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## Revolution: 1991–93

When Mikhail Gorbachev returned to Moscow from his house arrest in the Crimea on August 22, 1991, he expected to be greeted as a hero. He did not realize that the hero who had defeated the coup was none other than Boris Yeltsin.<sup>1</sup> Gorbachev's position looked dubious, because the putschists had expected that he would join them, and Gorbachev had appointed them all. At his first press conference after the coup on August 22, 1991, in Moscow, Gorbachev made a fatal gaffe. Although the coup had shown that communism needed to be finished off, he declared like a latter-day Don Quixote: "I am convinced that socialism is correct" (Dunlop 1993, 259). He would "fight to the end for the renewal of the party" (Aron 2000, 458).

From that moment, Gorbachev was history, although he formally remained president of the USSR until December 1991. The popular view was that the party was over. As Aron (2000, 459) observed: "The political 'centre' . . . disappeared. This was a revolution, and in revolutions there is no centre."

Also the Soviet Union was over. The aborted August coup was Russia's revolution. The new ruler of Russia was its popularly elected president, Boris Yeltsin. He believed in an open and free society without any official ideology or ruling party. The values he emphasized were democracy, a multiparty system, the defense of human rights, a market economy, private property, and free travel. The dominant slogan was to build "a normal society." The eternal Russian ambition to be original was gone. Yeltsin recognized how great a task he was facing, and he was morally prepared. Gaidar (1999, 64) characterized him "like a warrior-knight in a fairy tale

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1. This chapter draws heavily on Åslund (1995), which is the source when no other reference is indicated.

who had crushed the foe and burst into the enchanted castle only to find, instead of his long-suffering and beautiful princess, nothing but darkness, neglect, and piles of garbage. And now he was the one who had to deal with it all.”

Yeltsin thought strategically and moved radically on three issues. First, he had to secure his power. Second, he needed to dissolve the Soviet Union. Third, the rampant economic crisis cried for instant deregulation and financial stabilization. Nobody can do everything at the same time, so Yeltsin postponed political reform. Surprisingly, Russia succeeded in undertaking mass privatization in the midst of this turmoil. The initial attempt at financial stabilization failed, but the foundation for later success was laid.

Although Russia was the major international topic of interest in the West at this time, the West did next to nothing for Russia. Yeltsin’s attempt at a capitalist revolution ended in political calamity. In the fall of 1993, the parliament rose up in armed revolt against him, and Yeltsin was forced to call in special forces to quell the uprising. He stayed in power, but the revolution was finished.

## **Yeltsin’s Assumption of Power**

After the August 1991 coup, the USSR ceased to function as a political entity. The three Baltic republics—Estonia, Latvia, and Lithuania—claimed their independence. Yeltsin recognized them on August 24. Georgia, Armenia, Moldova, and Azerbaijan were well on their way toward national independence. The other republics were more hesitant, with Ukraine being pivotal. Yeltsin realized that he had to dissolve the Soviet Union before he could proceed with other policies. Nor could the rampant economic crisis wait. Soviet shops were empty in spite of galloping inflation. Output was in free fall and worries about impending mass starvation were great. Something had to be done very fast, but few knew what to do.

At the time, the Russian political system seemed the least urgent problem. Russia had just democratically elected a president; the parliament had also been popularly elected even if its election had not been fully democratic; the Soviet Russian Constitution of 1978 could be amended to serve a democracy. Nor was it obvious what a political reform should look like. Yeltsin concluded that his extraordinary popularity and authority enabled him to put off political reform, but he made one exception: He wanted a new constitution.

Yeltsin undertook one major political act. On August 23, he signed a decree that “suspended” the activity of the CPSU during the investigation of the party’s “anti-constitutional activity” during the coup. The party was prohibited in several steps, with some decisions made by Yeltsin, others by Gorbachev. On August 24, Gorbachev resigned as general secretary of the

CPSU and dissolved its Central Committee (Remnick 1994, 495). The Russian authorities sealed off the Central Committee headquarters in the center of Moscow. After the dissolution of the CPSU, Gorbachev as president of the USSR confiscated the extensive CPSU property, while the Communist Party won its right to survival through a lengthy court appeal (Aron 2000, 468). Yeltsin transferred the CPSU property in Russia to the presidential administration, which became financially autonomous within the state. Three of the leading putschists committed apparent suicides. Gorbachev arrested the others, but they were soon let out, and nothing really happened to them. Several of them could relaunch their political careers. Yeltsin harbored no vindictiveness.

In the immediate aftermath of the coup, a crowd had torn down the monument of the reviled founder of the Soviet secret police, Feliks Dzerzhinsky, outside Lubyanka, the KGB headquarters. But Moscow soon turned quiet and little happened. Everybody waited for Yeltsin's next move, and the public was upset when he went to Sochi at the Black Sea for a long vacation instead of consolidating his victory (Aron 2000). Yeltsin (1994, 106) noted in his memoirs: "Everything depended on my taking a position of brutal consistency."

September–October 1991 was a strange time. Formally, both Yeltsin and Gorbachev claimed sovereignty over Russia, but nobody took Gorbachev seriously. To his credit, he accepted the situation. Gorbachev managed foreign affairs and worked on a new union treaty, while Yeltsin ruled Russia. Everybody just waited for what Yeltsin would decide.

Yeltsin minimized political reform and opted for a provisional political solution. He demanded the right to rule by decree for one year from November 1, 1991. The still-obedient Russian parliament granted him far-reaching powers to change government structures, appoint all ministers, and adopt a large number of decisions on economic reform by decree (Shevtsova 1999). Yeltsin's official explanation was that the economic crisis was so serious that it demanded a temporary solution.

Popular sentiment against the party and bureaucracy was severe. This was possibly the one and only opportunity to break down the secret police that had plagued the Soviet Union. Yeltsin did act against the KGB, but he split it rather than abolished it. In October 1991, he divided the Russian republican branch of the KGB into five agencies. The Ministry of Security was the repressive heart of the old KGB, which guarded domestic security. Gradually, its range expanded, and in 1995, it was renamed the Federal Security Service (FSB). Other agencies arising from the KGB were the Foreign Intelligence Service (SVR), the Federal Agency for Government Communication and Information Services (FAPSI), which handled eavesdropping and electronic interception, the Federal Border Guard Service (FSP), and the Federal Tax Service, which treated taxpayers like organized criminals (Remington 2006, 235). The KGB was humiliated and weakened, but it was not broken.

## Dissolution of the Soviet Union

Yeltsin understood that the Soviet Union was over, but he had to dissolve the union in a way that was politically acceptable to the Russians. In his memoirs, Yeltsin (1994, 115) presented the union dissolution as a positive choice: "I was convinced that Russia needed to rid itself of its imperial mission."

The decisive moment was December 1, 1991, when Ukraine held a referendum on its independence, which won overwhelming support of 90 percent. Simultaneously, Ukraine's communist leader Leonid Kravchuk was elected Ukraine's president with a large majority, and he stated unequivocally that Ukraine would be independent. Ukraine was seen as the key-stone in the arch, without which the Soviet Union was not viable.

Yeltsin acted instantly. In complete secrecy, he organized a meeting one week later with Kravchuk and the reformist speaker of the Belarusian parliament, Stanislav Shushkevich. They met with only a handful of aides at a desolate Belarusian hunting lodge (Belovezhskaya Pushcha). Together these three heads of state agreed to dissolve the Soviet Union. As Yeltsin (1994, 113) saw it: "In signing this agreement, Russia was choosing a different path, a path of internal development rather than an imperial one." He insisted that this was "a lawful alteration of the existing order," because it "was a revision of the Union Treaty among [the] three major republics of that Union."

As a replacement for the USSR, they set up the loose Commonwealth of Independent States (CIS), which appeared most inspired by the British Commonwealth. Soviet President Gorbachev was not invited to the meeting and was kept in the dark. His continuing attempts to form a looser version of the Soviet Union, a "Union of Sovereign States," had been jeopardized. The CIS agreement meant that the Soviet Union was finished. Yeltsin emphasized that the CIS would be a minimal organization: "There will be no coordinating organs. . . . If there is coordination, it will be between the heads of state of commonwealth members. They will have some kind of a working group to resolve certain questions, and that's it."<sup>2</sup>

Yeltsin's next delicate task was to persuade the Soviet military to accept the dissolution of the Soviet Union. On December 11, 1991, Yeltsin stormed into our conference room in the White House in Moscow like a bull, beaming with manic self-confidence, energy, and happiness. I never saw a stronger man in my life. First Deputy Prime Minister Gennady Burbulis told me that they had come from the Ministry of Defense. Yeltsin had given a speech to the Soviet general staff and convinced them to join Russia. Yeltsin had salvaged the peaceful dissolution of the union. The previous day, Gorbachev had tried to convince the same generals to stand up for the Soviet Union, but he failed. Possibly dissuaded by the failure of the

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2. "We Are Taking Over" (interview with Yeltsin), *Newsweek*, January 6, 1992, 13.

August coup, the Soviet/Russian military stayed calm. Earlier Yeltsin had won the loyalty of several senior generals who defected to him during the coup (Dunlop 1993, 248).<sup>3</sup>

Some Russian democrats were taken aback by Yeltsin's abrupt abolition of the Soviet Union and abandoned him, but a protest in Moscow that evening gathered only a few thousand demonstrators. Instead, most of the Soviet republics that had been left out of the Belarusian meeting wanted to join the CIS. Yeltsin quickly accommodated them, and on December 21, a meeting for all the republican heads of states was held in Alma-Ata, then the capital of Kazakhstan. The CIS was expanded to include 11 republics. Only Georgia and the already independent Baltic states stayed outside. The treaty of 1922 on the formation of the Soviet Union was formally abrogated, leaving the remaining Soviet institutions and Soviet President Gorbachev without legal foundation.

All the many Soviet institutions had to be reconsidered. Yeltsin moved swiftly. About 80 superfluous Soviet industrial ministries and state committees were disbanded, and their assets were taken over by the newly independent states. Russia took control of the Soviet State Bank as of January 1, 1992 (Aron 2000, 473–74). Essential Soviet institutions were merged with their Russian counterparts and subordinated to Russian ministers. One new CIS authority of note was established, a single joint command for the strategic forces, to avoid nuclear proliferation. Only one important Soviet institution survived, the Soviet ruble, which would cause considerable harm.

Yeltsin decided that Russia would not make any claims on territories of other former Soviet republics, although many such claims could be justified, because Stalin had altered most of the republican borders. In 1954, Khrushchev had grandly presented the Crimea to Ukraine on the tercentenary of its union with Russia. No fewer than 25 million ethnic Russians lived in other Soviet republics. Large Kazakh territories were traditionally Russian and inhabited by ethnic Russians. Furthermore, the new state borders were neither demarcated nor watched. By consistently respecting the existing borders, Yeltsin left a valuable, peaceful legacy.

On Christmas Day 1991, Gorbachev and Yeltsin met for a whole day in the Kremlin, settling Gorbachev's resignation as USSR president. Although no love was lost between them, both behaved like gentlemen. Yeltsin granted Gorbachev quite comfortable conditions for the rest of his life, while Gorbachev transferred the nuclear briefcase and other ultimate state secrets to Yeltsin, who moved his office to the Kremlin.

In 1992, some talked about the possibility of a subsequent breakup of the Russian Federation, but that was never very likely. To begin with, Russia's population is 80 percent ethnically Russian, and Russian is the all-

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3. Yeltsin went on to give us, a group of Western economists, an excellent presentation of his radical economic reform plans for forty minutes without any notes.

dominant language. Only about 17 percent of Russia's population lives in territories considered ethnic minority regions, and in many of them the majority of the population is not of that ethnic group. The Muslim population is usually assessed at 10 percent. Chechnya, with a large and compact Chechen population on the border of Russia, is quite an exception (Remington 2006).

## Attempt at Radical Market Reform

Another major task Yeltsin focused on was building a market economy. In September and October 1991, Moscow saw an unusual development. Five different competing economic policy teams were created.<sup>4</sup> Each of them aspired to form Yeltsin's next government. They sat at different dachas outside Moscow where they elaborated on their economic programs. Yeltsin took his time and listened to their proposals.

