5

Russia

The Arduous Transition to a Market Economy

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Russia's transition to a market economy is the most controversial.[1] Everything is in dispute: the initial conditions, the goals of the policymakers, the actual policy, the outcomes, and of course the culprits.[2] From the outset it was obvious that the Russian transition would be particularly difficult, because of two forces: the legacy of communism in Russia and the severity of the political and economic collapse.

In most other postcommunist countries, communism was imposed by force from outside. In contrast, Russia was the very origin of communism. The communist system prevailed for seven decades and distorted both minds and structures. In addition, much of the Soviet system reflected tsarist perceptions. Russia's long imperial tradition made it difficult for Russians to identify with a much smaller nation, confusing their national identity. The country also had a strong tradition of conservative state ideology. As Richard Pipes (2005, 1) put it, "The dominant strain in Russian political thought throughout history has been conservatives that insisted on strong, centralized authority, unrestrained either by law or parliament."

The last few years of the Soviet Union saw multiple collapses—of a country, a political system, a ruling party, an economic system, and the economy itself.

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2. I have discussed these issues in much of my writing. This account draws primarily on Åslund (1995) and Åslund (2007). The best detailed analysis of the Gaidar program is Dąbrowski (1993a).

The Soviet demise was protracted, allowing scholars to focus on their favorite piece. Russia itself harbored a vigorous and acrimonious debate. For economists around the world, Russia offered a litmus test of their ideas. The biggest debate was between capitalism and socialist economy, but the sideshows were many and the fights equally fierce.

In hindsight, conclusions vary because the Russian economy went through three very different periods. From 1989 to 1998, output contracted sharply, officially by half, though the real decline may have been about a quarter; we shall never know. In the decade between 1999 and 2008, the economy grew more rapidly than ever before, at 7 percent a year. Since then Russia's economy has barely grown, and most experts now forecast little growth or stagnation in the near future.

This chapter identifies the main features of the Russian transition to a market economy. The first section describes the collapse of the Soviet Union. The second section presents the main goals of postcommunist reform in Russia. The third section discusses what went right in the Russian reforms and the fourth what went wrong. The fifth section examines the financial crisis of 1998. The sixth section is devoted to the partial reversal of market reforms. The last section draws conclusions about what could have been done differently.

The Collapse of the Soviet Economy

Around 1980 the Soviet economy was not merely stagnant, it was petrified. Soviet citizens believed that everything was permanent, that nothing would ever change. The command economy was by no means efficient, but it appeared stable—and to many that was good enough. The Soviet leadership spoke about transition from extensive growth, using ever more resources, to intensive growth, based on higher efficiency, but it never happened. The Soviet invasion of Afghanistan in December 1979 followed by the Moscow Olympics in 1980 represented both the overstretch and the peak of Soviet power.

The lack of economic reforms in the Soviet Union in the 1970s was made possible by the large expansion of oil and gas exports and the rise in their international prices. From 1981 oil prices fell steadily, severely reducing Soviet foreign revenues and slowing economic growth (Gaidar 2007).

In 1980 President Ronald Reagan launched his Strategic Defense Initiative, popularly known as Star Wars, which shocked the Soviet Politburo. It exposed Soviet technological and economic backwardness.

In March 1985 Mikhail Gorbachev became Secretary General of the Communist Party of the Soviet Union (CPSU). He made hesitant steps toward economic change, initially presenting the aggravated arms race with the United States as a reason for economic reform (Åslund 1995, 27). He launched a campaign against drinking and in 1986 a campaign against "unearned" or private incomes. These efforts were old-style Soviet disciplinary campaigns. His early reign, in 1985–86, was dominated by the empty slogan "acceleration," which amounted to little but increased investment in machine building and more quality control. In fact, his early economic changes increased the budget deficit to 6 percent of GDP in 1986 and the deficit gradually rose to 9 percent of GDP in 1989 (Åslund 1995, 47) before skyrocketing to 31 percent of GDP in 1991 (EBRD 1994).

In 1987 Gorbachev launched *perestroika*, an eclectic mixture of economic reforms. The first reform, in August 1986, allowed large state corporations to pursue foreign trade independently. The main reform, the Law on State Enterprises, came into force in January 1988. It gave managers of state enterprises greater freedom of action but relieved them of accountability. In May 1988 the Soviet Union adopted the Law on Cooperatives, which legalized a wide range of private enterprises.

State enterprise managers controlled many of the new "cooperatives." An unintended consequence of the new law was the formation of 2,000 unregulated banks that were formally cooperatives. These banks became machines for monetary expansion that rewarded speculative activities. In the winter of 1989–90, a series of laws on leasehold were adopted that made it possible for state enterprise managers to purchase their enterprises for the profits of those companies (Åslund 1995, 29–31).

Seemingly inadvertently, these piecemeal reforms constructed a machine for rent seeking by enterprise managers. One reason why these poor economic policies were adopted was that political leaders were unaware of the real state of affairs and ignorant of economics and refused to draw on international expertise. Another was that the powerful state enterprise managers lobbied for them.

In 1990–91 the Soviet economy fell apart. The causes were many. No one could control wages any longer, as newly autonomous enterprise managers raised both wages and prices. Competition arose between the Soviet government and the governments of the union republics, leading to ever higher social expenditures and lower taxes. The 15 union republics increasingly refused to send their tax revenues to the union treasury. Worse yet, 15 new republican banks started competing with the Soviet Gosbank by issuing credit in rubles. Meanwhile, most prices stayed fixed, leading to nearly complete shortages. In 1991 GDP probably fell 15 percent, and the budget deficit was about one-third of GDP. Inflation exceeded 100 percent, and a vast monetary overhang guaranteed much higher future inflation. The Soviet Union emptied its currency reserves completely and defaulted on its foreign payments.

