister Sergei Stepashin declared on a visit to Washington, D.C., in July 1999, “Russia’s exit from the August crisis was much faster than any of the experts had predicted.”⁴

But the real change was psychological, and that will be slower to fade. The shock of the crash caused a change in the attitudes of the Russian elite. Prior to the crash *transition Western-style* was the official script, and *markets* and *capitalism* were its slogans. Market reformers either led the government or played key roles in it. But after the crash the elite mind-set shifted. The slogans of market reform were abruptly discredited, and the notion that Russia was on a fast track to success was abruptly dispelled. The chief casualty of August 1998 was a state of mind.

Thus the crash of August 1998 provides a dramatic symbolic close to the period that began with the launch of market reforms in January 1992. Between those two conveniently placed bookmarks lies the extraordinary first chapter of Russia’s uncertain emergence into the post-Soviet era. Russia ends the decade as it began it – in crisis, divided over its past, uncertain of its future.

To most observers, it is a story of failure, or at best a false start. Russia today has sunk to a level of weakness not seen since the early 1920s, when the country lay prostrate after a decade of war, revolution, and civil war. The gap between the Russian economy and that of the United States has

⁴ Speech by former prime minister Sergei Stepashin at the US–Russia Business Council, July 26 1999.

grown immense. One telling statistic is the difference between the two national governments' resources: the revenues of the Russian federal government in 1999 are expected to be in the range of \$16–17 billion; those of the US government will be about \$1.7 trillion, or 100 times larger. There is an even greater gap in private-sector investment. As the twenty-first century begins, Russia is on the verge of falling out of the ranks of the industrial powers.

Yet Russia is never as strong as she seems; and Russia is never as weak as she seems. Dollar measures exaggerate Russia's weakness and understate its potential wealth and strength. It has a highly educated population with a strong scientific and engineering culture. Its natural resources are the world's largest. And it still has thousands of nuclear warheads and missiles, backed by strong martial traditions and a 500-year record of military success. Russia will rise again. Indeed, it will be the worse for the world if it does not.

But in what guise? As a democratic, free-market economy? To many, the crash of August 1998 signaled the failure of Russia's transition to the market. Yet the Nineties were a crucial decade of creation, in which a new post-Soviet order, for better and for worse, began to take shape. To understand where Russia is going now, it is essential to understand what happened during the crucial years after the Soviet collapse. Why did the nascent market economy crash? What, if anything, was achieved of lasting value? Is the present quasi-stabilization viable? What lies ahead, as Russia moves toward the end of the Yeltsin era and a critical leadership succession?

These are the key questions of this book.

A decade like no other

Only a surrealist painter could do justice to the Russian Nineties. The Russia that has emerged from the ruins of the Soviet Union is a crazy-quilt of contrasts and contradictions in which the implausible and the impossible coexist daily. The country is mired in the worst depression any industrial country has ever known. Yet alongside the idle factories there has sprung up a new market-based sector, driven by commodities exports, imported consumer goods, and financial speculation, which bubbled and frothed so long as high world commodities prices and plentiful short-term capital sustained it. Even as Russia's manufacturing and military industries lay paralyzed, Moscow became, for a time, the world's hottest emerging market and a city of golden opportunity.

The combination of collapse, boom, and depression has turned Russian society upside down. In the mid-1980s, the two men described

above – the bitter, drunken geologist and the self-confident, cynical young banker – might have been equal in status and income. Ten years later they were at the top and the bottom of a ladder that did not even exist before, and though today the banker may have been humbled a bit, the geologist's plight has only grown worse. Russian society has been torn in two by a revolution in property ownership, distribution of wealth, status, and moral values.

For a fortunate few – perhaps 20 percent of the population, concentrated mainly in Moscow and in regions with something to export – signs of new wealth began to appear within two or three years of the Soviet collapse. By the second half of the decade the streets of the capital were choked with foreign cars, old buildings were being refurbished and new high-rises were going up. Russian passers-by downtown were not merely well-dressed but often flamboyantly so. Anyone flying into Moscow could gaze in wonder at the thousands of new luxury houses (quaintly called *kottedzhi*, or *cottages*), many of them marvels of bad taste in red brick, dotting the suburban countryside. The excesses of the Russian *nouveaux riches* became legend, but the rich were not alone. An emerging Russian middle class bought expensive imported electronics and cars, traveled to foreign countries, and grew accustomed to the good life.