After two months, he made his decision. On October 28, 1991, Yeltsin made his greatest speech ever to the Russian Congress of People's Deputies:

I appeal to you at one of the most critical moments in Russia's history. Right now it will be decided what kind of country Russia will be in the coming years and decades. . . . I turn to you with determination to stand unconditionally on the road of profound reforms with support from the whole population. . . . The time has come to act decisively, firmly, without hesitation. . . . The period of moving with small steps is over. . . . A big reformist breakthrough is necessary. (Yeltsin 1991)

Yeltsin declared that the two central economic tasks were to establish economic freedom and financial stabilization:

We have a unique opportunity to stabilize the economy within several months and to start the process of recovery. We have defended political freedom. Now we have to give the people economic [freedom], remove all barriers to the freedom of enterprises and entrepreneurship, offer the people possibilities to work and receive as much as they earn, after having relieved them of bureaucratic pressures. (Yeltsin 1991)

Yeltsin emphasized the need for an instant liberalization of prices, macroeconomic stabilization, and privatization, providing a reasonable amount of detail. The Russian parliament, which had elected Yeltsin its chairman only on the third vote in May 1990, received Yeltsin's speech with rousing applause. Cleverly, Yeltsin put his programmatic speech for radical economic reform to a vote, and the deputies voted 876 to 16 in

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4. They were headed, respectively, by Grigory Yavlinsky (liberal but supported the maintenance of the Soviet Union), Yegor Gaidar (consistent market liberal and for Russia's independence), Yevgeny Saburov (liberal but cautious), Yuri Skokov (illiberal), and Oleg Lobov (illiberal). I talked to the first three camps during two visits to Moscow in September 1991.

favor (Aron 2000, 491). Yeltsin had received a nearly unanimous parliamentary mandate.

Yeltsin contemplated his choice of economic reform strategy. A major problem with prior Soviet and Russian reforms was inconsistency: "Russia's trouble was never a shortage or an abundance of reformers. The trouble was an inability to adhere to a consistent policy. . . . Not a single reform effort in Russia has ever been completed. . . . The goal I have set before the government is to make reform irreversible" (Yeltsin 1994, 145–47). Yeltsin acknowledged the depth of the economic crisis, and by the fall of 1991, "the rationing of virtually everything had reached its limit. The shelves in the stores were absolutely bare" (p. 150).

Russia was in a rampant economic crisis with nearly complete shortages and an actual state bankruptcy. Yeltsin reckoned that a radical economic reform had to be introduced as soon as practically possible. He and his chief reformer Yegor Gaidar wanted to launch the radical economic reform as one package. In his reform speech, Yeltsin had warned that it would be in mid-December 1991, but the other union republics protested that they were not ready. Although Yeltsin had declared: "We have no possibility to coordinate the terms of the reforms with the conclusion of all-embracing inter-republican agreements," as a good will gesture to the other republics, he delayed Russia's reform launch until January 2, 1992 (Yeltsin 1991).

Gaidar (1999, 114) justified his choice of early price deregulation: "There were no reserves to ease the hardships that would be caused by setting the economic mechanism in motion. Putting off liberalization of the economy until slow structural reforms could be enacted was impossible. Two or three more months of such passivity and we would have economic and political catastrophe, total collapse, and a civil war."

After the ten reform programs that had been presented between October 1989 and October 1990, Russians were tired of programs and called for action. Gaidar opposed formulating another detailed reform program. He wanted to present his program through deeds, although he wrote articles and made many public appearances to clarify his policies. A list of 70 planned legal acts was approved through a government decree in November 1991.

As it turned out, not formulating a formal reform program was a serious mistake (Yasin 2002, 167–68). First, neither ordinary Russians nor the elite quite understood what a market economy was. They preferred cherry-picking and did not understand the need for a consistent system. The reformers badly needed a pedagogic and lucid reform program to teach the population their policy. Second, all governments need a program as a tool for coordination, especially at a time of profound change. An official program would have been especially useful in the revolutionary chaos. Third, the reformers had not thought all their ideas through or agreed on them. The elaboration of a reform program would have improved their own con-

sistency. Finally, the old Soviet civil service remained in place, and it was deeply hostile to reform. A reform program would have dictated the direction of government policy to them.

Russia appeared set to repeat the radical economic reforms of Poland in 1990 and Czechoslovakia in 1991, with a concentration of major reform measures in a “big bang” in January 1992. Yet, Yeltsin (1991) did not quite speak of a big bang, but suggested vaguely: “The reform goes along a number of directions simultaneously, all-embracing and dynamically.” In the early fall of 1991, Gaidar (1993) did not envision full liberalization and stabilization until Russia had introduced its own national currency, which he reckoned could be done only after nine months. The Gaidar team’s initial working document proposed a gradual stabilization and liberalization program to be implemented in the course of one year, not too different from the 500-day program (Dąbrowski 1993a).

As the macroeconomic crisis deepened in late 1991, the reformers turned more radical and opted for a more concentrated big bang. Both Yeltsin and Gaidar used the term “shock therapy,” although their actual approach to reform was somewhat partial. The reforms came to lack the desired concentration and comprehension, but that was difficult to avoid in the post-Soviet chaos.

## **A New Type of Reform Government**

Yeltsin’s next step was to form a new government, which was equally daring and innovative. He decided to put the government in the hands of Russia’s best economists: “When forming the government, we discard the priority of political considerations to the benefit of professionals” (Yeltsin 1991). “It was high time to bring in an economist with his own original concept, possibly with his own team of people. Determined action was long overdue in the economy, not just in politics” (Yeltsin 1994, 124).

His reform speech was largely drafted by Gaidar, arguably the best and most erudite Russian economist. He had set up his own Institute of Economic Policy in Moscow, where he had gathered the cream of Russia’s young economists, with a sister institute in St. Petersburg. Gaidar had the best team of economists ready to take over the Russian government, and Yeltsin moved quickly, making this team his new government. However, Yeltsin considered it impossible to have a 35-year-old nonpolitician confirmed as head of the government by the Russian parliament (Yeltsin 1994, 125). Over November 6–8, 1991, Gaidar became deputy prime minister as well as minister of finance and economy. Yeltsin made himself prime minister, and his chief political aide Gennady Burbulis became first deputy prime minister. A row of young reformists aged 35 to 40 took over major portfolios in the government. Anatoly Chubais, who became minister of privatization, was to be the most prominent.

Gaidar's new ministers were professional economists with doctoral degrees who knew English and had studied mainstream Western economics, although largely on their own in the Soviet Union. They were the most intelligent and well-educated children of the foremost intellectual *nomenklatura*. The Soviet Union had cut itself off from the world so completely that none of them had earned a degree abroad. One of the young reformers, Sergei Vasiliev (1999, 86), characterized their group like this: "A group of professional economists, the Gaidar team, had some understanding of the situation and proposed a more or less adequate approach to handling the economic challenges at hand. No other group of economists was able to come up with a comprehensive programme." Their dilemma was that they were highly elitist and distant from the population. They undermined their credibility by proudly calling themselves a kamikaze government.

When forming the new government, Yeltsin restructured it completely. The old Soviet government had a dozen deputy prime ministers and almost 100 ministers, but Yeltsin's new Western-style government had only three deputy prime ministers and 23 ministers. All the many industrial ministries were abolished. The State Planning Committee (Gosplan) was renamed the Ministry of Economy and deprived of most of its old functions. The Ministry of Finance became the dominant ministry, as in a normal capitalist government. The main innovation was a State Property Committee, which was a ministry of privatization. Over time, several branch ministries returned. The number of ministers would steadily increase, as did the number of deputy prime ministers, but the new type of government persisted.

A big question was what to do with the tens of thousands of apparatchiks, predominantly in their 50s and 60s because of the Soviet gerontocracy. Several Eastern European countries had launched lustration of officials, dismissing senior party officials and secret police informers. Three lines of thought dominated Yeltsin's thinking. First, Stalin had made purge a dirty word from which Yeltsin (1994, 127) distanced himself:

In seventy years, we have grown tired of dividing people into "clean" and "unclean." . . . To break everything, to destroy everything in the Bolshevik manner was not part of my plans at all. While bringing into the government completely new, young and bold people, I still considered it possible to use in government work-experienced executives. . . .

Second, immediately after the Russian revolution in February 1917, the provisional government headed by Prince G. E. Lvov had decided to dissolve the tsarist civil service, which had caused chaos in the whole country (Pipes 1990, 298–300). Yeltsin (1994, 129) was acutely aware of this historical precedent and wanted to avoid it at any price: "It would have been disastrous to destroy the government administration of such an enormous state. Where it was possible to put in experienced 'old' staff, we did. And sometimes we made mistakes."

The third reason for Yeltsin's reluctance to purge the old administration was that he originated from it. He was proud of his achievements as a party official (Yeltsin 1990), and a large group of his old comrades from Sverdlovsk joined him in the Kremlin. Yeltsin also harbored a strange and exaggerated affection for state enterprise managers, which would lead him into jeopardy time and again in the years ahead (Yeltsin 1994, 168–73).

Yeltsin made this conscious and premeditated choice himself, and its consequences were fundamental. The old *nomenklatura* survived, and no real discontinuity occurred, especially at the regional level, where democratization was limited. His most serious omission was not to dissolve the KGB, which was to reemerge as the dominant state power a decade later. Presumably, Yeltsin felt that he needed the old security police after the coup, and the armed uprising in October 1993 reinforced his resolve. Several top KGB officers were to become Yeltsin's drinking partners, and they drew out all of his worst traits, as documented by his chief bodyguard Aleksandr Korzhakov (1997) in his mean-spirited memoirs.

Yeltsin's private life complicated his policies and particularly his personnel decisions. Like most old party apparatchiks, he was a heavy drinker. When he drank, he wanted privacy and liked the company of big, heavy, middle-aged men such as himself. These men tended to be enterprise managers, KGB officers, and old apparatchiks. A *banya* (sauna) company developed, which included Yeltsin's chief bodyguard Korzhakov, and his later appointees, FSB Chairman Mikhail Barsukov, First Deputy Prime Minister Oleg Soskovets, Minister of Defense Pavel Grachev, Kremlin Property Manager Pavel Borodin, and Yeltsin's tennis trainer Shamil Tarpishchev. These men were reactionaries and several were serious criminals who fought the reformers during the day and drank with Yeltsin at night. The *banya* team intentionally made Yeltsin as drunk as possible, to promote their policy line. The reformers had no access to this company, and their drinking habits were no match either. For long periods, Yeltsin disappeared from the public eye, and the suspicion was that he devoted himself to heavy drinking in this bad company. He was a Janus-faced man because he pursued a Janus life (Shevtsova 1999).

Yeltsin was remarkably tolerant. He allowed full press freedom and accepted untold criticism of himself. The Soviet Union had persistently discriminated by ethnicity, favoring Russians and the dominant ethnicity in each union republic. Jews in particular had suffered discrimination. Yeltsin ignored ethnicity and opened the floodgates to all ethnic minorities. His government always had several Jewish ministers. Yeltsin was also keen on promoting young people, appointing many ministers and two prime ministers in their 30s. Being strong himself, he was not afraid of highly educated people or strong personalities. He appointed the occasional woman minister, but only in this regard did he not advance much from Gorbachev's time.

Yeltsin was also tolerant of foreigners. He invited the International Monetary Fund (IMF) and the World Bank, which obtained extensive access from the beginning. He accepted that a sizable group of foreign economic advisors assisted his government. Professor Jeffrey Sachs of Harvard University was the most prominent advisor. I was his partner in this endeavor. I remember the exhilarating feeling when, in early December 1991, I received my own office in the old Central Committee headquarters at the Old Square, which had been taken over by the reform government. In the old days, this building was hermetically closed to foreigners.<sup>5</sup> In the corridors, rows of safes were standing, because the new liberal government was to be open. The safes were to be sold to the new commercial banks. Our work was hectic and highly productive because the reformers knew how to use experts.

## Launch of Market Reform

The all-dominant problems were massive shortages and high inflation, leading to demonetization and dollarization. Half a liter of vodka or a pack of Marlboro were more useful currencies than ruble bills. Output was still in free fall.

Yet some gained from the high inflation, which is the most regressive of taxes. A small rent-seeking elite of state enterprise managers and their companions benefited from subsidies and subsidized credits paid by the state, but society paid the inflation tax that financed their fortunes. The destabilizing subsidies were often extracted through bribery, and since such contracts were not legal and thus could not be secured in court, the many commercial banks that thrived on the high inflation became a gangster killing field. Bringing down inflation was vital for the well-being of society, but it was resisted by a commercial elite that was as powerful as it was criminal.

Every possible macroeconomic problem was present. Fifteen central banks issued ruble credits without control or coordination. Both the Central Bank of Russia and the Ministry of Finance were weak and rudimentary. The payment system was a relic of the prior nonmonetary world. Money was not unified, because different shops existed for people with special coupons, and rationing was extensive. Nor was the exchange rate unified. According to the most credible estimates, the Soviet budget deficit in 1991 was about 31 percent of GDP (EBRD 1994). Public expenditures skyrocketed beyond control. Since prices remained regulated, price subsidies surged with rising costs. Russia also suffered from a huge monetary

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5. I had that office for 16 months. Then we were transferred to the premises of the Ministry of Finance, which was quite a reasonable decision.

overhang, because people were compelled to hold much more money than they desired.