By the autumn of 1991 the Soviet economy had collapsed. People feared starvation because of the nearly complete shortages. Output was in free fall, and the country was on the verge of hyperinflation. Russia was in a revolutionary situation.[3] The rules of ordinary politics were suspended.

3. This fundamental insight was most clearly formulated by Vladimir Mau and Irina Starodubrovskaya (2001) and Michael McFaul (2001).

The Main Goals of the Postcommunist Reform in Russia

The aborted hardline coup in Moscow on August 18–21, 1991, started Russia's transition from communism. Boris Yeltsin was the undisputed victor in this drama, his legitimacy burnished by his democratic election as Russian president with 57 percent of the vote on June 12, 1991. His mandate was fresh and his democratic credentials as a victorious outsider beyond doubt. The problem was that he was the single institution of great legitimacy.

In September 1991 I went to Moscow twice. The first visit was with economist Jeffrey Sachs for a World Economic Forum meeting; the second was with economist David Lipton. Jeff and I met with Grigory Yavlinsky, who headed one reformist group. He told us he wanted to work with President Gorbachev and favored a looser Soviet Union, which we found unworkable. We then met with an alternative team led by Russian Deputy Prime Minister for Economy Yevgeny Saburov. His key idea was that the ruble had to be nationalized, an idea we liked. David Lipton and I went to see him and his team later in September. At that meeting we realized that Saburov and his team had neither a clear strategy nor sufficient courage to see through reforms.

At the end of this trip, on September 20, I met my old friend Aleksandr Shokhin, who had been appointed Russian minister of labor in August. He told me that he and others were working on an economic reform program with Yegor Gaidar at a dacha outside of Moscow. They hoped that Yeltsin would appoint them to the new government. I was relieved. I had visited Gaidar's new Institute for Economic Policy in June 1991 and been impressed. Gaidar was the foremost economic analyst in Russia, and he had gathered the best and brightest young Soviet economists around him. Shokhin and I agreed that Jeff Sachs, David Lipton, and I would work with them as soon as they had been appointed to the government. I also heard of two alternative hardline teams under old-style state enterprise managers who were personally close to Yeltsin, but the Gaidar team was Yeltsin's only sensible choice.

In January 1992 the transition to a market economy in Russia started. The aims were the same as in Central and Eastern Europe—to build a normal market economy with free prices and free trade among private enterprises—but the preconditions were far worse. Until the end of 1991 the Soviet Union was formally still one country, but it had ceased to function as such. The initial conditions for the economic transition in Russia were awful: near hyperinflation, almost complete shortages, international default, depleted international reserves, and output in free fall.

The immediate goals of the Russian reformers were to stop the precipitous fall in output and halt the hyperinflation. To do so they needed to bring fiscal and monetary policy under control and restore minimal international reserves, which required international financial support. In this the Russian reformers were inspired primarily by the Polish reforms instigated by Leszek Balcerowicz two years earlier. Although Poland had much better initial conditions, the challenges were of a similar nature, and Poland had had a brief bout of hyperinflation in October 1989 (Dąbrowski 1993b).

For privatization, however, Poland was no model, as its privatization had stalled. Instead, the Russian reformers looked primarily at the mass privatization in Czechoslovakia, because rampant *prikhvatizatsiya* (insider privatization by managers) was under way in Russia. As Boris Yeltsin (1991) put it, "Privatization in Russia has been going on for a long time, but wildly, spontaneously, often in a criminal fashion. Today we have to seize the initiative." Minister of Privatization Anatoly Chubais (1999, 29) added, "At the end of 1991, the spontaneous privatization was steamrolling all over. It was the theft of the common property, but this theft was not illegal, because legal schemes of destatization did not exist." His insight was that what was not privatized would soon be stolen. Therefore, the Russian reformers opted for a simplified version of the Czech voucher privatization in order to privatize as much as possible as quickly as possible.

A special Russian problem was that the ruble zone persisted. Gaidar's (1993) view was that Russia should "nationalize" the ruble and effectively break up the ruble zone, but it seemed difficult to do so quickly. Russia did not have any electronic money or even electronic money transfers. All transactions were made by hand with currency or handwritten bank transfers. No new bank notes were available, and it would have taken months to print them.

What Went Right

For two months after the August coup, Yeltsin was barely seen. Everyone waited restlessly for the decisions of this political giant. On October 28, 1991, he came out in full force, making his greatest speech ever to the Russian Congress of People's Deputies. His long and detailed presentation corresponded to the Balcerowicz program of September 1989. Dramatically, Yeltsin (1991) called for a radical market reform.

> I turn to you with determination to stand unconditionally on the road of profound reforms.... The time has come to act decisively, firmly without hesitation.... The period of movement with small steps is over.... A big reformist breakthrough is necessary.... We have stood up for political freedom and now it is necessary to give economic [freedom], to eliminate all obstacles to the freedom of enterprises and entrepreneurship, to give people the opportunity to work and get as much as they earn.... I call on all citizens of Russia to understand that a transition once-and-for-all to market prices is a severe but necessary step.... The reform will go in a number of directions simultaneously and dynamically.

Gaidar was the main author of this speech. Sensibly, Yeltsin put the program outlined in the speech to a vote in the Congress of People's Deputies, where 876 deputies voted in favor and 16 voted against (Aron 2000, 491). He had received a political mandate for radical market economic reform.

Yeltsin appointed his new government on November 6–8. He became prime minister himself, and Gennady Burbulis became first deputy prime minister. A number of 35- to 40-year-old professional economists became leading ministers, notably Deputy Prime Minister and Minister of Finance and Economy Gaidar, Deputy Prime Minister and Minister of Labor Shokhin, Minister of Privatization Chubais, and Minister of Foreign Economic Relations Petr Aven.

