

Russia's Capitalist Revolution:

Why Market Reform Succeeded and Democracy Failed

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RUSSIA'S CAPITALIST REVOLUTION

WHY MARKET REFORM
SUCCEEDED AND
DEMOCRACY FAILED



PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

ISSUES

1. Revolution: Important for our understanding
2. Why did market reform succeed?
3. Why did democracy fail?
4. Who is Mr. Putin?
5. Russia's Future?

1. Key to Understanding Russia's Transformation: It was a Revolution.

Literature on Russia's transformation fall into two categories: Those who recognize it as a revolution and the others.

Revolutionary Situation

"communist societies...are in the throes of a serious systemic crisis which... fits very well the concept of a 'revolutionary situation' as defined by Lenin. ... [a] stalemate between the ruling elite of a country and its population: the former could no longer rule, and the latter would no longer let themselves be ruled in the old way."

Richard Pipes, *Foreign Affairs*, 1984

A Revolution Means

- Temporary breakdown of all institutions minimizes state capacity.
- A few policymakers have great freedom for half a year.

Policymakers need to act fast and focus on essence, but mistakes are inevitable.

**“To wait
means to fail.”**

**Mart Laar, former Prime Minister of
Estonia, 1992–94 and 1999–2002**

2. Why Did Market Reform Succeed?

- Enough was done in the brief window of opportunity in 1991–92 to secure the market economy,

BUT

- Initial economic results poor because reforms insufficient.
- Financial crash cleansed the market economy and completed financial stabilization.

2. Why Did Market Reform Succeed? Sound Policymaking

A Brief Window of Opportunity of "Extraordinary Politics"