As if to add insult to injury, Russia was hit by several severe external shocks. The USSR effectively defaulted and lost all access to international financing, which sent the exchange rate plummeting. In 1991, the trade system of the nations of the Council for Mutual Economic Assistance fell apart. In 1992, trade with other former Soviet republics plummeted as the Soviet trade system collapsed.

The question was where to start. A popular idea among Russian economists was currency reform, because Lenin had done so in the 1920s (Kazmin and Tsimailo 1991). He had introduced a new parallel currency that had been convertible, while the old ruble had been inflated away. However, the objections against a currency reform were manifold. No preparations had been made, and Gaidar (1993) estimated that a currency reform would require nine months of preparations. Soviet Prime Minister Valentin Pavlov had just carried out a limited and highly unsuccessful currency reform in January 1991, so why repeat an unpopular failure? A currency reform would only eliminate the surplus stock of money, while the imbalance between the flows of incomes and expenditures would remain (Gaidar 1990). The unfortunate consequence of this decision, however, was that the harmful ruble zone lasted until the fall of 1993. A currency reform would have terminated it earlier.

Since currency reform was not a realistic option, the monetary overhang and the imbalance between supply and demand could be eliminated only through price rises. The Russian reformers believed that a swift, comprehensive deregulation of prices had to start the transition to a market economy. On December 3, 1991, Yeltsin signed a decree on “the transition to free (market) prices and tariffs, formed under the influence of supply and demand” on producer goods, consumer goods, services, and labor.<sup>6</sup> This price deregulation was truly far-reaching, involving 80 percent of producer prices and 90 percent of consumer prices. Among producer prices, energy, some commodities, and transportation were excluded, but most of these prices were hiked fivefold. A basket of essential consumer staples, such as milk and bread, was initially excluded as well to ensure that nobody would starve, but these prices were liberalized from March to May 1992 (Koen and Phillips 1993).

The year 1992 started as intended with a big bang. Gaidar led the charge with intelligence and determination. His two main policies were radical price liberalization and the balancing of the consolidated state budget. The long-awaited price liberalization took place as announced on January 2, 1992. It was preceded by tremendous fear. People lived as under Damocles’ sword. They thought that the sky was the limit for un-

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6. “Decree of the President of the Russian Federation on Measures to Liberalize Prices,” *Ekonomicheskaya gazeta*, special issue, December 1991.

regulated prices, because the huge monetary overhang made the existing free prices extremely high. The authorities were worried about a possible explosion of popular anger and brought in extra police on the day of price liberalization. But no public protest was reported, although prices rose instantly by about 250 percent, far more than the 100 percent the government had expected. Gradually, shortages diminished. One after the other, goods that had not been seen for years reappeared in shops, and many perishable products that had never survived the Soviet distribution system, such as bananas and kiwi fruit, suddenly surfaced. Yet shortages disappeared more slowly than had been the case in Poland, because many local regulations persisted, such as ceilings on profit margins.

A serious concern was domestic trade. Most Russian reformers doubted that it could be liberalized rapidly, but the absence of trade liberalization preserved shortages. Their slow elimination enabled Gaidar to convince Yeltsin to sign a truly radical presidential decree on freedom of trade on January 29, 1992, that stated: "Enterprises, regardless of their form of ownership, and citizens are granted the right to engage in trade . . . without special permission. Enterprises and private citizens may sell things . . . in any place of their convenience."<sup>7</sup>

The purpose was to free retail trade completely so that it could develop from the bottom up. Poland's reformer Leszek Balcerowicz had done the same there in January 1990. The popular reaction was as extraordinary in Russia as it had been in Poland. All kinds of people took to the streets, not to protest but to sell. Suddenly, everything was available, but soon a political reaction arose. Well-to-do Muscovites objected to the disorder and dirt of street bazaars, and the quality of what was being sold was often dubious. The official trade system naturally opposed this stiff competition. Municipal authorities complained about not receiving any revenue from the untaxed street trade, and racketeers were upset over not being able to charge street traders their horrendous protection fees. The popular understanding of the benefits of rational allocation through free trade was limited. After three months, Moscow Mayor Yuri Luzhkov prohibited street trade and the mayors of other big cities followed suit. The otherwise passive police made the pursuit of street traders a priority task. Protection rackets secured their hold over retail trade.

The reformers wanted to liberalize foreign trade, unify the exchange rate, adjust it to the market, and make the ruble convertible, but their endeavors were impeded by the communists' complete depletion of Russia's currency reserves, and the subsequent extremely low exchange rate of the ruble. Still, the reformers succeeded in a near-complete deregulation of imports for the first half of 1992. It was not controversial because

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7. "Decree of the President of the Russian Federation on the Freedom of Trade," *Rossiiskaya gazeta*, February 1, 1992.

everybody wanted to end shortages, and the extremely low exchange rate allowed any decent Russian product to be sold.

Given that the prices of oil and natural gas, Russia's main exports, were regulated far below world market prices, export licenses and quotas had to be maintained. The commodity exporters insisted on these regulations, which made them millionaires daily. The government could do little but introduce a complex system of surrender requirements for exporters to tax exporters somewhat and make sure that they repatriated some earnings. Yet from July 1992 the exchange rate was essentially unified and allowed to float. Two big problems remained. One was export control for commodity exports, and the other was the lingering state trade within the CIS (Michalopoulos and Drebenstov 1997).

Gaidar's second great task after price liberalization was to balance the consolidated state budget. He focused on a few major cuts, while trying to maintain a high level of revenues. First, the price liberalization instantly eliminated large price subsidies. Gaidar's second big strike was against military procurement, which he initially slashed by 85 percent, which eventually became 70 percent. For the rest, he tried to keep state subsidies and public investment low.

Gaidar accepted the common view that a major tax reform had to wait. Still, the old sales tax, which differed for every good, had to go. Gaidar replaced it with a value-added tax (VAT), which he unwisely put as high as 28 percent. His assumption was that the parliament would bargain for a lower VAT and agree on something like 20 percent, but the unpredictable parliament just voted it through. This excessive rate had to be slashed to 20 percent after a year. The payroll or social security tax stayed at 38 percent of the wage fund. Corporate profit taxes had come down to 32 percent and personal income taxes stayed at 12 percent for most people, with a maximum of 30 percent for the wealthy, who somehow escaped income taxes anyway (IMF 1993). The tax burden remained high because of Gaidar's fear that collection would founder.

The union treasury was starved in 1991, but only because the republics had revolted against the union. The old tax collection system continued to function amazingly well, because taxes were still collected from big state enterprises by state banks. State enterprises were even forced to pay their taxes in advance each month through automatic deductions, granting the state a positive *Tanzi-Olivera* effect (that is, the Treasury gained revenues from the inflation tax). Amazingly, Gaidar succeeded in turning a budget deficit of 31 percent of GDP in 1991 to a slight budget surplus on cash basis of 0.9 percent in the first quarter of 1992.

The price liberalization and fiscal tightening put the Central Bank of Russia under extraordinary pressure. The monetary overhang was eliminated, and the real money supply (M2) shrank by two-thirds, from 77 percent to 25 percent of GDP (RECEP 1993, 116). On November 22, 1991, the reformers suffered their first serious defeat in the parliament when the

government's request for control over the Central Bank was rejected. Instead, Ruslan Khasbulatov, the speaker of the parliament, supervised the Central Bank, and he turned against radical market reform at this time.

Khasbulatov nominated Georgy Matiukhin, a professor of economics, as chairman of the Central Bank in August 1991. Khasbulatov's support for Matiukhin made the reformers suspicious of him, but he belonged to neither camp and felt closer to Gaidar (Matiukhin 1993). He ended up in a hopeless intermediary position, honestly trying to pursue a moderately strict monetary policy. On one hand, he tried to push for positive real interest rates as fast as possible. On the other, he allowed the money supply to increase substantially. As a result, the money supply (M2) expanded by as much as an average of 11 percent a month from January to May 1992. After spiking at 245 percent in January 1992, monthly inflation declined to 12 percent in May 1992 (figure 3.1). This initial attempt at financial stabilization started unraveling in April 1992, when the parliament started a serious onslaught on the reform government, and it fell apart altogether in June.

The precipitous fall in output continued, but it appeared to moderate. In 1991, industrial production had plummeted by 14.7 percent, and the decline had accelerated during the year, but the slump was somewhat less, at 13.5 percent, during the first half of 1992 (RECEP 1993, 116). Although this was a substantial decline, it was expected. Eastern Europe had experienced similar contractions, and since the Soviet economy was far more distorted, its output drop had to be bigger (Winiecki 1991, Kornai 1994).

The reform government had succeeded in making a breakthrough for the establishment of a market economy, but it was not even close to halting inflation or reviving the economy. One of Gaidar's advisors, Sergei Vasiliev (1999, 86), reflected:

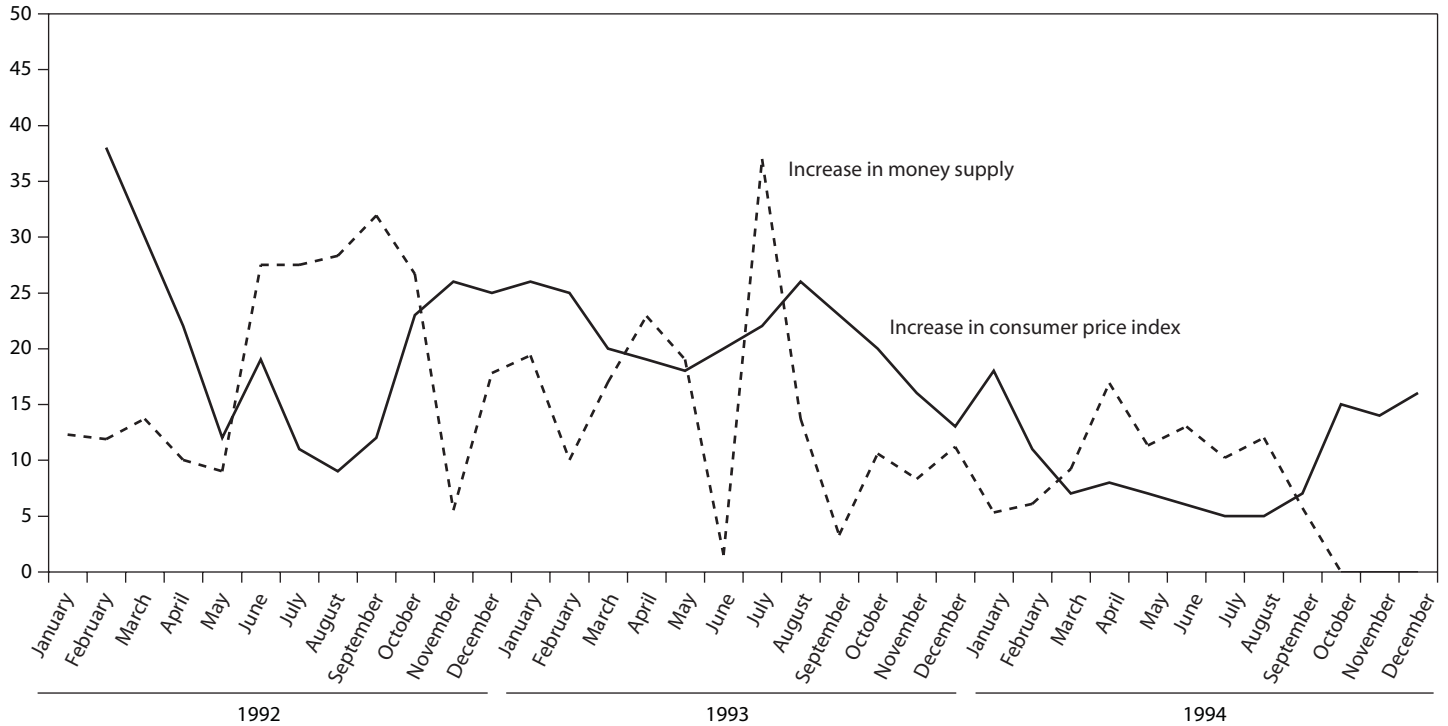
In the period following the Soviet Union's collapse, all the major social groups were, in effect, paralysed. Actions taken by the government, consequently, were of tremendous significance. . . . The reform government failed to make good use of that short period when it had virtual freedom to do what it deemed necessary. The reformers claimed that there was no significant resistance to reform, but in practice they constantly made compromises with the conservatives. . . . Still, thanks to the institutional vacuum, many transformations were quite smooth. The first phase of the reform was more successful than the reformers had expected, but that period did not last long. As early as spring 1992, the government came under strong pressure from various lobbies. The agrarian lobby was the most effective, and by summer of 1992 it had actually wiped out the success of stabilization in the early months of reform.