One of the young reformers later characterized their group as "a group of professional economists, the Gaidar team, [that] 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 program" (Vasiliev 1999, 86).

Almost all ministers were new. Yeltsin realized that he needed to go outside his usual circle. With amazing intuition, he selected the best and the brightest. Gaidar took charge of policymaking in macroeconomics and regulatory politics, Chubais of privatization, and Aven of foreign trade. Much less happened in other areas. Both the initial political economy of reform and the selection of the cream of Russia's young elite economists with the most international experience for top government posts followed John Williamson's (1994) prescription for successful reforms.

In forming this government, Yeltsin created a normal, modern government with functional rather than sectoral ministries. The old Soviet government had a dozen deputy prime ministers and almost 100 ministers; the new government had 3 deputy prime ministers and 23 functional ministries. The Ministry of Finance replaced the State Planning Committee as the dominant ministry. The main novelty was the creation of the State Property Committee, as the ministry of privatization was called.

As soon as the reform government had been formed, young reformers took over the old Soviet ministries and started their feverish work according to a plan of reform decrees. They drew on all the international expertise they could mobilize. I was part of a group of Western economists who started working with the new government in November 1991. The International Monetary Fund (IMF) and the World Bank sent staff to Moscow at that time, although Russia was not as yet a member of either organization.[4] Quickly, serious market economic reforms were designed.

Unlike most former Soviet leaders, Yeltsin understood that the Soviet Union was over and that Russia could not start functioning before the Union was dissolved. As he later wrote, "I was convinced that Russia needed to rid itself of its imperial mission" (Yeltsin 1994, 115). The challenge he faced was to do so in a fashion that was politically acceptable and peaceful.

On December 1, 1991, Ukrainians voted overwhelmingly for independence

4. In November 1991 Sachs, Lipton, and I formed an advisory group that worked directly under Deputy Prime Minister Gaidar at the Council of Ministers, where we had our offices, financed by the Swedish government and the Ford Foundation. Our group gradually expanded to about 30 people, as various groups financed by the European Union and the US Agency for International Development (USAID) joined us because of the access to the government we could provide. After Gaidar was ousted, in December 1992, we worked primarily with Deputy Prime Minister and Finance Minister Boris Fedorov. Andrei Shleifer set up a similar group to advise Chubais on privatization, financed primarily by USAID.

in a referendum. A week later, in great secrecy, Yeltsin gathered the reformist leaders of Ukraine and Belarus. The presidents of the three founding states of the Soviet Union signed a treaty dissolving the Soviet Union. On December 21 the other republics joined them in signing a joint treaty dissolving the Soviet Union; on December 25 the Union was officially ended. No great empire has ended so swiftly or peacefully (Lieven 2000).

The peaceful dissolution of the union was one of Yeltsin's greatest achievements. But as Russia has recovered economically, few Russians realize how dysfunctional the Soviet Union was in 1991 and hold its dissolution against Yeltsin. In his April 2005 annual address, Yeltsin's hand-picked successor, Vladimir Putin, stated that "the collapse of the Soviet Union was the biggest geopolitical disaster of the [20th] century."

The most fundamental economic issue was price liberalization. Gaidar (1999, 114) took a firm lead, noting that "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." On January 2, 1992, the long-expected price deregulation occurred. All had waited for it with fear, but no public unrest was reported, although prices skyrocketed by 250 percent. Meanwhile, shortages disappeared, albeit only gradually. With price liberalization, large price subsidies were eliminated.

Another daring strike by Gaidar was his plan to cut arms procurement by 85 percent in 1992 alone (in the event, he cut arms procurement by 70 percent that year). His position was adamant: "The Soviet Union cannot expect to embark on economic development until it demilitarizes itself" (Gaidar 1993, 77). Strangely, the much-feared military-industrial complex was unable to lobby successfully against this policy. The large armaments producers did not close down, however. They lingered on in vegetation, extracting state subsidies for years.

The reformers wanted to liberalize foreign trade, unify the exchange rate, and make the ruble convertible, but the communists had depleted the currency reserves, driving down the free exchange rate, so that the average Russian monthly salary was just $6 in December 1991. The reformers succeeded in pushing through the near complete deregulation of imports, because people wanted to be rid of shortages, but oil and gas exports remained regulated, because their domestic prices were controlled far below world market prices. The state claimed that it needed to capture the price difference. Another problem was continued state trade with other post-Soviet countries at highly distorted prices.

Chubais and his advisors approached privatization as the art of the possible. They recognized the need to coopt some stakeholders and fight others. They wanted to get politicians out of enterprises, to "depoliticize economic life" and exclude the old branch ministries. They accommodated managers and employees (Boycko, Shleifer, and Vishny 1995, 10–11).

In June 1992 the Congress of People's Deputies adopted the privatization law, the last reformist law passed. Most shares were given to employees and managers; a minority of shares was sold at voucher auctions, which in effect concluded the privatization. Unlike the other reform ministers, Chubais stayed on as privatization minister until November 1994 and in the government until January 1996. He succeeded in completing his work. The last voucher auction was held in the summer of 1994, by which time 16,500 large enterprises had been privatized through voucher auctions. Privatization stood out as the most thorough reform, and it proceeded the longest. Small-scale privatization was undertaken locally; it proceeded quickly and quite easily.

> 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. (Vasiliev 1999, 86)

The basis of a market economy—free prices, trade, and private enterprise—had been laid, but financial stabilization, and therefore economic recovery, remained elusive. Politically, the borders of the country had been swiftly defined, but reform of the political system was left for later. Although much remained to be done, Russians enjoyed more political freedom in the 1990s than ever before or after in their history.