IDEA: Radical market reform

Yeltsin's Program Speech, Oct. 1991

Parliamentary support received

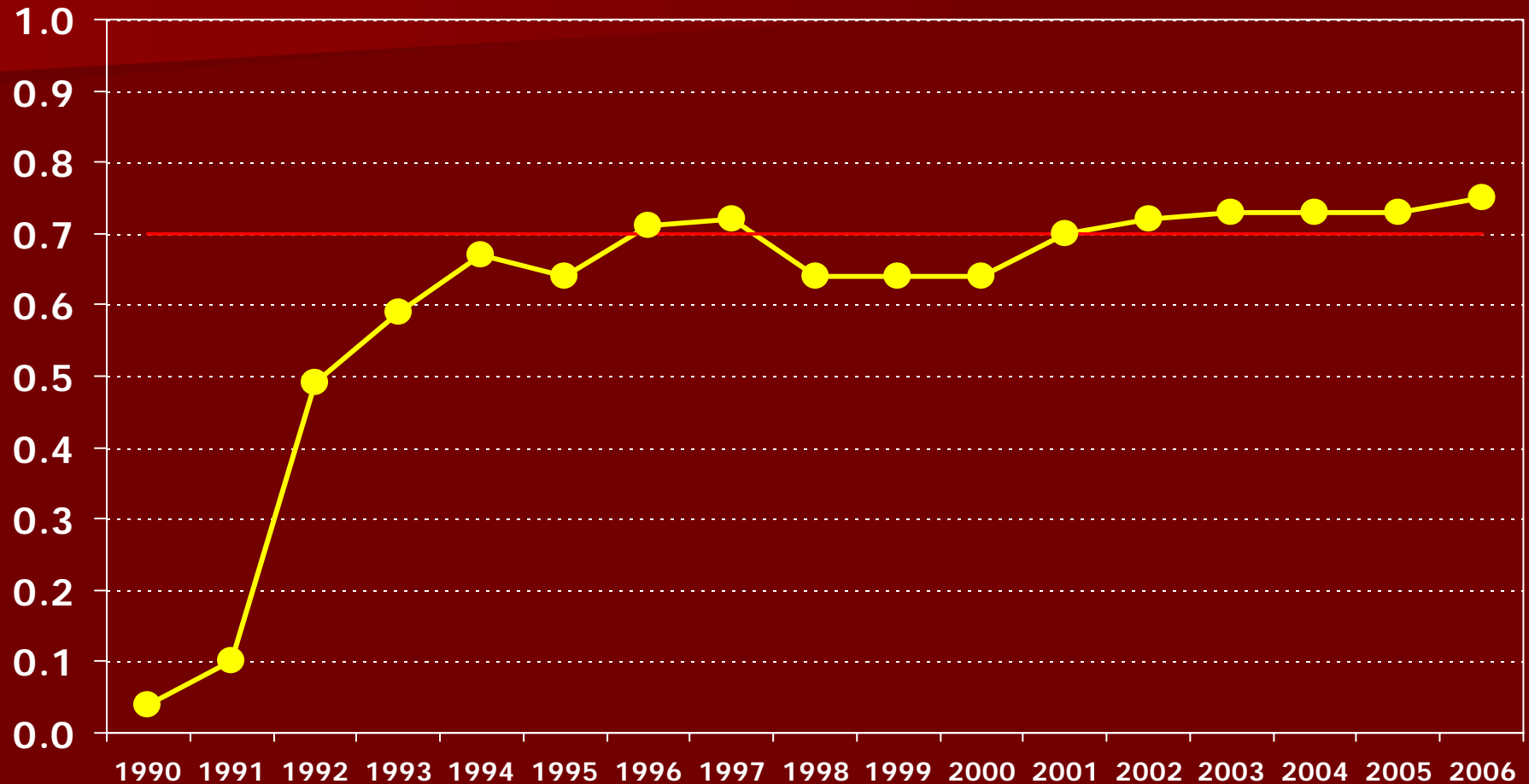
Reform Government appointed, Nov. 1991

Policy actions elaborated

Implementation, Jan. 1992

Substantial Deregulation

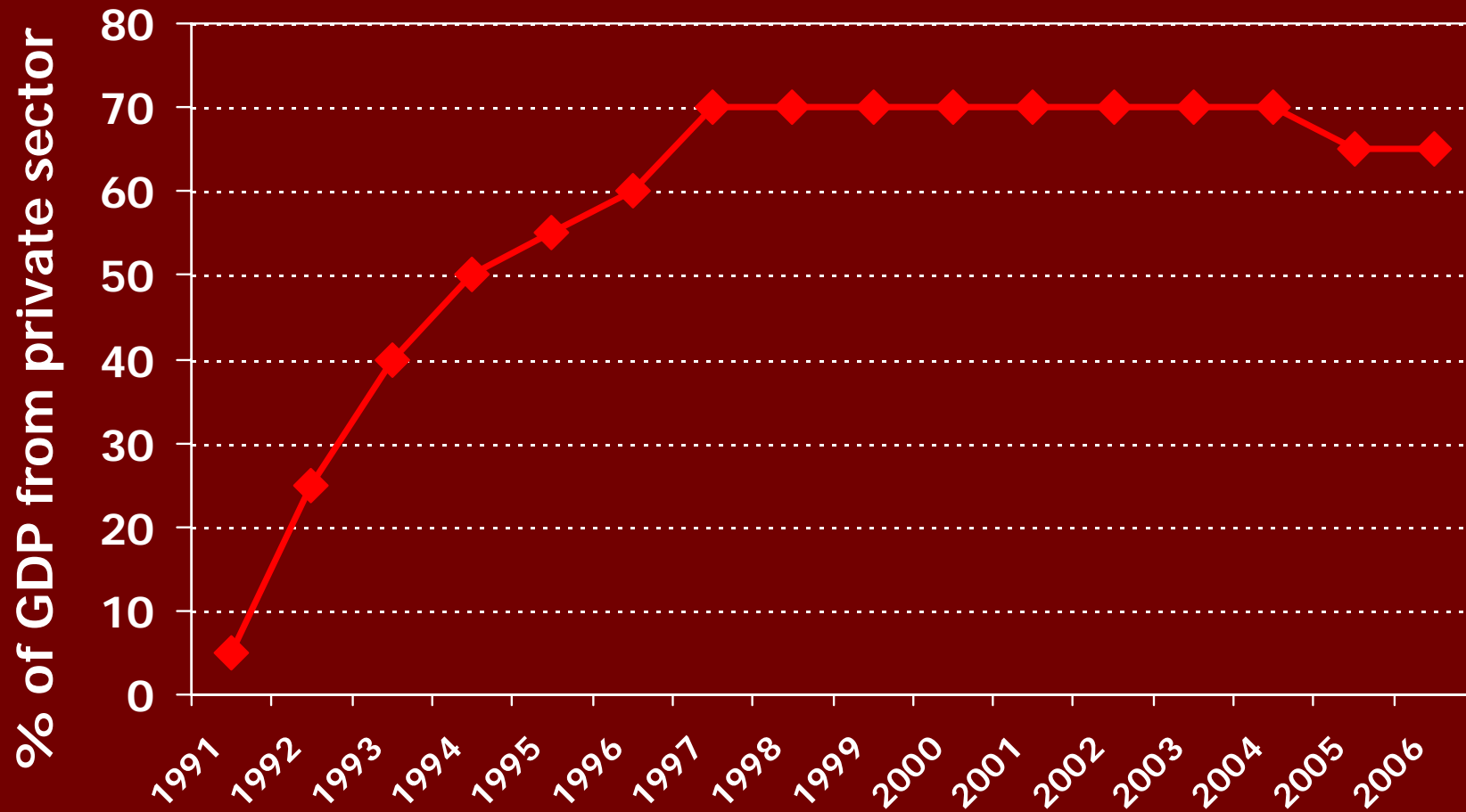