## Parliamentary Revolt Against the President

In the fall of 1991, Yeltsin was Russia's unquestioned political leader. Even the communists in the parliament supported him. He left political reform

**Figure 3.1 Monthly inflation and monetary expansion, 1992–94**

percent



Source: RECEP (1993, 116–18).

for later, a major mistake and arguably the greatest of his career. Unfortunately, he would not change this decision until September 1993, when it was too late, as Yeltsin recognized in his memoirs:

Maybe I was in fact mistaken in choosing an attack on the economic front as the chief direction, leaving government reorganization to perpetual compromises and political games. I did not disperse the Congress. . . . Out of inertia, I continued to perceive the Supreme Soviet as a legislative body that was developing the legal basis for reform. I did not note that the very *Congress* was being co-opted. The deputies suddenly realized their omnipotence, and an endless bargaining process ensued . . . but the painful measures proposed by Gaidar, as I saw it, required calm—not new social upheavals. Meanwhile, without political backup, Gaidar’s reforms were left hanging in midair. (Yeltsin 1994, 127)

Russia’s political foundations were much shakier than Yeltsin realized, because according to the old Brezhnev constitution the parliament was sovereign. The constitution could be amended instantaneously through a vote by two-thirds of the deputies. Yeltsin favored a new constitution, but provisionally he had the old one altered in a democratic manner. This solution had two serious shortfalls. First, a qualified majority could change the constitution at any time in any manner. Second, the Brezhnev constitution did not provide for any division of power: the Congress of People’s Deputies was sovereign, as had been the case in Europe until the 18th century when Montesquieu’s (1748/1977) ideas of division of power spread. Constitutions with sovereign parliaments tended to be dysfunctional and lead to violent resolutions, such as the partition of Poland in 1772, the royal coup in Sweden the same year, or the civil war in England in the mid-17th century.

The Russian Congress of People’s Deputies had been elected in March 1990 before full democratization. It was poorly structured, with the deputies floating between changing factions. In the spring of 1992, roughly one-third of the deputies identified themselves as communists, and one-third were democrats supporting Yeltsin. The final third were so fluid that they were called the “marsh” (*boloto*). Soon the marsh was for sale, leading to substantial parliamentary corruption, and it floated in the direction of the state enterprise lobby. Many deputies were accidental, because they formed a second echelon of politicians after the first echelon had been elected to the USSR Congress of People’s Deputies in March 1989. They did not represent their voters, or even maintain contact with their constituencies, so they were neither responsible nor accountable.

The Congress styled itself comically like an operetta. In February 1992, I visited Speaker Khasbulatov’s chief of staff in the White House, which the Congress had taken over. The White House is huge and has many entrances. At the first entrance, I was met by a fierce-looking group of armed men dressed in White Guard uniforms from the Civil War. At the second entrance, an equally intimidating horde of uniformed and armed Cossacks told me off. Finally, I found the right entrance, where Khasbulatov’s

staff met me. They were dressed in the gray suits or black leather jackets characteristic of the old Central Committee, where they had all worked before. I made sure to remember the right entrance for my later visits.

Russia needed a constitutional order with a stable division of power as well as a founding parliamentary election, which could have led to the creation of real political parties as well as a democratic majority (McFaul 2001). Yeltsin was supreme from August until November 1991, and he could have asked the Russian Congress of People's Deputies to dissolve itself, and it would have obediently accepted. Yeltsin's failure to do so was a major sin of omission that might well have been the most important reason for the subsequent failure of democracy in Russia.

However, Yeltsin alone was not at fault. He had wanted a new constitution but did not manage to hammer out an agreement before the political consensus fell apart. Hardly anybody surrounding him had a good understanding of democracy building. Nor was any relevant advice from foreign political scientists apparent. Most prominent Western political scientists denounced the radical market reforms that Yeltsin realized were necessary, and their preoccupation was increased social benefits rather than democracy building.<sup>8</sup>

Many considered the old Soviet constitution legitimate, just because it was a constitution, although it was unrelated to democracy. The transitologists who dominated Western comparative politics regarded negotiated solutions as preferable (Karl and Schmitter 1991). At this time, many economists went to Moscow to tell Yeltsin and Gaidar in no uncertain terms how to carry out the economic reforms.<sup>9</sup> Some political scientists met with them as well, but they appear not to have pushed any clear policy advice.<sup>10</sup> Many books put forth policy advice on how to undertake the economic transition to capitalism,<sup>11</sup> but I am unaware of any normative book that proposed how to build a democracy. Thus, mainstream Western political scientists were neither right nor helpful.<sup>12</sup> If they played any role it would have contributed to Yeltsin's failure to dissolve parliament in the fall of 1991.

Ironically, Yeltsin himself had promoted the two men who were to lead the opposition against him. After Yeltsin had been elected Russian president in June 1991, he supported the candidacy of his first deputy, Khasbulatov, as speaker. Ethnically, Khasbulatov was a Chechen, and he was a

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8. A case in point is Przeworski (1991), the dominant political science book on transition at the time.

9. I know, because I did, but so did many others.

10. I owe this point to Michael McFaul.

11. See Allison and Yavlinsky (1991), Åslund (1992), Blanchard et al. (1991), Kornai (1990), Peck and Richardson (1991), and World Bank (1991).

12. Naturally, there are exceptions, but the best publications appeared much later, notably Diamond (1995), Bunce (1999), and McFaul (2001).

respected professor of international economics at the Plekhanov Academy, Moscow's prime business school. Unfortunately he knew virtually nothing about economics, as was so often the case with Soviet professors of political economy.<sup>13</sup> As chairman of the parliament, however, Khasbulatov showed extraordinary skills, manipulating the majority at will and persuading it to make the most unexpected decisions. Before the presidential elections in 1991, Yeltsin had coopted a reformist communist general, Alexander Rutskoi, to gain votes from moderate communists and made Rutskoi his vice presidential candidate. Rutskoi's main attractions were his good looks and that he was a general (Yeltsin 1994).

Yeltsin did not get much of a honeymoon after the August coup—only three months, of which he rested for two months. Vice President Rutskoi made his first attack on the new government on November 18, 12 days after its appointment, insinuating that its ministers were toddlers. Four days later, Khasbulatov incited the parliament to refuse to give the reformers control over the Central Bank, which made monetary stabilization impossible. Khasbulatov and Rutskoi became the opposition leaders, clearly disappointed to have been left out of the government, and their opposition would grow ever greater until the storming of the Russian parliament in October 1993.

Yeltsin's appointment of a government of young, outstanding economists was brave, and the economic reforms required them. But many were upset about these appointments. The Russian parliamentarians saw themselves as victorious revolutionaries. The parliament had defeated the August coup, and revolutionaries not only know that they are right, they also think that they have the right to everything. They were exceedingly pompous and irresponsible. This was particularly true of Khasbulatov and Rutskoi. The activists in Democratic Russia also felt they had been let down, although they continued to support Yeltsin and his government. And the old *nomenklatura* was, of course, furious all along. Such divisions are associated with any revolution, but they were aggravated because the Russian parliament did not have much of a legislative role, with Yeltsin legislating by decree in 1991–92. Therefore, the new ministers did not have to appear much before parliament and were poorly known by the parliamentarians, who became idle and frustrated.

The powerful state enterprise managers also felt excluded. So did the old reform communist economists, who had no role to play in the economic reforms, which they opposed. The old academicians spoke contemptuously of the ministers as "junior researchers" and opposed shock therapy as "unprofessional," arguing for a larger budget deficit, looser monetary policy, and price regulation, which revealed their complete eco-

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13. In May 1990, I held a seminar with Khasbulatov at the Stockholm School of Economics. His résumé stated that he was fluent in English, but he spoke none. When a banker asked him what to do about the monetary overhang in the Soviet Union, Khasbulatov responded that it was no problem at all—the more money there was, the more production there would be.

conomic ignorance.<sup>14</sup> Most of them joined the reestablished Communist Party of the Russian Federation.

The revolutionary staff rivalry was aggravated by Russia's immense generational divides. Most who had been hardened by the Great Terror in 1937 and World War II as adults remained Stalinists. Gorbachev and his cohort, by contrast, identified themselves as the "children of the 20th Party Congress" in 1956 who had come of age during Khrushchev's thaw. They were the last believers in socialism and its possible reform. The next generation, which had matured under Brezhnev, was cynical and passive. Having never been allowed to make careers, they have played a minimal role in Russian politics. Sensibly, Yeltsin boldly reached out to the more idealistic and ambitious post-Brezhnev generation of Gaidar.

At the World Economic Forum in Davos, Switzerland, in January 1992, Academician Oleg Bogomolov complained about the ignorance of the new Russian ministers. One of them, Deputy Prime Minister Aleksandr Shokhin, a young professor of economics, responded that unlike the older generation, his generation had learned English and had read the international economic literature.<sup>15</sup> "We did not only read your books—we wrote them," Shokhin added sarcastically, because many old Soviet academics did not write themselves but exploited younger ghostwriters. The mutual aggression between the older and younger generation of Russian economists was extraordinary, just like the generational divide between feudal fathers and radical sons in Ivan Turgenev's novel *Fathers and Sons* from 1861.

When the old-style critics had no other argument left, they denied that general laws of social science applied to Russia with quotations from the 19th century romantic Russian poet Fedor Tyutchev: "Russia cannot be understood with the mind, or measured by an ordinary yardstick: She has a special status—All you can do is believe in Russia." This was a motto of the Slavophiles. A famous quote by Winston Churchill added to the obfuscation: "Russia is a riddle wrapped in a mystery inside an enigma." But he uttered those words in 1939, when the Soviet Union was as closed as a society can be.

Along these mystic lines, one group of reform communists argued: "Our situation is special. It cannot be described with general rules" (Pettrakov et al. 1992). Khasbulatov (1992) concurred: "The economic reforms must not be based on abstract and extremely simplified models, but on decisions derived from real life, on considerations of the real situation in the economy, the population of the country, and the experiences of the whole political and socioeconomic history of Russia." In practice, these

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14. See Abalkin (1992), Arbatov (1992), Bogomolov (1992, 1993), Fedorenko et al. (1992), Khasbulatov (1992), and Pettrakov et al. (1992).

15. I attended that session.

old Slavophile arguments won in politics, but eventually they lost out in economics.

The Gaidar government's political management left much to be desired. The new ministers were Russia's best young economic researchers belonging to the intellectual elite in Moscow and St. Petersburg. Most of them had been members of the CPSU, because that was a requirement for elite membership, but they were no politicians. Yeltsin explicitly stated that he appointed them as professionals, and they were proud of not being politicians. They delegated politics upwards to First Deputy Prime Minister Burbulis and Yeltsin. The liberal Burbulis was the single link between the young reform ministers and Yeltsin, and that was not enough. After several months, they became politicians, but that was too late.

However radical and resolute Yeltsin sounded, he was a politician who hedged his bets, and he was more intuitive than consistent. After appointing his young reform ministers, he kept them at a distance and gave them no direct access to himself. "The ministers would clear all matters requiring my involvement through Burbulis" (Yeltsin 1994, 156). Even Gaidar had minimal access to Yeltsin. The government was housed in the old CC headquarters at the Old Square, while Yeltsin and his presidential administration sat ensconced in splendid isolation in the Kremlin. Although President Yeltsin formally was prime minister, he rarely participated in the weekly cabinet meetings. No radical reform would have occurred without Yeltsin's blessing, but his involvement was insufficient for full-fledged political support. Regardless of Yeltsin having arranged this himself, he became disenchanted:

Soon it became evident that the Gaidar government, which was rapidly making one decision after another, was in complete isolation. Gaidar and his people never traveled around the country to take the pulse of the nation. From the outset, these ministers perceived the Khasbulatov parliament as an instrument of pressure on them, as a symbol of everything that was reactionary, everything that had to be fought. That was their attitude to Ruskoi, the vice president, as well. . . . [B]y sophisticatedly refusing to "dirty their hands with politics" and leaving all political initiative to their chief, the Gaidar team made a tactical error that cost us all a great deal. (Yeltsin 1994, 158–59)

The first severe confrontation between the reform government and the Russian Congress of People's Deputies took place in April 1992. Khasbulatov had mobilized a majority of the parliament in opposition to Yeltsin. His two key demands were a looser, even more inflationary, fiscal policy, and reduced power of the president. From this time, a new constitution was a permanent topic of discussion, but no common ground was to be found. The Congress wanted to have all power, which Yeltsin opposed.