What Went Wrong

The most spectacular miscarriage of the Russian transition was the failure to achieve financial stabilization. In 1992 Russia was ravaged by 2,500 percent inflation, and Russians tended to identify this reform with hyperinflation. Different observers emphasize different problems, ranging from the ruble zone, external default, the lack of foreign assistance, excessive public expenditures, loose monetary policy, barter, flawed federal-regional relations, poor tax collection to an inadequate tax system. In any case, as a consequence of unsuccessful macroeconomic policies, economic recovery started only in 1999, after the financial crash of 1998. Russians correctly perceive the 1990s as a time of economic decline, but many blame the reforms rather than the resistance to reform or policies of the preceding decades.

Five major problems were involved. The first was political. Reformers failed to gain control over the central bank. For a government intent on pursuing monetary stabilization, little is more vital than responsible central bank leadership. Yeltsin's candidate for chairman of the Central Bank of Russia was Boris Fedorov, a strong and highly competent reformer. On November 22, 1991, Yeltsin suffered his first major defeat at the hands of his erstwhile ally Ruslan Khasbulatov, the speaker of the Russian parliament, who supported Georgy Matiukhin for the post. Matiukhin (1993) was a reasonable man, but he wanted to adopt a middle course, reducing inflation to a "moderate" level, by which he meant 10 percent a month. Without control over subsidized credits, which were really financed by the government, the government could not control the budget deficit.

The second and arguably greatest problem of this period was the persistence of the ruble zone. At the beginning of 1992, 15 republican central banks were issuing ruble credits. The three Baltic countries departed in the summer of 1992, managing to escape with just under 1,000 percent inflation. The other central banks were caught in a prisoners' dilemma, competing in the issuance of credit. In 1992 Ukraine was the victor, issuing more credit than Russia and experiencing a smaller contraction in GDP (though in 1993 its hyperinflation surged to 10,200 percent). Gaidar wanted to dissolve the ruble zone as soon as possible. Just before entering government he argued for "the introduction of a new Russian republican monetary unit," but he warned that "preparation of a monetary reform takes time, the minimal period being roughly nine months. During that period counting on effective control over aggregate demand is not possible" (1993, 84).

We foreign economic advisors argued for a quicker monetary reform by issuing coupons or just stamping the ruble notes, drawing on the experience of the disastrous dissolution of the Austro-Hungarian Empire. Only Czechoslovakia established its own currency early and escaped very high inflation, and only Czechoslovakia stayed a democracy throughout the interwar years. Despite his conviction, Gaidar did not push for early monetary reform, and all other constituencies opposed it. State enterprise managers wanted to continue to export their worthless wares to other former Soviet states at the expense of Russian state credits, the old Soviet establishment hoped to maintain the ruble for sentimental reasons, other former Soviet states called for Russian subsidies, the IMF aspired to stay out of a political strife and did not mind Russia financing the other countries, and the European Union was planning to launch its own common currency. In 1993 Finance Minister Boris Fedorov fought tooth and nail to end the ruble zone. By the autumn of 1993 he succeeded, but without the cooperation of the Central Bank of Russia the disruption was disorderly. Meanwhile, hyperinflation had erupted in all the ruble zone states, laying the ground for authoritarian rule, as had been the case in the Austro-Hungarian successor states in the interwar period.

The third big problem was that the Russian government failed to deregulate domestic energy prices and exports of oil and gas early on. Gaidar understood this issue well, whereas Yeltsin did not. Gaidar later blamed himself for not having pushed harder for the deregulation of oil and gas prices at the start of 1992, when these prices were raised only five times, but I doubt that he could have won that battle. In December 1991 international oil prices were 200 times higher than the state-controlled Russian oil price at the free exchange rate. The gains from arbitrage of the few well-connected players who indulged in this game were just too large. Aven (1994) shows how great the problems were in export deregulation. Greater courage and sense of principle might have helped, but the rents were enormous. Many people were killed in this trade, especially in the great aluminum war between gangs over control of the large Siberian aluminum plants. In Central Europe price discrepancies were smaller, making late or slow deregulation of energy prices less damaging there.

The fourth major shortcoming of the Russian reforms was external. Russia received no international financial support for its economic reforms during the crucial five months of energetic reform from November 1991 to March 1992. In 1990 and 1991, the G-7 leaders devoted their summits to the Soviet political and economic crisis, but they concentrated on Gorbachev and were not ready to support Yeltsin, although he exhorted the West to help in no uncertain terms and on Western conditions (Yeltsin 1991). Only on April 1, 1992, when the reformers were losing out against the Congress of People's Deputies, did President George H. W. Bush and German Chancellor Helmut Kohl declare their intent to mobilize a Western aid package of $24 billion. This amount was widely considered adequate, but the nature of the assistance was never specified (Sachs 1995). Russia did receive substantial Western financial "support," but it was in the form of export credits, notably agricultural credits designed to support US and EU agriculture, which impeded Russian economic reforms by reinforcing rent seeking.

The fifth obstacle, which perhaps mattered the most in the long run, was the old Russian parliament and constitution. The parliament was elected in March 1990, before real democratization or parties; 86 percent of its members had been members of the Communist Party. The parliament was unwieldy, with slightly more than 1,000 members, who elected a smaller bicameral parliament. Political loyalties were fluid. In 1991 roughly one-third were democrats, one-third were hardline communists, and one-third were called the "marsh" because of their fluid votes. Yeltsin could count on majority support in the Congress of People's Deputies for only three months after the August coup.

Strangely, Congress controlled the constitution. With a majority of two-thirds, which the skillful speaker Ruslan Khasbulatov could mobilize, it could instantly change the old Soviet Constitution of 1978. Yeltsin should have asked the Congress to dissolve itself when he could have, in October/November 1991. Russia could then have held early elections, bringing in a new, normal parliament based on political parties, as Czechoslovakia and Hungary did. In his memoirs Yeltsin (1994, 127) agreed:

> 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.... 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.