EBRD transition index, 1990–2006



0 = low

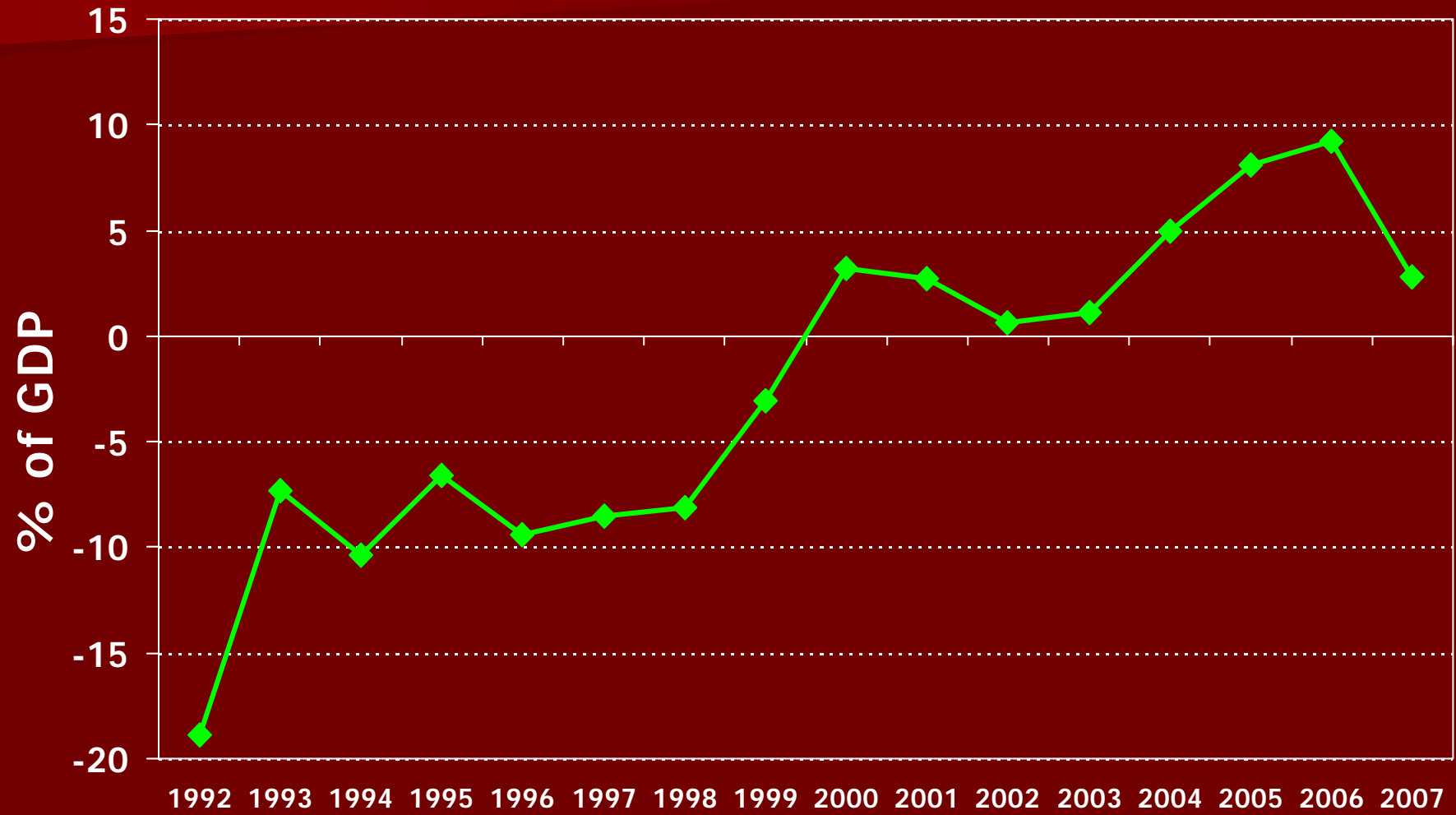
1 = high

Fast Privatization



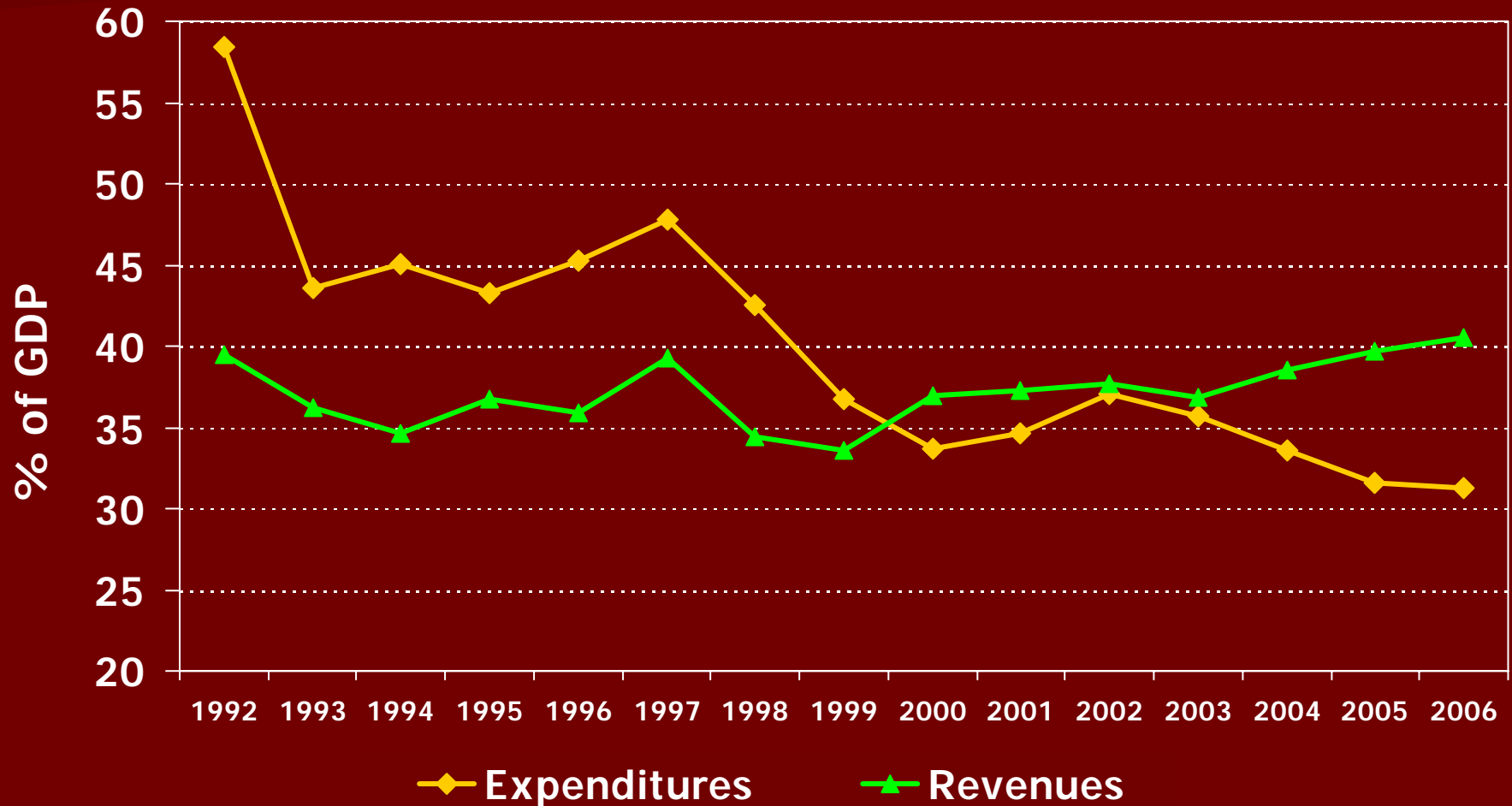
Sources: EBRD

Frightful Budget Deficit Led to Financial Crash in 1998



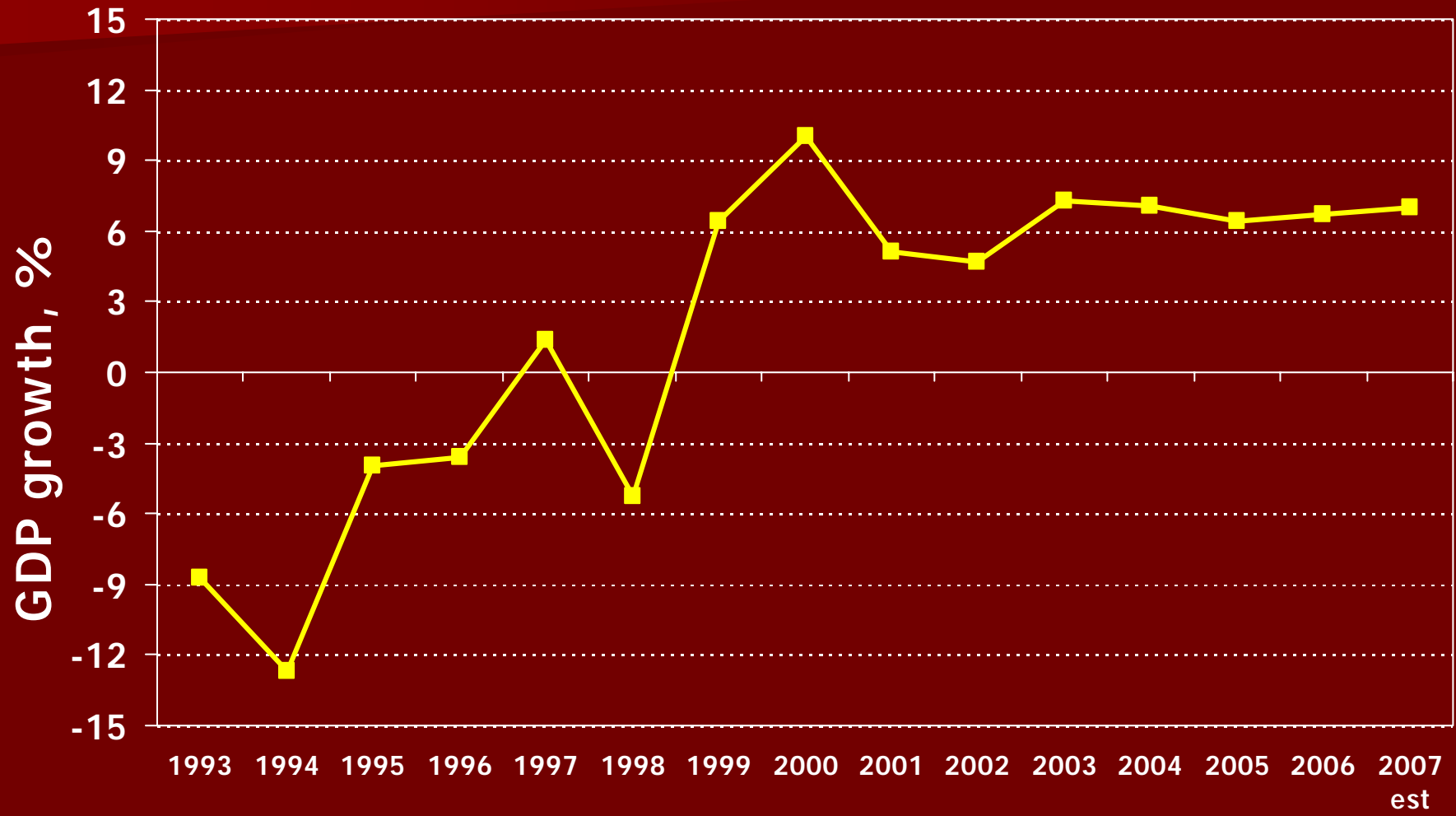
Sources: EBRD

Budget Consolidation through Sharp Expenditure Cuts



Sources: EBRD

GDP Growth Bounced with Subsidy Cuts



Sources: EBRD, IMF World Economic Outlook

A Dynamic Market Economy since 1999

1. Critical mass of market reforms and privatization
 2. Conservative macro policy
 3. But minimal reforms since 2003
- 6.7 percent GDP growth a year