Yeltsin was a patently poor negotiator. When negotiating with the Congress, he started with concessions, making certain personnel changes before its session and promising to replace three to five ministers with experienced industrialists, but he did not secure anything in return. Char-

acteristically, he did not even talk to Gaidar about this important issue but “passed this list on to Gaidar through Burbulis, since [Yeltsin] considered it premature to meet with the government at this time.” Feeling abandoned by Yeltsin and under heavy attack from the congress, Gaidar and his ministers walked out of the Congress and submitted their collective resignation, to Yeltsin’s surprise and appreciation. Thanks to their determined action, the government survived. Gaidar grew to be a politician, but the political isolation of the reformers was overwhelming (Yeltsin 1994, 164–67; Murrell 1997, 100–104). As a concession to parliament, Yeltsin (1994, 159–60) dismissed Burbulis as first deputy prime minister in April 1992, which absurdly left the Gaidar government with minimal contact with its boss.

Rather than taking the lead, Yeltsin took a lot of time off in early 1992. He marveled over how wonderful Russia’s state enterprise managers were. They were well organized in the Russian Union of Industrialists and Entrepreneurs, which had been founded by the old liberal CPSU apparatchik Arkady Volsky, who was a skillful man for all seasons. Volsky opposed radical market reforms, because his constituency benefited from subsidized credits and foreign trade arbitrage. Now, Yeltsin had forgotten why he had launched radical economic reform and wanted “industrialists” in his government, not understanding that they were the main opponents of his reforms (Yeltsin 1994, 164–73).

After having failed to liberalize energy prices at the beginning of 1992, Gaidar tried to do so repeatedly, but now Yeltsin was dead set against it. At a cabinet meeting in May 1992, Yeltsin sacked Gaidar’s minister of energy, Vladimir Lopukhin, for having advocated energy price liberalization, which Gaidar did as well. Yeltsin did so without having informed Gaidar (Yeltsin 1994, 166–67).

In May–June 1992, Yeltsin appointed three heavy industrialists as deputy prime ministers. Most prominent among them was Viktor Chernomyrdin, the last Soviet minister of gas industry and the founder of Gazprom, the state corporation that compounded all the Russian assets of his former ministry. In June 1992, the parliament sacked Matiukhin as chairman of the Central Bank, accusing him of excessively strict monetary policy. In came the last chairman of the Soviet State Bank, Viktor Gerashchenko, although he had been complicit in the August 1991 coup and had carried out the unpopular Pavlov monetary confiscation in January 1991. Yeltsin elevated Gaidar to acting prime minister in June 1992, but these personnel changes meant that the first attempt at radical economic reform was over. For the rest of 1992, Russia slid toward hyperinflation with a minimum of policy.

A consequence of this fierce standoff between the president/government and the legislature was that no reform legislation could be adopted from June 1992 until December 1993. “[D]ecisions made by one branch of government were automatically canceled out by the decisions made by another” (Gaidar 1999, 230). Considering that the transition to a market

economy required hundreds of new laws, the reform effort was impeded and distorted. Many concrete decisions concerning privatization or deregulation could be undertaken by decree, but general laws and legal codes had to be negotiated in parliament.

## Ambitious Mass Privatization

Political attitudes toward privatization were peculiarly volatile. Nationalization of the means of production was one of the last communist dogmas to fall, but after the 500-day program had made privatization acceptable, a broad consensus demanded instant mass privatization. At first, both the right and the left complained that privatization had not already been carried out, but after Russia had undertaken the largest and fastest mass privatization in world history, it was sharply criticized.

In December 1990, Russia had enacted a Law on Enterprises and Entrepreneurial Activity, and in the summer of 1991 the Russian parliament adopted one law on privatization and another on personal privatization accounts. Unfortunately, their drafters had not thought through the privatization, so these early laws could not possibly work.

An intense public debate on privatization took place in the first half of 1992. Since Russia was dominated by big enterprises, the debate focused on their privatization. All agreed that privatization had to be extensive and fast. The questions concerned primarily how to privatize and who would benefit. State managers were quickly taking over the nominally state-owned enterprises, because Russia's Enterprise Law of 1990 effectively left the managers as masters of state enterprises. A Soviet decree on leasing of April 1989 allowed them to "lease" their state enterprises, gradually seizing them as property. In February 1992, some 9,500 state enterprises were leased, and they accounted for 8 percent of total Russian employment (Frydman et al. 1993, 20–22). Between 1989 and 1991, a plethora of associations, concerns, and corporations were set up as ministerial officials attempted *nomenklatura* privatization. By the end of 1991, Russia harbored more than 3,000 such associations. Against this backdrop, Yeltsin (1991) stated in his big reform speech:

For impermissibly long, we have discussed whether private property is necessary. In the meantime, the party-state elite has actively engaged in their personal privatization. The scale, the enterprises, and the hypocrisy are staggering. The privatization in Russia has gone on for [a long time], but wildly, spontaneously, and often on a criminal basis. Today it is necessary to grasp the initiative, and we are intent on doing so.

Russians talked about *prikhvatizatsiya*, a Russian pun combining the words for grabbing and privatization. A strong sense prevailed that what was not privatized would be stolen by the old elite. Chubais (1999, 29)

noted: “At the end of 1991, the spontaneous privatization was steam-rolling all over. It was the theft of the common property, but this theft was not illegal, because legal schemes of de-statization did not exist.”

A major aim of privatization was to ensure that managers did not usurp everything. Another threat was that the old industrial ministries or their subsidiaries would replace themselves with holding companies. State managers proposed that enterprises be given to the workers, presuming they could exploit their workers. Democrats and reformers hoped for mass privatization through vouchers distributed to all to give every Russian a share. Unlike in Central and Eastern Europe, restitution to former owners was not an issue.

Chubais’ advisors, Maxim Boycko, Andrei Shleifer, and Robert Vishny, were the main thinkers behind the Russian privatization, and they published a forceful book, *Privatizing Russia*. Their view was that:

[A]t least in Russia, political influence over economic life was the fundamental cause of economic inefficiency, and...the principal objective of reform was, therefore, to depoliticize economic life. Price liberalization fosters depoliticization because it deprives politicians of the opportunity to allocate goods. Privatization fosters depoliticization because it robs politicians of control over firms. (Boycko, Shleifer, and Vishny 1995, 10–11)

Under communism, managers had been selected and promoted by political criteria. The only cure was to separate politicians from property:

In our view, controlling managers is not nearly as important as controlling politicians, since managers’ interests are generally much closer to economic efficiency than those of politicians. Once depoliticization is accomplished, the secondary goal of establishing effective corporate governance can be addressed. (Boycko, Shleifer, and Vishny 1995, 65)

Another key idea was to unify cash rights and control rights to align the incentives of owners and managers and stop the rampant asset stripping. Managers should be made interested in profits and asset values rather than taking assets out of a company.

After extensive debates and negotiations, the government managed to persuade the Russian parliament to amend the Privatization Law and adopt a Privatization Program in June 1992. These were the last reform acts to be promulgated. The outcome was a compromise with three different options for privatization. First, importantly, enterprise associations were to be broken up and enterprises were to be privatized individually, which was done quite consistently. Then, large enterprises were transformed into joint stock companies. The property rights would not be collective but individual and transferable. The Russian privatizers pragmatically appealed to a spectrum of stakeholders to make sure that real privatization was possible. The managers were coopted by the reformers, and the most popular option gave 51 percent of the shares to managers and workers. The indus-

trial ministries, however, were hostile to privatization, because it would deprive them of their control over state enterprises, but they were defeated.

For Chubais, the main goal of privatization was “to form a broad stratum of private owners.” Other important aims were to improve the efficiency of enterprises, to create a competitive market, and to pursue rapid privatization.<sup>16</sup> Realizing the limits of their power, the Russian privatizers kept auxiliary objectives short. State revenues were not even a consideration, because no improvement in the functioning of enterprises could be expected until they had been privatized. Václav Klaus in Czechoslovakia sold privatization as an ideological program, while Chubais emphasized its material benefits to various stakeholders. In hindsight, Klaus’ approach was more beneficial in the long run, but both countries got privatization done (Appel 2004).

In August 1992, Yeltsin made privatization the centerpiece of his speech on the anniversary of the coup. He advocated the benefits of capitalism for ordinary people: “We need millions of owners rather than a handful of millionaires.” He emphasized equality of opportunity and freedom of choice. His big news was that Russia would undertake a voucher privatization: “The privatization voucher is a ticket for each of us to a free economy.”<sup>17</sup> These two statements were to come back to haunt him.

The idea of voucher privatization for Russia was born relatively late, at a conference at Harvard University in Cambridge, Massachusetts, in February 1992 in a conversation among Chubais’ main advisors on privatization.<sup>18</sup> The inspiration came from Czechoslovakia, whereas Poland and Hungary showed problems with privatization to be avoided. The Russian scheme was simpler than the Czechoslovak one. Every Russian received one privatization voucher for free before the end of January 1993. Unlike in Czechoslovakia, the vouchers could be traded, because the privatizers wanted to encourage an early concentration of ownership. They worried that the vouchers would disperse ownership too much to allow effective owners’ control. Chubais exaggerated the material benefits Russians would gain from the voucher privatization, arguing that such a voucher would be worth a Volga car. This would cost him a great deal in the future, but his goal was not egalitarianism but a normal market economy based on predominant private ownership.

Yeltsin issued a decree on the issue of privatization vouchers in August 1992. Enterprises were privatized through auctions, where anybody with vouchers could bid for stocks of a specific company. The first voucher auctions were held in December 1992, and they continued relentlessly despite

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16. “State Program for the Privatization of State and Municipal Enterprises of the Russian Federation for 1992,” *Rossiiskaya gazeta*, July 9, 1992.

17. *Rossiiskaya gazeta*, August 20, 1992.

18. The advisors were Maxim Boycko, Andrei Shleifer, and Dmitri Vasiliev. I attended that conference.

considerable political tumult. The last voucher auctions took place in the summer of 1994. Meanwhile, 16,500 large enterprises (with more than 1,000 workers each) had been privatized in this way.

The voucher privatization was more successful than anybody had dared to hope. This was the largest privatization the world had ever seen. The distribution of shares, however, was not quite as expected. Only 20 percent of the shares of the companies were actually sold at voucher auctions, largely to outsiders, whereas 18 percent of the stocks belonged to managers and 40 percent to workers in 1996, and the managers often controlled their employees' shares. A critical mass of private enterprise had been built, because Russia claimed 920,000 private enterprises in 1995 (Blasi, Kroumova, and Kruse 1997, 189, 192–93).

Russia had hardly any small, private firms. "According to official statistics, as of January 1, 1992, in all of vast Russia only 107 retail stores, 58 cafeterias, and 56 service enterprises had been privatized" (Gaidar 1999, 167). Yet, small-scale privatization was neither innovative nor complicated, and it was swiftly done. Experimental sales of shops had started in St. Petersburg in 1991, and that city's privatizers were given the chance to apply their skills to the whole country. The lesson was clear: let the local authorities sell small enterprises at auctions and encourage them to do so quickly.

After Chubais had become minister of privatization in November 1991, he quickly established a new privatization apparatus throughout the country, and it started with the sale of small enterprises. In February 1992, the first shops were auctioned off in Nizhny Novgorod in a theatrical televised auction in the presence of both Gaidar and Chubais. Exploiting the old communist mechanisms, Chubais set up stiff monthly plan targets for the small-scale privatization by which officials were assessed.

Small-scale privatization gained full speed in July 1992, and an average of 5,000 to 6,000 small firms were sold each month until July 1993. By August 1994, the government assessed that no fewer than 106,000 small firms had been privatized. Quantitatively, the small-scale privatization was an unmitigated success, and it was not very controversial. Qualitatively, however, it was not all that great. In fact, few auctions were held and most shops were sold cheaply to their managers. Often, many liens and regulations persisted for years, rendering it difficult to distinguish between a privatized and state-owned shop. New private shops looked far better.

Housing was privatized with relative ease. By and large, it was given away almost for free to its tenants, who enjoyed quasi-property rights. Commercial real estate was a nightmare because usually about five different agencies had claims to the same property. One agency used the premises, whereas it formally belonged to another, and a third was entitled to rent income, and a fourth to possible sales revenues. It took years to align all these dispersed property rights. In agriculture, the old communist establishment ruled, and most peasants were old, conservative, and fearful, rendering land privatization nearly impossible.