For the rest the price has been horrendous. Most Russians have told pollsters all through the decade that they are worse off than when the market reforms began, and since the August crash the polls have sunk to new lows. Russian cities are plagued by organized crime. There are beggars in the streets and prostitutes in the hotels, and in the railway stations, where refugees arrive from the periphery, the misery is beyond description. Unemployment exceeds 13% of the workforce and could grow much larger, while the remaining safety nets of the Soviet era continue to unravel. Infant mortality has risen, average lifespans have dropped sharply, the Russian population is growing smaller and older, and infectious diseases like tuberculosis have reappeared in force. In the statistical manuals, in the hospitals and the morgues, in the courts and the orphanages, Russian society reveals the shock it has undergone and the tribute paid by its weakest citizens for the sudden move from one system to another.

The extremes of the Russian Nineties also polarized the views of observers. Two views came to dominate. For some it was the sordid story of the collapse of an old regime. A rent-seeking elite, sprung from the Soviet nomenklatura, had grabbed the country's property and made off with it. What they built was not free enterprise or a market economy, but a corrupt imitation – “crony capitalism,” some called it – based on financial-industrial cartels, mafia gangs, and wholesale plunder. On this

view, the very idea of a transition to a normal market economy was naïve, since the “cronies” could hardly be expected to undermine their own power and profits. It was a structure built on “chicken legs,” as one chastened banker put it after the August crash, and it was doomed to fail.

Yet for others, the building of a new order made Russia in the Nineties the most exciting and hopeful place in the world. It was a time of feverish building, not only of offices and cottages for the rich, but of new businesses and institutions based on new skills and products. An entire new tertiary sector of trade and services—the area most neglected by the Soviet era—roared to life, as a generation of young Russians leapt to the task of creating private companies in fields as diverse as advertising, consumer credit, television, franchising, and computer software. In government, reform-minded politicians, though never more than a handful at the top, dismantled the Soviet-era controls and set about building new state institutions to regulate a private economy. For those who took their inspiration from the powerful trends in the global economy in the 1990s, the transition to a market economy in Russia seemed unstoppable.

The strange thing is that both views were true. The question no one could agree on was, What did they add up to?

August 1998: the music stops

The crisis of August 1998 suddenly provided a brutal answer. It was as though the music abruptly stopped and the lights went on, revealing appalling corruption and weakness. The August crash brought out in sharp relief, as no other event could have done, how deformed and fragile the emerging political order and economy had proved to be when tested. It showed that Russia’s transition to a money-based economy and a national market were still only partial, and that large parts of the country still stood outside it. Much of the “new” economy hid underground, out of sight of the tax collector, while much of the “old” economy had retreated into a virtual world of barter and quasi-monies.

But August 1998 also showed something else: there was no longer any bridge back to the past, and those who initially talked of turning back found that they could not. What the crisis revealed above all was how dramatically Russia had changed over the course of the decade. For better or for worse, a revolution has begun in Russia.

The word revolution is much abused, and in the next chapter I will spell out what I mean by it. But the key point is this: to call events in Russia by their right name reconciles the “collapse” story and the “transition” story, and provides a sounder basis for understanding what is happening now and what may come next.

First, the “collapse and takeover” story. It is right but it does not go far enough. The Soviet system collapsed and was taken over by its survivors, but it is much more than that. An entire order – the entire political, economic, and ideological system of Soviet Marxism–Leninism – has been overthrown. The basis for the command economy and the one-party dictatorship no longer exists. It has been replaced by a new set of economic and political institutions, founded on different constitutional and ideological premises, which though still fragile and uncertain are a world apart from the past. A new class has come to the fore, and has seized property and power. The individuals within it, to be sure, are descended from the Soviet administrative class, the *nomenklatura*. But they no longer owe their rank and privileges to the communist state and the command economy. They are in business for themselves, and that central fact is changing their roles and behavior.

Secondly, the “transition” story. Those who describe the Russian Nineties as a transition to the market have likewise only captured half of the picture. The revival of liberal economic doctrines in the last generation, and the tidal wave of globalization, privatization, and liberalization that has swept the globe, are the story of our age. Market transition has been the single most powerful revolutionary force in post-Soviet Russia – and the forces driving it – technological change and global competition – will continue to act powerfully on Russia.

Yet transition was not the only game going on in Russia in the Nineties. The reformers’ agenda overlapped with those of other players who were busy extracting rents, gaining power, salvaging a collapsed state, or simply trying to do their jobs and get by-and for whom “market transition” was an unfamiliar or threatening foreign ideology, or simply a convenient opportunity for stripping assets or advancing political causes. Transition as a driving force is real. But so are the complex reactions to it in the Russian setting, which is undergoing massive political and social upheaval at the same time.