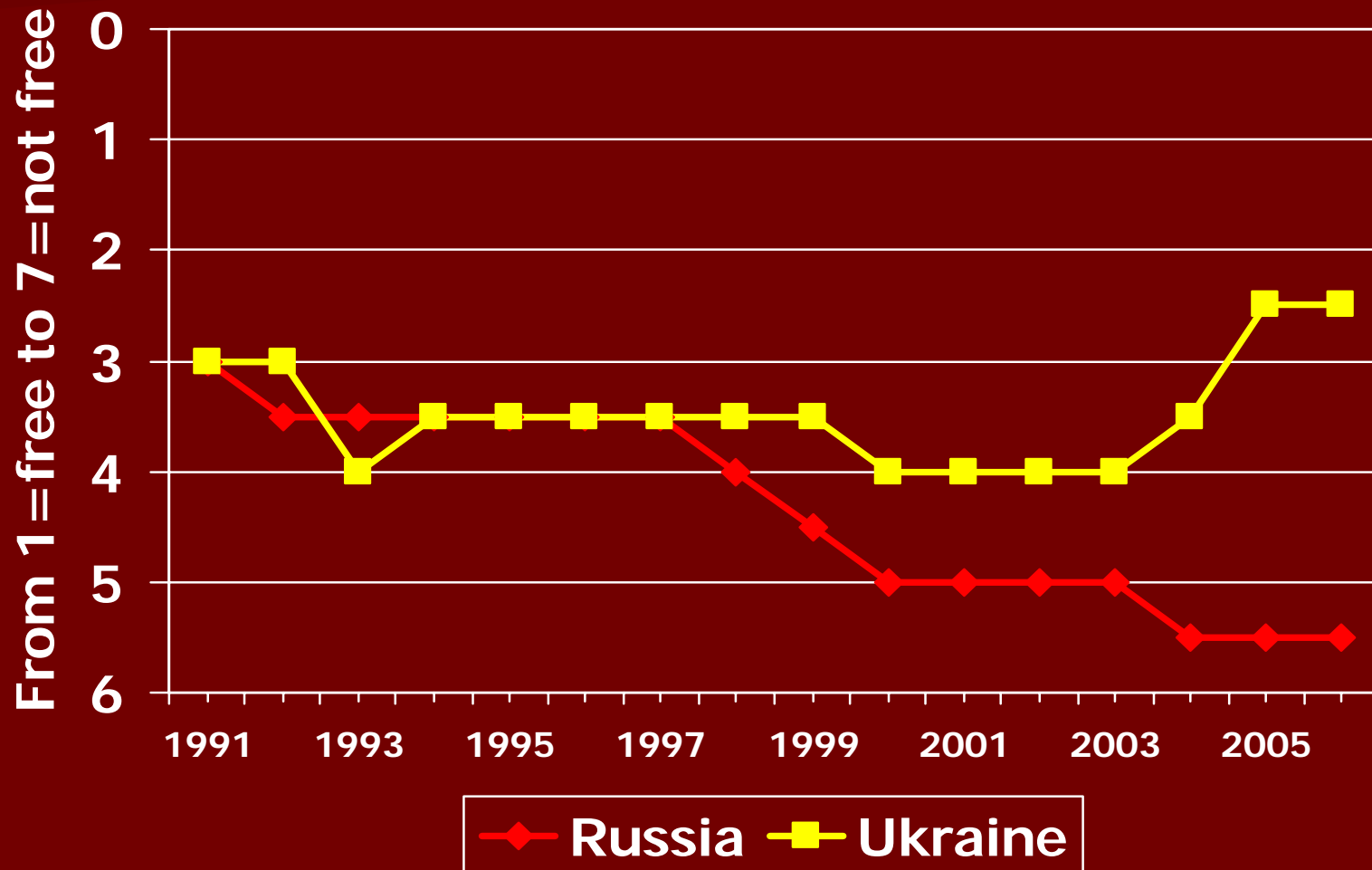
3. Why Did Democracy Fail?

- No concept
- No program
- Therefore, no early democracy building
- Old, unrepresentative parliament survived for too long and stunted party development
- New constitution: Excessive presidential powers
- Putin chose authoritarian rule