Chubais' privatization was the greatest success of Russia's reform. In late 1994, the European Bank for Reconstruction and Development assessed that half of Russia's GDP originated in the private sector (EBRD 1994). Most of Russia's large, medium-size, and small enterprises had been privatized, while large sectors, such as agriculture, infrastructure, and the military-industrial complex, remained completely public.

## **Abortive Financial Stabilization**

The appointments of three state enterprise managers as deputy prime ministers in June 1992, and of Viktor Gerashchenko as chair of the Central Bank in July, marked the end of the first attempt at macroeconomic stabilization. The money supply (M2) increased by a monthly average of 28 percent between June and October, and inflation rose to 26 percent a month from November to February 1993 (figure 3.1). Russia was approaching hyperinflation, which starts at 50 percent a month (Cagan 1956). The velocity of money was rising, which means that the inflation tax plummeted, because people and enterprises escaped from rubles to dollars or goods.

Gerashchenko maintained the extreme position that no monetary overhang had existed. He insisted that the prior ratio between money and GDP had to be restored through massive monetary emission:

Could the economy manage with the former money supply when the prices were rising[?]. . . . [W]ere the previous monetary resources really sufficient to exist at the present price level, when the wholesale prices have risen 16 to 18 times? According to my view, they were inadequate. (Gerashchenko 1992)

The concern of Gerashchenko and the industrialists was rising inter-enterprise arrears. Partly, the nonpayments signaled a healthy capitalist instinct to care about money, but the centralized state payment system could not cope with the large number of new enterprises, and no collection system existed, but if so desired that could be resolved through advance payments. The industrialists easily colluded in demands for the issue of more money to net out the debts and to "index" their working capital. For some time the government and Central Bank complied (Sachs and Lipton 1993). Jeffrey Sachs assessed Gerashchenko as "the worst central banker in world history," which was a fair judgment.

## **A Bonanza for Rent Seeking**

The reason for the failure of financial stabilization was that rent seekers made fortunes on the rent-seeking machine built by Gorbachev's partial reforms. In 1992, Russia's rents were possibly the greatest the world has ever seen. The four main sources of rents were regulated commodity exports, subsidized grain imports, subsidized credits, and state subsidies.

First, total export rents were no less than \$24 billion or 30 percent of GDP in 1992. State-controlled, domestic prices of commodities were at most one-tenth of world market prices, and more than 70 percent of Russia's exports were commodities subject to export quotas (Aven 1994, 84). Total Russian exports outside the CIS amounted to \$42.2 billion. Collected export tariffs were some \$2.4 billion, while GDP was only \$79 billion in 1992, because of the very low exchange rate (World Bank 1996b).

Another large source of rents was subsidized imports, which the IMF (1993, 133) calculated at 17.5 percent of GDP in 1992. Because of the fear of starvation, Russia maintained special exchange rates for so-called critical imports until 1993, subsidizing such imports to 99 percent. The Russian importers of grain bought hard currency for only 1 percent of the going exchange rate in 1992, allowing them to pay only 1 percent of the world market price for imported grain, while bread was sold at ordinary domestic prices. Ironically, \$12.5 billion of foreign credits designated as humanitarian aid did not support but rather undermined economic reform efforts, whereas the outside world did not provide any support for the economic reforms in the first half of 1992.

A third source of rents was the emission of subsidized state credits. The Central Bank of Russia issued new credit equivalent to 31.6 percent GDP in 1992 (Granville 1995b, 67). As these loans were largely given at an interest rate of 10 to 25 percent a year, while inflation that year was 2,500 percent, they were sheer gifts. These gifts rendered Gerashchenko very popular among the Russian elite, although the banking sector was rampant with crime thanks to his largesse.

The fourth source of rents was direct enterprise subsidies provided by the state budget amounting to 10.4 percent of GDP in Russia in 1992 (EBRD 1997, 83).

From these four sources, total gross rents amounted to an incredible 90 percent of Russia's GDP in 1992. And that does not include some rents such as tax exemptions. Presumably, rents have never been larger as a ratio of GDP anywhere in the world than they were in the former Soviet Union in 1992. Select citizens became conspicuously wealthy when they transferred these rents and subsidies from state enterprises to their private accounts through transfer pricing or outright theft.

By the end of 1992, it was easy to despair. Russia appeared a state captured by rent seekers, ranging from state enterprise managers, state officials, bankers, and new entrepreneurs to organized crime. Could this rent-seeking machine be broken? Strangely, in the course of 1993, most of these rents disappeared, in part because of policy, in part due to a normalization of the market.

Although Gaidar had been ousted as acting prime minister in December 1992 and replaced by the industrialist Chernomyrdin, a strong reformer became minister of finance, the young and forceful economist

Boris Fedorov, who had been one of the authors of the 500-day program. With authority and militancy akin to that of Chubais, Fedorov started systematically sorting out macroeconomic policies. Energetically, he bombarded everybody with sensible policy initiatives. Sometimes he succeeded, sometimes not.

## The End of the Ruble Zone

The most fundamental flaw was the ruble zone, which had to be broken up. At the beginning of 1992, 15 republican central banks competed in issuing ruble credits. If one country issued more credits than the average, it gained a disproportionate share of the common GDP, but it condemned itself to hyperinflation.

The collapsed Habsburg Empire had faced a similar dilemma after World War I. One single country, Czechoslovakia, had swiftly abandoned the common currency zone, and established its own national currency. It was the only Habsburg successor country to avoid hyperinflation and maintain democracy until World War II. All the others faced high inflation, which contributed to their political destabilization and the failure of democracy (Pavolsky 1928). These lessons were well understood and discussed in the West at this time (Sargent 1986, Dornbusch 1992). Unfortunately, the CIS countries did not heed these lessons.

In the summer of 1992, the three Baltic countries broke out of the ruble zone and established their own national currencies. Kyrgyzstan followed in May 1993. The other 11 countries stayed in the notoriously inflationary common currency zone. From the outset, Gaidar (1993) and other Russian reformers had advocated the “nationalization” of the ruble. Fedorov pushed this line with great fervor, because the cost to Russia was enormous—22 percent of GDP in 1992 (IMF 1994b), which was part of the cost of the credit emission. However, the IMF considered this a political question, on which it preferred to be neutral, and it advocated coordination of monetary policy (Odling-Smee and Pastor 2002). But that could not have worked (Granville 1995b, 2002).

In July 1993, Gerashchenko, until then the greatest cheerleader of the ruble zone, suddenly finished it off by declaring Soviet rubles null and void, characteristically without consulting the minister of finance. A chaos of exchange queues outside all banks erupted again and lasted for several days, exactly as after Pavlov’s unsuccessful currency reform in January 1991. In 1993, the 10 other countries remaining in the ruble zone experienced hyperinflation, that is, more than 50 percent inflation in the course of one month, while Russia escaped with an inflation of “only” 840 percent. By September 1993, the ruble zone broke up, and a basis for monetary stabilization had been created (Granville 1995b).

## An Effective IMF Agreement

Apart from breaking up of the ruble zone, another major improvement facilitated by Fedorov was that Russia concluded an agreement with the IMF on a Systemic Transformation Facility in April 1993, which provided Russia with a framework for macroeconomic policy. This agreement established quarterly credit ceilings and compelled the Central Bank to raise interest rates, which Gerashchenko actually did. By November 1993, Russia had attained a positive real interest rate, and monetary emission started moderating.

A third important measure was that Fedorov managed to unify the exchange rate, which reduced import subsidies from 17.5 percent of GDP in 1992 to some 4 percent of GDP in 1993. He also minimized the destabilizing foreign commodity credits (IMF 1994a).

Fourth, Fedorov tried to raise or liberalize energy prices, and he was partially successful. Oil and coal prices were actually liberalized, and the prices of natural gas and electricity were hiked substantially. In addition, energy taxation rose through the imposition of VAT and increased excise taxes.

Many factors contributed to these policy improvements. Through their own suffering, the Russian people had learned the social costs of high inflation, and that it did not boost but disrupted production. The price distortions abated as the real exchange rate rose sharply. As a result, the average Russian wage rose from \$6 a month in December 1991 to \$114 a month two years later (figure 3.2). As arbitrage helped alleviate distortions, rents declined. The inflation tax dwindled when people and enterprises learned not to hold more rubles than absolutely necessary, which led to high velocity and demonetization (Åslund, Boone, and Johnson 1996). The IMF had finally become seriously engaged in the Russian stabilization, and it imposed some international norms on Chernomyrdin and Gerashchenko. Yeltsin, however, remained aloof from macroeconomic stabilization policy. As a consequence, in 1993 these rents were halved from their 1992 level, and they fell even more in 1994, but they started rising again from 1996 to 1998 (figure 3.3).

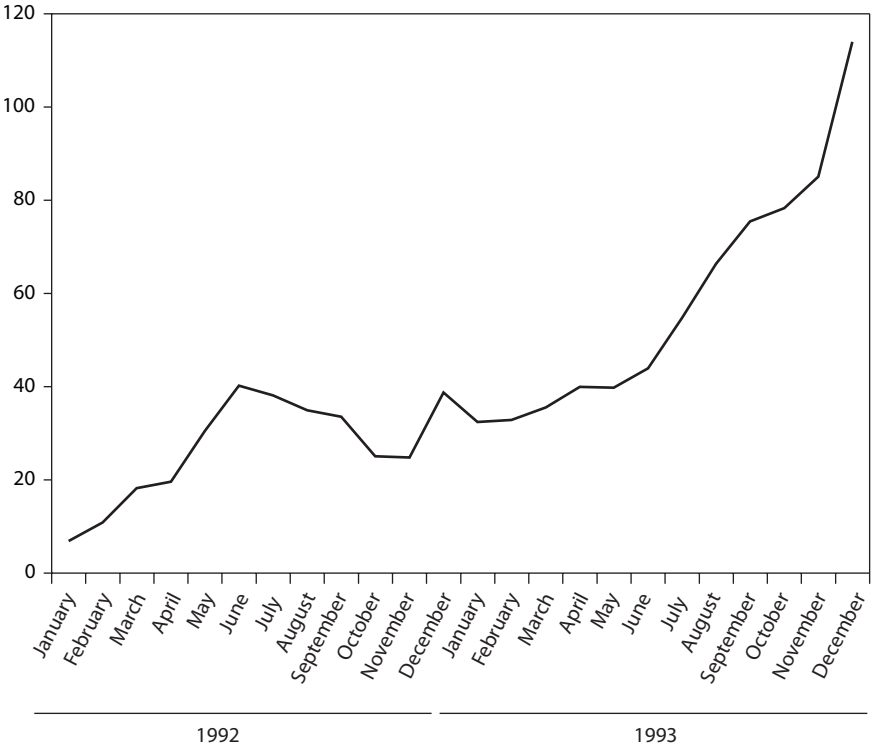
Although much of the groundwork for financial stabilization had been laid, stabilization remained elusive. Monthly inflation stayed in the double digits throughout 1993 and only halved from 26 percent in January to 13 percent in December 1993.

## Failure of the West to Act

The Soviet political and economic crisis and postcommunist transformation were dominant topics across the world in 1990. Everybody who was

**Figure 3.2 Monthly average wage, 1992–93 (US dollars)**

US dollars per month



Source: Åslund (1995, 185).

anybody took a clear position. At their summits in the summers of 1990 and 1991, the leaders of the G-7, the world’s seven leading industrialized democracies, discussed whether and how to support the collapsing Soviet Union economically. But they abstained from any decision. Admittedly, Gorbachev arrived to the G-7 summit in London in July 1991 with a contradictory economic memorandum, showing that he had no clear idea about what he wanted, and his economic policies were in shambles.

The situation changed completely with the abortive August 1991 coup, which marked Russia’s democratization. The three big question marks were eliminated: the Soviet Union, the CPSU, and Gorbachev. They were replaced with Russia and Yeltsin. Yeltsin’s big reform speech in October 1991 was as clear, market-oriented, and West-oriented as anybody could have asked for. Russia’s intention to undertake a radical market economic reform was abundantly evident. Yeltsin (1991) exhorted the West to help Russia at length and in no uncertain terms:

**Figure 3.3 Rent seeking, 1991–98**

rents as share of GDP



Sources: Åslund (1999); author's estimates.

We turn officially to the IMF, the World Bank, the European Bank for Reconstruction and Development and invite them to elaborate detailed plans in cooperation with and participation in the economic reforms.

We appeal to the developed countries and international organizations for technical assistance first of all for the training of personnel, analysis and elaboration of recommendations on principal economic, ecological, and regional questions. . . .