It is the combination of these two forces – the collapse of the Soviet order and the worldwide tide of economic and technological change – that makes the Russian Nineties a revolution. But thinking of the situation in this way has one important implication: revolutions are not a matter of a decade, but of a generation or more. This one began well before the Nineties; it will go on well into the next century. The tide of change in Russia is not spent; indeed it is still building.

Yet the Russian Nineties have also taught how enormous an undertaking it is to change from one world view to another, from one political system to another, and from an old economy to a new one. It was naïve, in retrospect, to believe that capitalism in Russia could be built in a decade.

The world constructed by the Soviets was in its way as unique a system as has ever existed. It had its own ideology, its own culture and institutions, and its own language, formed over more than thirty years of revolutionary upheaval and reinforced over another three decades. It was as internally consistent and highly evolved, in its way, as its market-based Western counterpart. Today's Russians (at least, those over thirty) grew up in it, spoke its language, learned its customs, and knew no other. For those who were adults when Gorbachev's reforms began, an inner core of Soviet habits, beliefs, values, and expectations remains. The revolution will not be complete until those who were children when the Gorbachev reforms began are running the country.

Overcoming the Soviet legacy is more than a matter of culture. Russia remains "hard-wired" to its Soviet past, by the layout of its pipelines and its power-lines, the location and technologies of its industries, and the geographic distribution of its workforce. There is also an institutional legacy, which shows up in the way accountants measure costs or the financial system treats value, in the managers' habit of relying on their friends rather than their lawyers, in the restrictions on setting prices, changing jobs, selling land or real estate – all these and a myriad more are inherited from Soviet practice.

If undoing the old is difficult, building the new is even more so. Of all the countries in the world today that are trying to build market economies or liberalize them, none is coming to the task from as great a remove as the Russians, or in the midst of such political and social upheaval – not the East Europeans and not the Chinese, and certainly no Western country. For the second time in this century, Russia is performing on itself a vast experiment in social engineering, reshaping its state and its society and its economy all at once.

Seen in this broader perspective, the Russian Nineties were only the first chapter of a story that will take another generation, if not two or three, to finish telling. Russia, especially in the major cities, looks on the surface like a "normal" country. There is peace, the buses run, the streets are lighted, people go about their business. But Russia cannot yet be considered normal. Society has been badly damaged. The political system is still in flux. Above all, as the August crash showed dramatically, the economy is still a no-man's-land, neither socialist nor capitalist. In its first decade, the attempted transition to the market created far more losers than winners, and the consequent build-up of popular disillusionment and anger is dangerous political tinder. Until a post-Soviet order emerges that can produce growth, pride, and a reasonably shared wealth it cannot be considered more than temporarily stable.

Why did this happen? Why did the Russian Nineties prove in so many

respects a false start? What was achieved that might yet provide a sounder base? What changes will prove viable and lasting? This book looks for the answers in the origins and evolution of the market-based institutions and players that grew up in the first post-Soviet decade. There are chapters on the banks and capital markets, entrepreneurship and privatization. Crime and corruption have a chapter of their own, but so does the law. Other chapters describe what is happening to Russians' health, families, occupations and values. Lastly, and most important, we look at the Russian state – at once partner, accomplice, and antagonist of the new private sector.

The book's central finding is that Russia is still in motion. The twin forces that acted on it so powerfully in its first post-Soviet decade – revolutionary collapse at home and the tides of change in the global economy – are far from spent. The quasi-stabilization we see in Russia today, founded on what remains of the Soviet inheritance, is not viable over the longer run, because it cannot generate growth and prosperity. A new post-Soviet order is still evolving, even though its final shape cannot yet be known. Only one thing is sure: if it stays on the road to capitalism, Russia will no more resemble the models of liberal theorists than do, say, the capitalist systems of Brazil, Mexico, or for that matter Italy or Japan. Capitalism Russian-style, if it survives long enough to evolve to a stable final form, will be a uniquely Russian amalgam.⁵

“Old Soviet hands” like me bring their own perspective to the new Russia, because they know how different the old system was and how far the country has come in a remarkably short time. The distance is truly from one civilization to another. Whether at the end of the road Russian capitalism will be prosperous, efficient, democratic, or just, are questions that are not yet foreclosed. They are the Russian agenda for the twentieth century.

⁵ This is a central argument of Rose Brady's excellent book, *Kapitalizm: Russia's Struggle to Free its Economy* (New Haven, CN: Yale University Press, 1999).