Yeltsin's Greatest Mistake

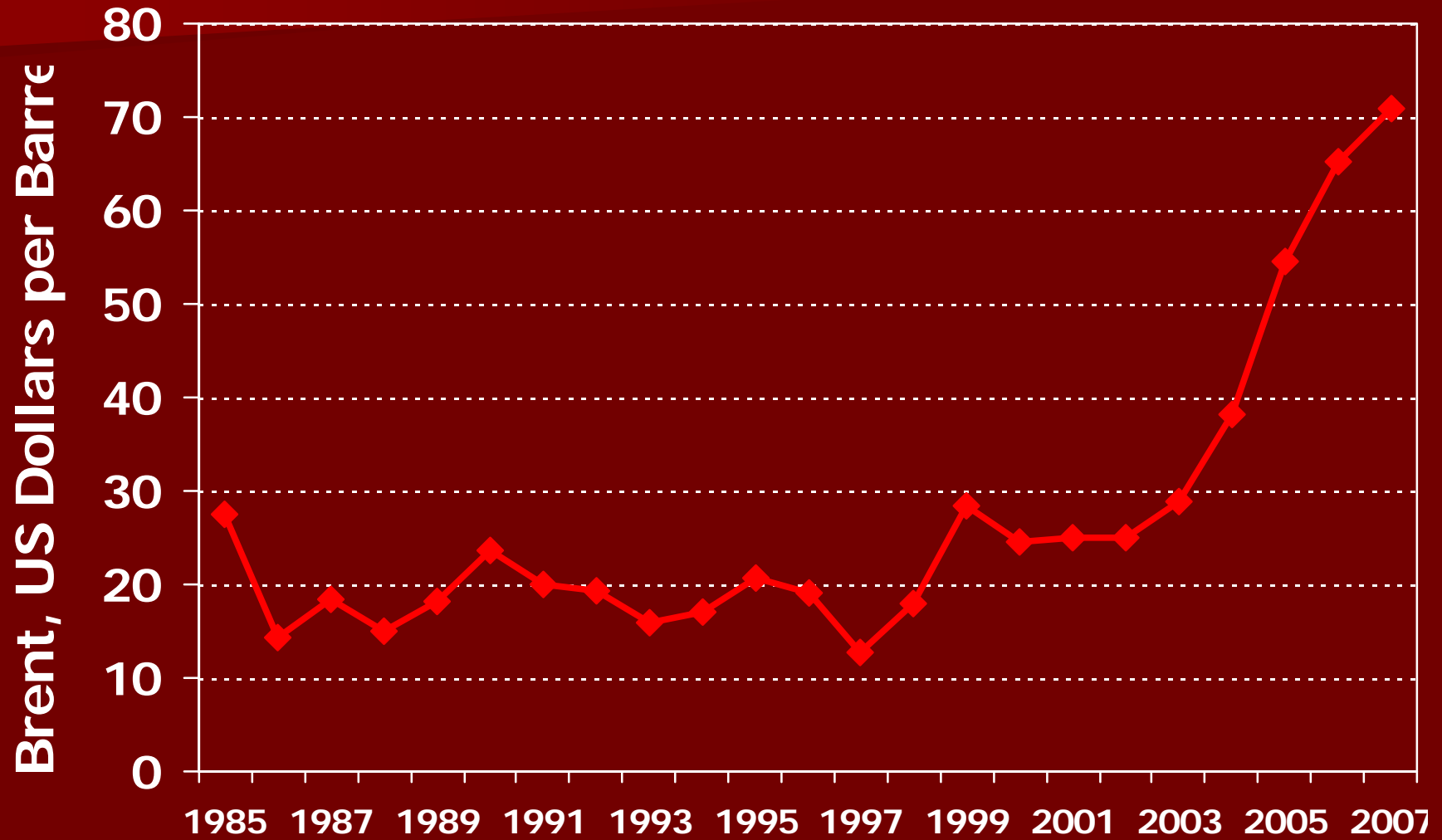


Russia's Authoritarian Reversal Was Not Inevitable



Source: Freedom House

High Oil Price from 2003 Allowed Putin to Indulge Himself



4. To Understand Putin

Putin 2000–2003: Authoritarian Reform

- Second Chechnya War
- Media control
- Recentralization of power from regions
- Tax reform
- “Dictatorship of law”

Putin 2004–07: Pure Authoritarianism

- Yukos confiscation and renationalization
- Reinforced authoritarianism and deinstitutionalization
- Acceptance of rising corruption

Putin's Future:

He Has to Stay in Power

1. Personal authoritarian rule rarely survives a succession because no real institutions are left.
2. He is widely accused of grand larceny and needs all immunity he can get.

Political Instability

- Putin has betrayed all his KGB friends by selecting Dmitri Medvedev.
- Either Putin purges them soon or they are likely to instigate a coup against him.

Putin's Choice: Back to Nicholas I

- Overcentralization of personal power
 - Ruling through the secret police
 - Increasing repression as is necessary
- Anachronism!