Instead, Yeltsin called for and received the right to rule by decree for one year. But serious reform requires serious legislation. All kinds of people ran to Yeltsin and received his signature on contradictory decrees, which had short shelf lives and were often ineffective. His decision to rule by decree deprived Russia of normal economic legislation until 1998.

The Congress of People's Deputies grew ever more unruly. Speaker Khasbulatov had been elected as a Yeltsin ally, but he never overcame his shock over not having been invited to lead the government, and many other prominent politicians reacted similarly. Congress turned populist, pursuing irresponsibly high public expenditures. By April 1992 it was in full opposition to Yeltsin's government. The last reform law, the privatization law, was passed in mid-June.

However radical and resolute Yeltsin sounded in the winter of 1991–92, he was a politician who hedged his bets, being 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," he wrote (Yeltsin 1994, 156). Even Gaidar had minimal access to Yeltsin. The government was housed in the old Central Committee headquarters at the Old Square while Yeltsin and his presidential administration sat in the Kremlin. Although President Yeltsin was formally prime minister, he rarely participated in the weekly cabinet meetings. By March he had become disenchanted with the reformers:

> 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.... By 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)

Yeltsin had arranged this system himself. He concluded that "if Gaidar had had just a little more time, he would have broken down the prejudice against him, his team, and his program" (Yeltsin 1994, 159). Burbulis was too weak a link between the Gaidar team and Yeltsin, and Burbulis was not an economic policymaker. Gradually, the members of the Gaidar team became politicians; arguably, Shokhin had been one all along. Chubais became a politician when preparing the privatization program, and by April 1992 Gaidar stood up and fought. By dramatically threatening to resign (apparently without informing Yeltsin), Gaidar got the Congress of People's Deputies to take a more moderate line (Åslund 1995, 94). Because of their technocratic approach, the reformers failed to develop a strong reformist narrative, allowing populists and communists to dominate the public debate.

Yeltsin became increasingly enthusiastic about state enterprise managers. In his 1994 memoirs, he stated that the reactionary state manager Yuri Skokov "was actually [his] 'shadow' prime minister" (Yeltsin 1994, 172). At a cabinet meeting in May 1992, Yeltsin sacked Gaidar's minister of energy because, like

Gaidar, he advocated price liberalization (Yeltsin 1994, 167). In his place, he appointed his old acquaintance Viktor Chernomyrdin, the last Soviet minister of gas industry and the founder of Gazprom. In June Yeltsin appointed two other state enterprise managers deputy prime ministers. In June the parliament sacked Matiukhin, who was replaced with the old Soviet State Bank Chairman Viktor Gerashchenko, who insisted on vast monetary expansion and opposed reform. Most reforms except privatization were over. Now the state enterprise managers dominated.

Many other problems existed, but these five were key. One unfortunate effect of Yeltsin's 1991 speech was that it raised unrealistic expectations. The president avoided forecasting how much the economy would contract or how high inflation would rise, but he promised an early improvement: "It will get worse for approximately half a year, prices will decline and the consumer market will be saturated with goods. And toward the autumn of 1992, as I promised before the elections, the economy will stabilize and the life of the people will gradually improve" (Yelstin 1991). When we complained to Gaidar about this unrealistic promise, he told us that Yeltsin himself had added this line because he wanted to offer people something positive. The assurance was unrealistic, as the much easier reforms in Eastern Europe had already shown. Yeltsin's words would come back to haunt the reformers.

Yeltsin firmly opposed any kind of lustration. He was acutely aware of the dissolution of the tsarist civil service after the February 1917 revolution 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" (Yeltsin 1994, 129). Yeltsin had made his career in the Communist Party and was closely connected with the old *apparatchiki* and KGB officers, with whom he socialized. These people remained his closest companions. In keeping them there, he faced opposition from his closest advisor, Burbulis, which may have been the reason why Burbulis lost out in the spring of 1992. Burbulis had no platform of his own. The retention of the old guard notwithstanding, Yeltsin was remarkably tolerant and often appointed competent young people to high positions without knowing them in advance.

Yeltsin's reorganization of the government was radical, but inevitably several elements of the old Soviet government persisted. Perhaps inadvertently, Yeltsin allowed them to reemerge. In the autumn of 1991, he split up the old KGB into several different organizations, reducing the total staff by half, but the essence of the KGB survived as the Federal Security Service (FSB). In the 2000s, the domestic arms of the organization were merged and reinforced. The Russian part of the Soviet Ministry of Gas Industry was never broken up because of the strength of its old minister, Viktor Chernomyrdin. Gradually, it was transformed into the giant state corporation Gazprom. The same was true of the nuclear industry and the railways, which became large state corporations. The combination of no lustration and the persistence of many state structures came back to haunt Russia in the 2000s.

The complexity of Russia's postcommunist transition allows multiple interpretations, but chronology can weed out outright misperceptions, because cause must precede effect. For example, the loans for shares of a few enterprises in late 1995 could not have caused problems in the early stages of the transition. The tax system and the tax collection called for severe reform, but until the financial collapse of 1998 the oligarchs were too strong for their taxes to be collected and until the end of 1999 the government lacked a majority in parliament, preventing it from adopting sensible tax laws. In fact, state revenues as a share of GDP remained high throughout the 1990s. The big fiscal problem was excessive public expenditures, notably enterprise subsidies.

Russia's initial conditions were extraordinarily difficult. Price distortions were enormous, and a mechanism of large-scale rent seeking developed before the end of socialism. The very difficult starting conditions called for reforms that were more radical and comprehensive than the reforms in Central Europe, but huge disparities between state-controlled prices and free prices as well as other structural distortions made radical reforms very difficult. Initial conditions thus made it likely that reforms would be less successful in Russia than in Central Europe.