I appeal to the world community. Russia carries out its reforms in its own interests, and not under external pressure. Help from the world community can facilitate our movement along this road considerably and accelerate the reforms.

Alas, the West ignored his call. Throughout 1991, US officials avoided any speculation about the possible breakup of the Soviet Union, although it had been abundantly clear from August. Infamously, as late as August 1, 1991, US President George H. W. Bush warned of the dangers of a breakup of the Soviet Union in his “chicken Kiev” speech in the capital of Ukraine (Goldgeier and McFaul 2003, 28). The US Treasury harbored only a narrow interest in the Soviet Union serving its debt, which it was obviously unable to do without major reform.<sup>19</sup>

19. The exception was Secretary of Defense Dick Cheney, who was a dissident in the Bush administration. He favored Yeltsin, the breakup of the Soviet Union, and democracy and market reform in Russia (Goldgeier and McFaul 2003, 33).

Rarely has such a great historical opportunity arisen, and seldom has it been so evident in its coming. The young Russian reformers were working night and day to prepare their reforms, and a strong informed Western opinion urged their governments to support Russian reform. The *New York Times* (November 12, 1991) editorialized: "The challenge for the West is to encourage Mr. Yeltsin's real, radical program by giving attentive assistance now." On December 17, 1991, the *Financial Times* concurred: "Now is the first and, perhaps, the last chance for the West to promote radical economic reform in the former Soviet Union." They could not have been more right.

In mid-November 1991, the deputy ministers of finance of the G-7 descended on Moscow. The Russian reformers happily welcomed them, presuming they wanted to discuss the Russian reform plans and Western assistance. Alas, they did nothing of the kind. The G-7 representatives were interested in only one thing, that the soon-to-be former Soviet republics guarantee their "joint and several" responsibility to service the Soviet foreign debt. The Soviet republican representatives agreed, although it was evident that they could not guarantee anything in the rampant financial crisis. During four days in Moscow, the G-7 representatives ignored the Russian reform plans and refused to discuss assistance. They left the Russian reformers in a state of shock. Gaidar (1999, 141) noted, "The initial response of Western political and financial elites toward Russian economic reform was extremely wary and cool."

The next Western initiative was a sheer diversion. US Secretary of State James Baker convened a high-level international conference on humanitarian aid to the former Soviet Union in Washington in late January 1992, just after Russia had launched its daring reforms. The US administration designed the conference to discuss only humanitarian assistance and not support for reform. Incredibly, the United States did not invite anybody from the former Soviet Union, as if to avoid a reality test. In February 1992, the well-informed *Washington Post* columnist Jim Hoagland concluded that the United States did not provide any support to Russia because President Bush reckoned that Boris Yeltsin was a transitional figure.<sup>20</sup> Bush just could not get Russia right.

On April 1, 1992, five months after his dramatic appeal to the Western governments, Yeltsin received an answer of sorts. In the face of a coming onslaught from the opposition in the Russian Congress of People's Deputies, Bush and German Chancellor Helmut Kohl declared their intent to mobilize a \$24 billion Western aid package for Russia, but they never substantiated their April Fools' claim.

The West took a very tough position in the Paris Club, which was to renegotiate Russia's excessive debt service, although Russia generously accepted responsibility for the whole debt of the Soviet Union (Gaidar

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20. *Washington Post*, February 11, 1992.

1999, 119–21). The Russian reformers suffered from the parliament's attack, and by June 1992 their first reform attempt was effectively finished. The demonstrative absence of Western support contributed to the fall of the Russian reform government.

The amounts discussed were minor in comparison with the potential benefits. The total request for financial assistance for Russian economic reform in 1992 was about \$25 billion, of which \$6 billion was intended for a stabilization fund. Almost all the "assistance" would have been in the form of credits. A reasonable bilateral US contribution would have been \$3 billion.

Meanwhile the United States reaped \$69 billion in a peace dividend in terms of saved military expenditures in 1992 (Åslund 2002, 400–401). In comparison, the Marshall Plan accounted for 2 percent of US GDP at the end of the 1940s, which would have meant \$125 billion for the United States in 1992 dollars (Milward 1984; US Census Bureau 1999, 459). The West did give Russia credits of \$12.5 billion in 1992, benefiting Western agricultural interests. These bilateral loans were commodity credits, which actually blocked reform, because they became rents for commodity traders and their corrupt conduits. They were not conditional on any reform measures and not coordinated with international financial institutions.

The window of opportunity of "extraordinary politics" when the West could help Russian economic reform was brief, lasting only five months from October 1991 until March 1992. But the West turned its back on Russia's Western-oriented and democratic reformers, providing solely humanitarian assistance. This was the only big chance for the West to support reform in Russia, and the responsibility for missing it rests squarely with then-President Bush. This was a folly comparable with that of Georges Clemenceau at Versailles or Neville Chamberlain at Munich. Sachs' (1994, 1995) argument that early Western aid was critical for the success of economic reform, and that its delay could lead to both political and economic destabilization, was fully substantiated.

The only significant US interest was in denuclearizing the other former Soviet republics, either by destroying their nuclear arms or transferring them to Russia. This was the obsession of Secretary of State Baker, and he accomplished it because of effective Russian cooperation (Goldgeier and McFaul 2003). Even so, the Bush administration ignored Russia's hardship, which could do nothing but breed future Russian resentment against the United States.

Russia became a member of the IMF and the World Bank, as did most other former Soviet republics, in the spring of 1992. Both organizations had started working intensively in Russia from the fall of 1991, but they were not formally entitled to provide financing until Russia became a member. Alas, by that time Russia's economic reforms were already failing. As if to apologize for having missed the chance, the IMF gave Russia a loan of \$1 billion in August 1992 without serious conditions. In June

1993, Russia applied for membership in the General Agreement on Tariffs and Trade, which became the World Trade Organization (WTO) in 1995. But accession to the WTO is a slow process, and in the 1990s it was no priority of the Russian government, which focused on managing its finances.

Yeltsin was primarily interested in becoming a full-fledged member of the G-7. He had a very positive view of the West, arguably naïvely so, but he did not quite know what to do with it. The Western leaders treated him with undue reserve because he was very Russian and an outsized hero. Unlike Gorbachev, he was not inclined to small talk, and Western leaders preferred the personable Gorbachev to the great Yeltsin.

Oddly, the most notable Western presence in Russia in 1991 and 1992 was independent economic advisors, the most prominent of whom was Harvard Professor Jeffrey Sachs.<sup>21</sup> Yeltsin and Gaidar invited foreign advisors, and they listened to them to a surprising degree. The foreign advisors were greatly inspired by the Polish radical economic reform, which most of them had worked on. They persistently argued for more radical, comprehensive, and consistent reforms, and they wrote analytical notes on various problems. To an amazing extent, the recommendations they made in 1991–93 were eventually carried out.

## **Dissolution of the Parliament and Shootout at the White House**

The strife between the parliament and the president only escalated. Russia maintained the cumbersome Gorbachev model, with an outer parliament, the Congress of People's Deputies of slightly more than 1,000 deputies, who selected a smaller bicameral parliament, the Supreme Soviet, among themselves. Each session of the Congress amounted to a new onslaught on Yeltsin, his economic reforms, and his presidential powers. Originally, the Congress had been convened once every half year, but Speaker Khasbulatov called in the Congress ever more often to foment his irreconcilable opposition to Yeltsin.

Yeltsin could not stand the Congress. He spent as little time as possible there, which infuriated the parliamentarians. Before each congressional session, Yeltsin held a few consultative meetings and sacrificed a few of his most loyal and effective—and consequently most disliked—ministers, which demoralized his administration. From time to time, Yeltsin hinted about taking his own proposal for a new constitution and the dissolution

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21. Sachs, David Lipton, and I operated an official economic advisory team to the Gaidar government financed by the Ford Foundation and the Swedish government. From the outset, we worked closely with the reform ministers, who had invited us, and with a large number of young and able Russian economists, most of whom have enjoyed impressive careers. In 1993, we had a total of 30 employees.

of the Congress to a referendum (Murrell 1997). This was a lose-lose strategy. Yeltsin neither stood up to the Congress nor reached any tenable compromise. Each session of the Congress brought major setbacks to Yeltsin and economic reform.

In December 1992, the Congress of People's Deputies demanded the ouster of Acting Prime Minister Gaidar, and Yeltsin had little choice. He had not put Gaidar up for confirmation by the Congress because he realized it would not approve him. Instead, Yeltsin nominated Viktor Chernomyrdin as his candidate for prime minister. He was the most prominent state enterprise manager, who accepted a market economy, although he was not committed to macroeconomic stabilization. He was easily confirmed on December 14. In his brief acceptance speech, Chernomyrdin stated ambiguously that he favored deepening market reform as long as people were not impoverished, but that the market must not be allowed to turn into a "bazaar." His first decision was a decree on general price regulation, but it was quickly revoked and its author sacked (Yasin 2002, 198). The outstanding British Foreign Office analyst of Russia's domestic politics, Geoffrey Murrell, passed his judgment after the December 1992 Congress:

Yeltsin's handling of the Congress had been dogged . . . by indecision and misjudgement. He had wavered between two courses—appealing to the people over the heads of an unpopular Congress with a dubious mandate, and appeasing his congressional enemies with tactical sacrifices. Either course pursued with energy and consistency might have worked. Yeltsin's failure to choose between them and the timing of his belated attempt at confrontation ensured his defeat. (Murrell 1997, 126)

Unfortunately, Yeltsin continued in the same manner. The December 1992 Congress saw the last compromise between Yeltsin and Khasbulatov. They agreed on a referendum in April 1993 on the basic principles of the new constitution, and that the Congress would not introduce constitutional amendments to undermine the president's power. The chairman of the Constitutional Court, Valery Zorkin, was also part of this compromise, because the court participated as part of the Khasbulatov political camp, which seriously discredited the Constitutional Court.<sup>22</sup>

The first four months of 1993 were devoted to this ever more heated strife over the constitution and referendum. The threat of impeachment of Yeltsin was first raised in November 1992, and soon it became a major theme in congressional attacks on the president (Murrell 1997, 119). The Congress underwent quite a metamorphosis. In mid-1992, the moderate industrialists' party, the Civic Union, set the tone. From the end of 1992, a "red-brown" majority of unreformed communists and extreme Russian nationalists dominated, while democrats abandoned this madhouse. Some democrats converted to hard-core nationalism, seemingly out of op-

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22. In 2003, the Constitutional Court elected Zorkin its chairman once again.

portunism to promote their careers. By the spring of 1993, the red-brown had achieved a two-thirds majority, allowing them to appoint the inner parliament, the Supreme Soviet, at will. Yet, the red-brown did not develop any grassroots organizations or popular support, becoming ever less representative. Yeltsin succeeded in having a referendum accepted on April 25, although the questions were largely set by the Congress.

The referendum was a huge victory for Yeltsin. He won on all of the four questions posed, and the turnout was high at 64.5 percent (Murrell 1997, 153):

1. Do you have confidence in President Yeltsin? 58.7 percent voted yes.
2. Do you approve of the socioeconomic policy carried out by the president and government since 1992? 53 percent voted yes.
3. Do you consider it necessary to hold preterm elections for the president of the Russian Federation? 49.5 percent yes (of those who voted, but only 31.7 percent of the whole electorate).
4. Do you consider it necessary to hold preterm elections of the people's deputies of the Russian Federation? 67.2 percent yes (of those who voted, but only 43.1 percent of the whole electorate).

The most important question was the final one about the dissolution of the parliament. A two-thirds majority was impressive, but Khasbulatov had cleverly imposed the requirement of a majority of the whole electorate for the last two questions. Yeltsin had the moral right to dissolve the parliament on the basis of this referendum, and he should have called for immediate new parliamentary elections. Instead, he did nothing. This was Yeltsin's final opportunity to resolve the conflict with the Congress in a peaceful manner, and he missed it.

By August, Khasbulatov and the parliament rebounded. The parliament took the position of "the worse, the better." In August, it adopted a budget for 1994 with a deficit of 25 percent of GDP, which would have sent Russia into severe hyperinflation. Minister of Finance Boris Fedorov refused to abide by such a budget, and the political stalemate over economic policy alone made a political explosion inevitable (Åslund 1995, 198).

The constitution offered no way out of the crisis. Facing a completely irresponsible and unrepresentative, but sovereign, parliament, Yeltsin had no choice but to disband it. He finally did so with a decree on September 21, complaining that the Supreme Soviet majority was flouting the will of the people, as it had been expressed in the April referendum. The political paralysis could only be resolved through new elections for a new parliament, based on the draft constitution that had been approved by the Constitutional Conference convened by Yeltsin. The new parliamentary elections were scheduled for December 12. This approach seemed the most sensible at hand, but it was much too late.