5. Russia's Future

Future Outlook

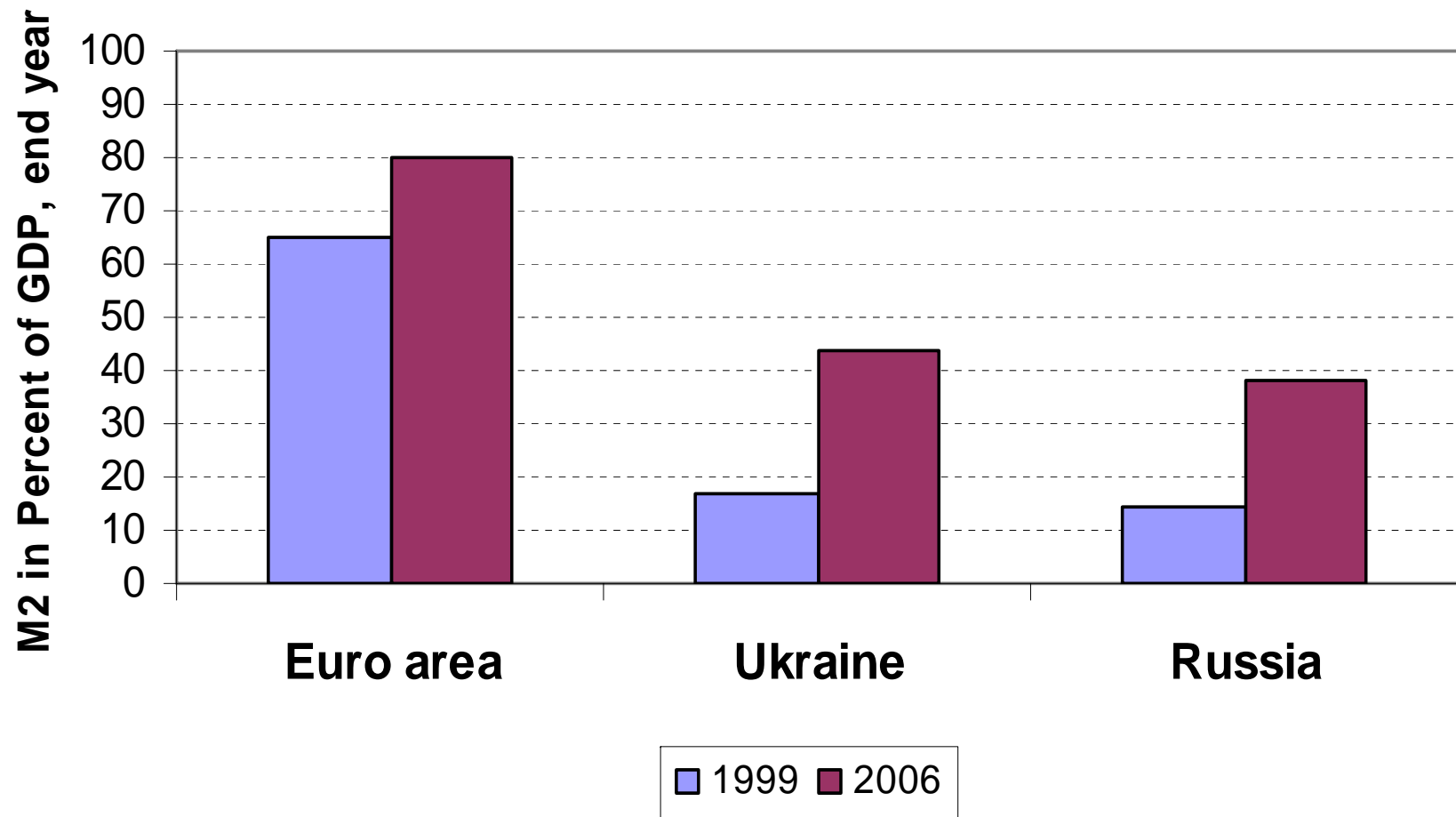
- High economic growth
- Macroeconomic policy wavering
- Corruption aggravated
- Political uncertainty

Many Growth Drivers

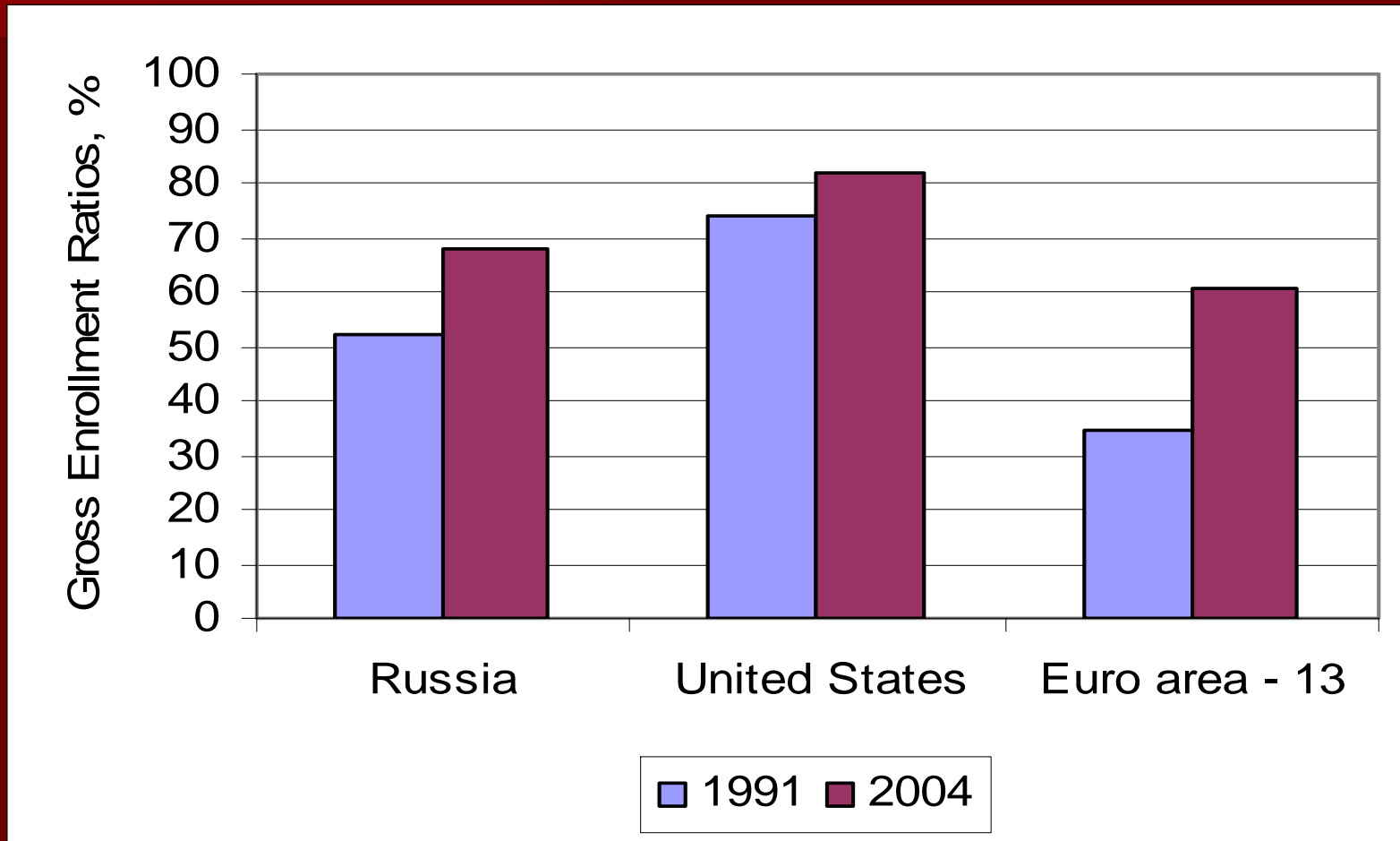
1. Remonetization M2/GDP should double
2. Huge profit in GDP: 37 percent in 2005
3. 68 percent of Russian youth go to university—more than in the European Union.
4. The number of enterprises rise by over 7 percent a year