Critics often argue that Russian reformers should have offered more social support. Doing so was hardly possible. The main social concerns were that wages and pensions were not being paid, revealing the breakdown in the power of the state. Another concern was the development of barter, another reflection of the weakness of the state, as the essence of barter was tax evasion. The persistently large budget deficit, which was caused by substantial subsidies to large companies, was a third sign of how weak the state was.

To sum up, five problems made the transition less successful than it could have been:

- Financial stabilization was not possible because the chairman of the central bank insisted on "moderate" inflation of 10 percent a month.
- The preservation of the ruble zone, with its competitive issue of ruble credits until the autumn of 1993, virtually guaranteed hyperinflation.
- Maintenance of low, regulated energy prices, combined with export quotas and licenses, allowed extraordinary rent seeking, which persisted because the rent seekers could buy the state (Murphy, Shleifer, and Vishny 1993).
- The Central and East European reforms benefited from early and sufficient international aid, whereas the Russian reforms did not.
- Yeltsin missed an opportunity by not dissolving the old parliament in November 1991 and holding early parliamentary elections that would have led to normal parliamentary legislation and the adoption of a new constitution that would have led to full democracy. There was no lustration and no real break with the old elite, not even the secret police. The irresponsible and excessively powerful parliament brought an end to the Gaidar reforms. The persistent problem has been the malfunctioning of the Russian state.

The Yeltsin-Gaidar government should have carried out an even more radical and comprehensive reform, as was the case in Poland, Czechoslovakia, and Estonia, but the old communist elite persisted, and its rent seeking delayed economic growth. Despite these problems, Russia did create a functioning market economy that delivered substantial growth for many years.

A Second Wave of Reforms after the Financial Crisis of 1998

In 1993 Finance Minister Boris Fedorov liberalized energy prices and exports and facilitated the dissolution of the ruble zone. After 1993 the only market economic reform that continued was privatization, but at that time, in 1995–97, the IMF finally delivered substantial support to Russia. Inflation fell, but the driver was strict monetary policy rather than tighter fiscal policy. The budget deficit stayed at 8–9 percent of GDP, far more than Russia could bear. Ironically, Russia received large private portfolio investments in 1996–97 because of the outsized government bond yields. The stock market boomed, although GDP continued to contract. This situation was not sustainable.

In March 1997 Yeltsin returned from a long sick leave and revived his old reform ideas. He appointed a new reform team led by First Deputy Prime Minister Chubais, but resistance from the elites was overwhelming. Chernomyrdin remained prime minister, the red-brown opposition held the majority in the parliament, the new big businessmen—the so-called oligarchs—opposed changes to the rules of the game, and the regional governors opposed the superiority of Moscow. In July 1997 the reformers attempted a major honest open privatization auction of Svyazinvest, the telecommunications holding company, but it led to the "bankers' war" between competing oligarchs, and the main victims were the reform ministers. These efforts were a false dawn. Chernomyrdin persisted and increased the budget deficit as usual. The rent seekers proved that politically they were far stronger than the reformers.

In October 1997 the East Asian financial crisis called the bluff of Russian economic policy. Foreign capital fled, stock prices plummeted, and bond yields surged. As the government had just increased the budget deficit, it was reluctant to reverse its policy. In March 1998 Yeltsin sacked Chernomyrdin and once again appointed a young reformist government. The new ministers were inexperienced and did not understand the severity of the financial crisis. They took sensible steps but did too little and acted too slowly. The IMF and the World Bank were by now well acquainted with Russia and quickly came up with a plausible stabilization program. Funding was no longer a big issue. In July the two institutions plus Japan put up $22.6 billion in emergency financing.

Their critical demand was that Russia reduce the federal budget deficit by reining in regional expenditures and steering a larger share of the total tax revenues to the federal treasury. Three constituencies—the regional governors, the communists, and the oligarchs—opposed this endeavor, defeating the government in the State Duma. On August 17 the Russian government defaulted on its domestic bonds, devalued the ruble (eventually by three-quarters), and froze foreign bank payments for three months. The shock was severe. Half the banks went bankrupt, and desperate depositors queued outside every bank. Electronic payments stopped functioning. Once again one could pay only with US dollars.[5]

At the time the Russian default looked like a major economic and political disaster. A *New York Times* headline read "Who Lost Russia?"[6] Old-style communists took over key posts. Many spoke of the end of the Russian market economic experiment and the renewal of hyperinflation, but the negative effects did not last for long. Inflation surged and output fell but only in 1998.

After its default Russia had no access to international finance, and its disappointed citizens were not ready to lend their government any money. The government had no choice but to eliminate the budget deficit. As tax revenues could not be raised swiftly, it could do so only by slashing public expenditures, which fell by 14 percent of GDP between 1997 and 2000. This drastic cut had been considered politically impossible before the crash. The cuts were concentrated on enterprise subsidies, which the World Bank had assessed at 16 percent of GDP in 1998 (Pinto, Drebentsov, and Morozov 1999). From 2000 to 2008, Russia ran a significant budget surplus. With rising tax revenues and nearly constant public expenditures after 2000, its public debt quickly shrank to nearly zero.

Quite unexpectedly, the crash of 1998 led to the start of the second generation of economic reforms, which the reformers had designed in 1997. Many good laws had already been drafted. The new government had little choice but to adopt the long-prepared tax code to put its public finances in order. Russia recorded growth of 6.5 percent in 1999. The crash itself brought about many bankruptcies that cleaned up enterprises' balance sheets; many young entrepreneurs took over, turning around old Soviet enterprises.