Yeltsin had not secured loyal troops. Nor did he have a clear action plan. Speaker Khasbulatov and Rutskoi, who had been deposed as vice president because of alleged corruption, led the White House opposition. They were aware of Yeltsin's plans, because the security services were not loyal to Yeltsin, and they had gathered hard-line Russian nationalists with plenty of arms. The government tried to isolate the White House and turn off its electricity, and it demanded that everybody leave by October 4, but the police force that surrounded the parliament was weak and demoralized. The parliament impeached Yeltsin and named Rutskoi president. It also replaced three power ministers with its own hardliners, two of whom had recently been sacked by Yeltsin for corruption. These appointments were a key mistake by Rutskoi and Khasbulatov, because they left the incumbent power ministers with little choice but to support Yeltsin. Together with Rutskoi, the parliament's power ministers tried to appeal to the men in uniform, but they failed to gather support. Even so, several thousand armed extreme Russian nationalists and communists made a few attacks, killing several people. However, street demonstrations were quite limited in size (Murrell 1997).

The real revolt erupted on October 3. Rutskoi emerged on the balcony of the White House and ordered his armed followers to attack the mayor's office nearby and the Ostankino television station in northern Moscow. Khasbulatov called for the seizure of the Kremlin. A full-fledged armed uprising was under way. The insurgents swiftly took the mayor's office. Intense shooting broke out at Ostankino, but the insurgents only partially occupied it, and at least 20 people were killed. The government had managed to defend the TV station and no further attacks on official buildings followed, although snipers indulged in wild shooting from rooftops in central Moscow. The red-brown forces barricaded themselves in the White House, and on the night of October 3–4, Russian special forces attacked with tanks. About 150 people were killed and more than 1,000 injured, but no parliamentarian was even injured. The leaders of the revolt, including Khasbulatov and Rutskoi, were arrested (Aron 2000, 552–53).

After the failed uprising, Yeltsin held a simultaneous parliamentary election and constitutional referendum on December 12, 1993, as he had promised. As after the August 1993 coup, he treated the rebels with amazing leniency. Rutskoi even made a political comeback as regional governor. Yeltsin's shortfalls lay in other areas. He should have dissolved the parliament much earlier, when his legal justifications were stronger. The armed uprising had to be quelled, but Yeltsin could have nipped it in the bud with minimal bloodshed. Yeltsin (1994, 269) provided his own candid criticism:

Now that the bloody events are over, it can probably be said that we were tragically mistaken. If the police had been armed, if the Interior Ministry officers had had the chance from the start to react properly to the armed attack, the ferocious barbarism of the night of October 3–4 in Moscow would have been avoided.

## Great Achievements but Mixed Results

The Russian revolution of 1991–93 included both great achievements and shortfalls. Rarely had a country fallen in as dire straits as Russia in late 1991. Hardly any elementary condition of state order existed. The borders of the state were not determined. No tenable political system was in place. Law and order were absent, with crime skyrocketing. The Soviet Union still had some 4 million men under arms and 30,000 nuclear warheads. Hyperinflation was around the corner, while shortages were unbearable, and output in free fall. The West sent emergency food supplies to forestall starvation. Russia's fate lay in the hands of one man, Boris Yeltsin, and he had a strong sense of his responsibility and direction. Intelligently and boldly, he drew radical conclusions.

Possibly Yeltsin's greatest achievement was that he finished off the Soviet empire effectively and peacefully. Such an act is never popular, but it was necessary, which Yeltsin understood. Dankwart Rustow (1970) emphasized the importance of securing the borders of a state before any democracy could be built. A state without secure borders cannot be stable (McFaul 2001, 9). Yeltsin understood that no Russian recovery was possible as long as the Soviet empire persisted. With an extraordinary sense of timing, he acted at the optimal time, one week after the Ukrainian vote for independence. One week earlier or later might have resulted in failure. Immediately after this daring move, Yeltsin secured the support from the Soviet general staff for Russia. He also established all basic state institutions. It was quite a feat that civil war did not erupt and that chaos was averted.

Domestically, Yeltsin concentrated on economic reform and left political reforms for later. It is easy to understand why. The economic crisis was rampant, whereas basic political institutions were in place. Yeltsin received eminent economic advice but no relevant political advice. He never showed any clear concept of how to build democracy, although accusations of him being authoritarian were greatly exaggerated. His greatest error was not to dissolve the predemocratic Russian parliament in August–November 1991, when he still had the authority to do so. Later on, he could have called a referendum on the dissolution of the parliament, but for too long he vacillated between compromise and confrontation, while his opponents grew more militant. In April 1993, he sensibly insisted on a referendum on the dissolution of parliament, but he still failed to dissolve it even after having won a two-thirds majority, only because Khasbulatov had imposed an absurd standard of assessment. That was the last chance for a peaceful resolution of the conflict between president and parliament. Since the parliament no longer represented anything, it had no reason to compromise. Yeltsin's dissolution of the parliament on September 21 came as a relief, because simultaneously he announced early parliamentary elections and a

constitutional referendum three months later. His failure was not to head off the parliament's armed uprising.

Gorbachev is often accused of having started his democratizing reforms too early, but his real blunder was that he did not go far enough to real democracy. Yeltsin went all the way to truly democratic elections, notably the Russian presidential election in June 1991 and the parliamentary elections in December 1993. Alas, he stopped short of completing the democratic institutions over 1991–92. Because Russia did not hold any early founding election after the democratic breakthrough, its party system was never cemented (McFaul 1993). There was nothing fatal or peculiarly Russian in this misstep. Poland and Latvia did the same and Ukraine did even worse. The roots of the later demise of Russia's democracy lay not so much in the shootout of the parliament in October 1993 as in Yeltsin's failure to act decisively early on to dissolve the illegitimate parliament in the fall of 1991 and establish constitutional order.

These conclusions run counter to the thinking of transitologists that there should be negotiated solutions and a separation and spreading out of economic and political reform (O'Donnell, Schmitter, and Whitehead 1986; Karl and Schmitter 1991). It is difficult to blame Yeltsin, given that the leading political scientists of the day recommended his course of action.<sup>23</sup> Yeltsin rightly saw an early window of opportunity, but he chose to focus on the dissolution of the USSR and economic reform rather than on building democracy. Yet the extensive bloodshed in October 1993 did stain Russia's budding democracy.

In the fall of 1991, Yeltsin wanted to undertake radical market economic reform, and he did not shy away from talking about shock therapy. His basic strategy was sensible and delivered at least six major successes through reforms that proved viable and irreversible. First, price deregulation, the basic precondition for a market economy, was extensive. Second, imports were almost completely liberalized, rendering Russia an open market economy. Third, Russia unified its exchange rate. Fourth, by attempting to cut military procurement by 85 percent, Gaidar single-handedly beat once and for all what had long been considered an unbeatable military-industrial complex. Fifth, mass privatization established predominant private ownership, which provided the basis for subsequent economic recovery. Finally, in 1992 and 1993, the number of small private enterprises mushroomed as never before or after, with a critical mass of nearly a million private enterprises legally registered. Near hyperinflation was less harmful to small private firms than the resurgent bureaucracy that subsequently strangled their expansion. In sum, most, although not all, preconditions for a market economy had been created. In each case, reforms

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23. The only success in democracy building in the postcommunist world has been the wholesale emulation of European Union institutions. None of the 12 CIS countries has consistently been democratic. At present, Freedom House (2006) rates only Ukraine as free.

worked because they were simple and radical. The unwieldy, extensive, and corrupt Russian state could not carry out any piecemeal reforms.

Within the economic reform, all problems arose from the failure to be sufficiently firm and radical (Dąbrowski 1993b). The main shortcoming was the inability to control inflation, which was primarily caused by the permissive monetary policy of the Central Bank and the persistence of the ruble zone. The Gaidar government opposed both but it was defeated. Without any restraint on monetary policy, inflation prevailed.

The strong energy lobby convinced Yeltsin that he must not liberalize energy prices, which kept their rents huge in 1992 and 1993. An early liberalization of energy prices would have solved this problem, but that might not have been politically possible given the extraordinary price discrepancy.

The big state enterprise managers spearheaded all these destabilizing acts, while also extracting subsidies from the state. Fortunately, none of these rent-seeking activities was tenable in the long run. People learned about the harm of high inflation from their own suffering. Many rents dissipated over time, but fundamentally macroeconomic stabilization was a political question: Would a small elite be allowed to thrive on inflationary gains or not?

The politics of transition turned out to be the opposite from what had been expected. The reformers feared, and their opponents hoped for, strikes from the coal miners and other workers who had been so militant from 1989 to 1991, but strikes ceased with reform, even though real wages fell precipitously and wage arrears proliferated. Another widespread worry was that the public would take to the streets when prices were liberalized, but, again, nothing happened. When prices of key consumer staples are hiked, people often protest, but not when prices are liberalized on a broad scale. The whole economic paradigm changed, and people could see that no specific group was singled out.

The population posed no obstacle to radical economic reform, contrary to the prevalent assumptions in political science and political economy. Not only Yeltsin but also his economic reform strategy enjoyed strong popular support until the summer of 1993, as recorded in a steady stream of high-quality opinion polls. The April 1993 referendum showed that a majority of the Russian population supported radical economic reform in the midst of economic hardship. Ordinary Russians wanted systemic change and they realized that hardship was inevitable, but the Russian government did not reform fast enough.

The political problem was not the losers, but the winners. The title of a seminal article by Joel Hellman (1998) formulated the dilemma: "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions." The state enterprise managers and their accomplices were the main culprits, opposing early and radical reforms because they could make fortunes on delaying and distorting the reforms, and under the fragmented political system only small interest groups could successfully pursue col-

lective action (Olson 1971). The political dilemma of Russia's postcommunist transition was that the ineffective budding democracy could not mobilize the people against the rent seekers in favor of more radical reform, as in Central Europe and the Baltics (Åslund 2007a).

Unfortunately, the reformers did not realize that the seemingly moderate state enterprise managers would be their main opposition. Many managers had opposed the August 1991 coup and welcomed Yeltsin. Reformers thought them progressive, but the managers simply wanted to make money on the collapse of the old system. They could enjoy freedom and control their state enterprises as their own property (Dobbs 1997).

After the transition to a market economy had started, the interests of the state enterprise managers diverged from the reformers because the managers favored a protracted and socially costly transition, with a maximum of rents being diverted to them. Yeltsin never understood this and damaged his reforms by veering over to their side in the spring of 1992. But the leading reformers did not understand, either—they tried to coopt and divide the state enterprise managers rather than defeat them.

On macroeconomic stabilization, no common ground existed between the reformers and the rent seekers, and any attempt by the reformers to reach a compromise just delayed stabilization and aggravated inflation. Fedorov's aggressive stabilization policy in 1993 was more successful than Gaidar's attempts to find compromises in 1992, but Fedorov benefited from the reforms already undertaken, the diffusion of rents, and the presence of the IMF. By contrast, Chubais succeeded because privatization allowed room for compromise: the state managers could accept giving away some of their quasi property rights to other stakeholders in exchange for legal guarantees for the rest of their ownership.

Although the assessment of the initial Russian transition from Soviet communism is mixed, it is impressive how many aspects of the transition were done right. In a revolution, many institutions are suspended and a few leaders play an immense role in confronting a small but fierce elite that is politically engaged (Mau and Starodubrovskaya 2001). The Russian capitalist revolution bears the imprint of one giant, Boris Yeltsin. Both successes and failures were direct consequences of his personal insights and frailties.

Yeltsin's strengths and weaknesses were reflections of his character. He was a hero who needed a monumental crisis to be at his best. At such times, he was invincible, like Winston Churchill and Charles de Gaulle. Ordinary governing, however, left him depressed, and he eased his depression with drinking. As a consequence, he did not play much of a role in day-to-day governing apart from in foreign and security affairs.

Russia's fundamental dilemma was that the greater magnitude of its economic and political quandary made it necessary to undertake a more comprehensive "big bang" reform than in Central Europe, but these ar-

duous preconditions also made such an undertaking far more difficult. The opportunity missed was the failure to make the initial “big bang” in January 1992 even bigger by liberalizing energy prices and commodity exports, while imposing a stricter monetary policy and ending the ruble zone. That might have been possible, because resistance at the time was unorganized. The Russian reformers were very close to taking that step. What was missing was the West, which did nothing to help Russia’s reformers at a most critical moment in the country’s history.