In December 1999 Russia held parliamentary elections. A majority of the deputies elected favored normal market economic reforms. On December 31, 1999, Yeltsin resigned and Vladimir Putin became president. The second wave of reforms was intensified under the new government, led by Prime Minister Mikhail Kasyanov. This government had it all: competent staff, parliamentary support, a substantial reform program, and financial stability. Three years of substantial economic reform followed, from 2000 to 2002. Major legislation adopted included a new tax code, a civil code, judicial reform, deregulation of small enterprises, and pension reform.

The three main economic aims of the reforms were achieved:

- By 1996, 70 percent of Russia's GDP originated in the private sector, according to the European Bank for Reconstruction and Development (EBRD 1996, 169).

5. I organized a conference in Moscow in September 1998. We had to carry tens of thousands of dollars in cash from Washington to pay for the Marriott Hotel.

6. John Lloyd, "Who Lost Russia?" *New York Times*, August 15, 1998.

- A competitive market economy was created. It was not as free as the reformers desired, but it was reasonably competitive compared with other countries at Russia's level of economic development.
- After the financial crash of 1998, it became politically feasible to achieve macroeconomic stability by eliminating the persistently large budget deficit.

Only seven years after complete chaos, Russia had created a dynamic market economy. It enjoyed a full decade of average real growth of 7 percent a year, the highest economic growth it ever saw.

Partial Reversal of Reforms

In the early 2000s, a superficial observer of the reform wave would have concluded that Russia had entered a virtuous circle of inclusive economic and political reforms, in line with the reasoning of Daron Acemoglu and James Robinson (2012). Alas, this was not the case. Instead, many reforms of the early 1990s, such as judicial and pension reform, were reversed.

Russia's greatest shortcoming all along has arguably been pervasive corruption, but the nature of corruption has changed. Various surveys have shown that the number of bribes has declined every year but that total volume of bribes has increased. This trend reflects the concentration of corrupt incomes among a small group of very wealthy top officials and businessmen. Such top-level corruption requires rigorous political protection, which is reinforced by authoritarianism.

Observers blame various factors and identify different dates of the reversal. One important factor was the combination of the hyperinflationary ruble zone and the regulated commodity prices and exports in 1992–93, which created vast fortunes for successful rent seekers, who later could purchase whatever services they desired from the state.

Critics of Yeltsin blame the storming of the Russian parliament and the adoption of a presidential constitution in late 1993. They complain about the free but not very fair presidential election in 1996, given that Yeltsin supporters dominated the media. Critics condemn the late discretionary and privileged privatizations of a few large companies in late 1995, the so-called loans-for-shares privatizations.

At the time Yeltsin's popularity rating was in the low single digits. The conventional wisdom was that the leader of the unreformed Communist Party, Gennady Zyuganov, would be elected president in June 1996. Chubais argued that the party would reverse all reforms and reintroduce communist dictatorship. He therefore offered state shares of a dozen large companies to some big new businessmen to be held as collateral for loans to the impoverished state treasury. The businessmen would receive the shares after the elections if Yeltsin won, whereas Zyuganov would confiscate their shares. They thus had a material interest in a Yeltsin victory.

Yeltsin won in the first round by a margin of only 3 percent of the vote. Chubais argues that his strategy of promising shares in the future to big businessmen was decisive given the media ownership of these businessmen. In the end only 12 stakes were transferred, and only 4 companies changed controlling ownership, one of which (Sidanco) soon went bankrupt. The other three—the oil companies Yukos and Sibneft and the metallurgical corporation Norilsk Nickel—became emblems of the rise of oligarchy in Russia (Freeland 2000).

The loans-for-shares privatization has remained highly controversial. It did not help that these companies were economically most successful (Shleifer and Treisman 2004). Many liberals believe that the reformers sold out to the oligarchs—a symbol to many of how the reformers compromised their values and abandoned justice and fairness. Some businessmen argue that they would have defended Yeltsin in any case. Chubais underlines how weak the reformers were, how weak the state was, and how severe the threat from the communists was.

The very bloody wars in Chechnya—the first began in December 1994 and the second in the autumn of 1999—received relatively little attention, but the unexplained house bombings promoted then Prime Minister Vladimir Putin to the presidency. Arguably, they were the most important developments undermining democracy.

The Putin reign can be divided into his four terms. In his first presidential term (2000–04), he pursued liberal market economic reforms while systematically reducing political and media freedom and consolidating his political power. His second term (2004–08) can be described as state capitalism, as economic policy turned from privatization and freer markets toward more state ownership and regulated markets. The signal event was the confiscation of Yukos in 2004. During Putin's third, informal term, when he was prime minister (2008–12), his focus moved from state capitalism to crony capitalism. His closest cronies in the private sector actively engaged in asset stripping, in particular of Gazprom (Milov and Nemtsov 2010). As yet, it is difficult to determine whether state or crony capitalism dominates his fourth term.

No significant market-oriented reforms have been carried out since 2003, and large state corporations have gobbled up private corporations in energy and banking. After Russia became a member of the World Trade Organization in 2012, its foreign trade policy turned more protectionist. In parallel Russia gradually become more authoritarian, although Freedom House still classifies its authoritarianism as mild.

A comparison between government behavior and impact on the economy during the financial crises in 1998 and 2008 is telling. In 1998 the government had no money to offer enterprises. On the contrary, enterprises were forced to pay taxes in cash. Many enterprises went bankrupt. As a result new entrepreneurs took over their assets, and their balance sheets were cleaned out. Joseph Schumpeter's creative destruction occurred.

In 2008 the opposite happened. The government had plenty of reserves, and it spent about $200 billion on various forms of enterprise subsidies, bailing out the largest and worst state and private corporations. The government's subsidies to loss-making companies crowded out new, potentially profitable companies, which suffered from an unlevel playing field (Davydova and Sokolov 2012). In 1998 the Russian government's dearth of financing forced it to put inefficient companies into bankruptcy, leading to creative destruction. But in 2009 the government bailed out all the big, unprofitable companies. The natural consequence was diminished competition and less economic growth.

Russia has ended up in a vicious cycle of corruption and poor governance that does not promote innovation, productivity, or growth (see Acemoglu and Robinson 2012). A major disruption appears to be needed to break this cycle. None is apparent. Most of the achievements of the market economic reforms persist, but Russia seems to have ended up in a suboptimal equilibrium for the time being.

What Could and Should Have Been Done Differently

I have emphasized how difficult the initial conditions were and how much was accomplished despite them. But several things could have been done to improve outcomes. My long-standing selection includes early parliamentary elections, early dissolution of the ruble zone, early deregulation of commodity exports and prices, and aggressive efforts to attract foreign aid.

The first and most important act would have been the dissolution of the parliament and the holding of early parliamentary elections. In early November 1991, Yeltsin could have persuaded the parliament to vote for its own dissolution. His window of opportunity was very narrow, only a few weeks. At that time Yeltsin would easily have won a parliamentary majority with Democratic Russia, which would have become a full-fledged liberal and democratic party. His reform ministers would have become politicians and not called themselves kamikazes. The parliament would have gained legitimacy and functioned as a legislature, adopting normal reform laws (McFaul 2001). The reformers could have won control over the central bank. The reform government would not have collapsed by June 1992, and reform plans could have been implemented. Instead, Yeltsin opposed early elections, trusting his political strength and ability to rule by decree, focusing on the economic emergency. Gaidar also opposed early elections, even if he stayed out of politics in 1991.

The second act the government should have undertaken was the early dissolution of the ruble zone. Had it done so, hyperinflation would have been avoided or at least mitigated. Gaidar wanted to break up the ruble zone early, but he did not have a plan of action; Yeltsin may not have had a clear view. Multiple forces soon made the early dissolution politically impossible.

The third desirable measure was the early deregulation of commodity prices and exports. Gaidar understood its importance and pushed for it, but Yeltsin was reluctant. Later, in May 1992, Yeltsin adamantly opposed deregulation and blocked it. Deregulation was done gradually, mainly in 1993 by Finance Minister Boris Fedorov (1999).

The fourth missed opportunity was the failure to mobilize an international aid package of $25 billion to finance stabilization and reforms in early 1992. Either Yeltsin or Gaidar should have gone to Washington in late 1991 and to Davos in January 1992. Neither did. They did not understand international financial lobbying. Jeffrey Sachs and I put considerable energy into such efforts, but we could do little without the principals. The main problem, however, was the reluctance of the US administration under President George H. W. Bush.

Many analysts argue that none of these actions was possible, but many also claimed that Gaidar's deregulation of prices and cuts in arms procurement were impossible. Even fewer observers thought that Chubais's privatization was possible, but he carried out the largest privatization in world history. In the period of extraordinary politics in late 1991 and early 1992, the impossible was possible. All four actions were debated at the time. Of the four, I believe that the most important was earlier and more comprehensive reforms. Only early radical reforms were truly successful.

Yeltsin played an enormous role. Without him Russia might not have attempted a transition to a market economy. Like Belarus it might have gotten stuck in a state-dominated economy. Yeltsin was daring and radical, but he was rarely consistent and he was a sly political survivor. Like Winston Churchill and Charles de Gaulle, he will stand out in history as one of the truly great political leaders. When I saw him in 2003, he happily boasted that he had built a dynamic market economy in Russia. When I asked him about politics, he said that he discussed them only with the president. Among the other players, very few—essentially Gaidar, Chubais, Fedorov, and Aven—made the main economic reform decisions. Much depended on their personalities and judgment.

Russians are confused about the history of the past three decades, leading to sayings such as "the damned nineties (*proklyatye devyanostii*)." Their confusion arises from the considerable time gap between cause and effect. It is true that Russians suffered economically in the 1990s, but the policies of the Yeltsin-Gaidar government did not cause all those problems. Because the later Russian reforms were so successful, most Russians do not remember how precarious the political and economic situation was in 1991. They do not understand that Russia would not have stabilized, politically or economically, without dissolving the Soviet Union, which to their great credit Yeltsin and Gaidar did. Nor do people realize that Gorbachev's piecemeal reforms in 1986–91 constructed Russia's rent-seeking machine, that the shortcomings of the reform government were only that it was not strong enough to dismantle it. The reforms of 1991–93 did not go far enough to produce economic growth. The second wave of reforms of 1998–2002 did deliver a decade of high economic growth. Unfortunately, many Russians think that rising state capitalism brought about economic growth, which in fact brought about the near stagnation that has characterized the economy since 2009.

In order to become successful in the future, reformers need to win back the narrative of the misunderstood 1990s and straighten out the record. The dissolution of the Soviet Union was not a tragedy but a necessary condition for the recovery of Russia. It was not "shock therapy" that prolonged the economic misery in the 1990s but Russia's very loose fiscal policy until 1998. Poland, the Czech Republic, and the Baltics enjoyed early, radical, and comprehensive reforms and saw growth in two to three years. Privatization did not cause corruption in Russia, it mitigated it. Corruption was spearheaded by the slow deregulation of exports and energy prices as well as loose fiscal policy.

For the future the big question is whether Russia needs stability and state capitalism or freedom, open market competition, and renewed privatization. The critical task is to transform Russia into a normal democracy, where "normal" means a parliamentary democracy with great transparency. Rule of law is not likely to be maintained in Russia without democracy. A clear division of power needs to be established. The state and the KGB need to be finally reformed. The lesson of postcommunist transition is that the greater the disruption of the elite the better. The large state conglomerates need to be broken up and fully privatized. As Gaidar and Aven noted, reform is likely to start again only when oil prices fall enough.

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