Investment no driver, but reasonable

Far Too Little Money Supply Allows Releveraging, 1999 and 2006

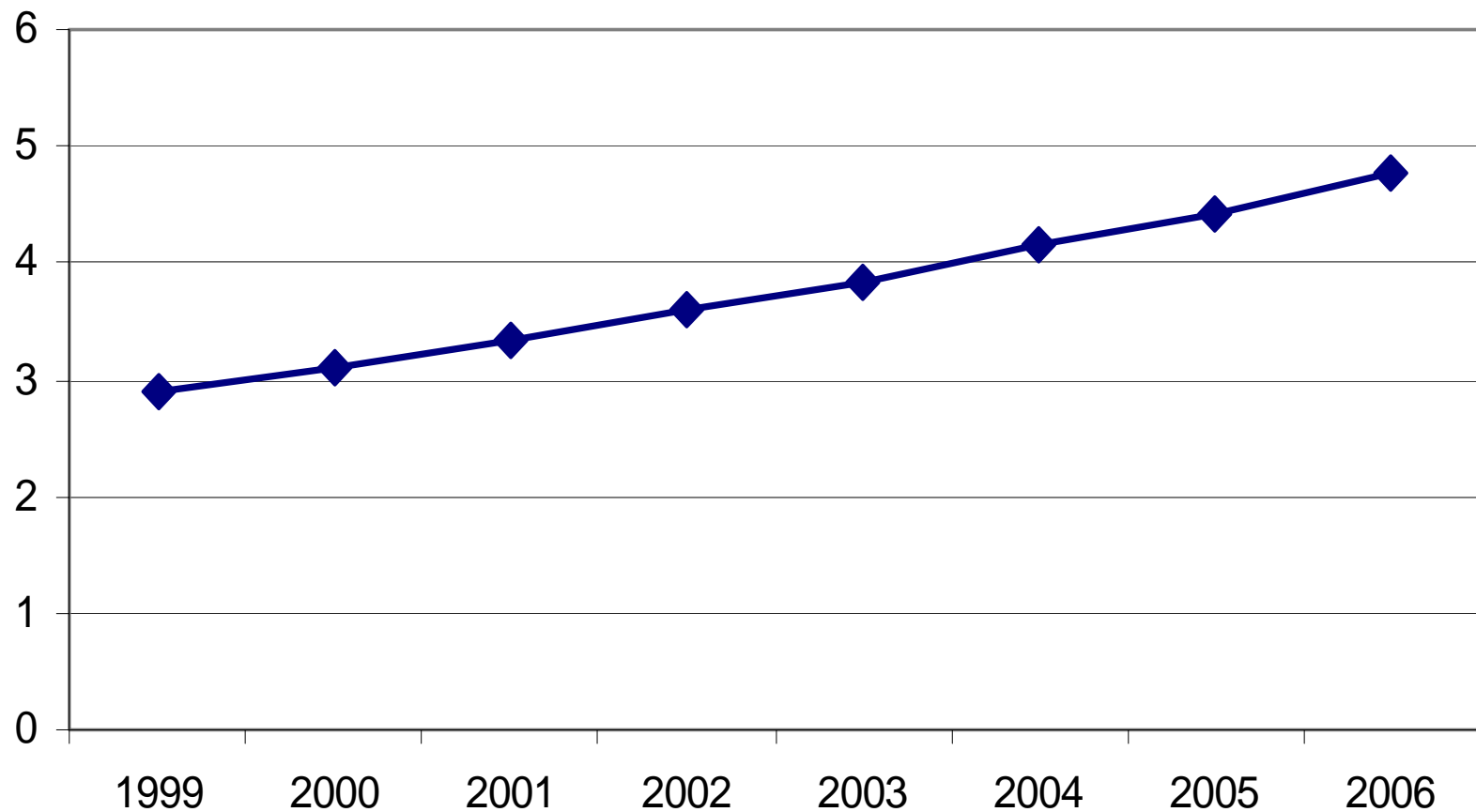


More University Education than in European Union, close to United States, 1991 and 2004



Source: UNESCO statistical database, 2007.

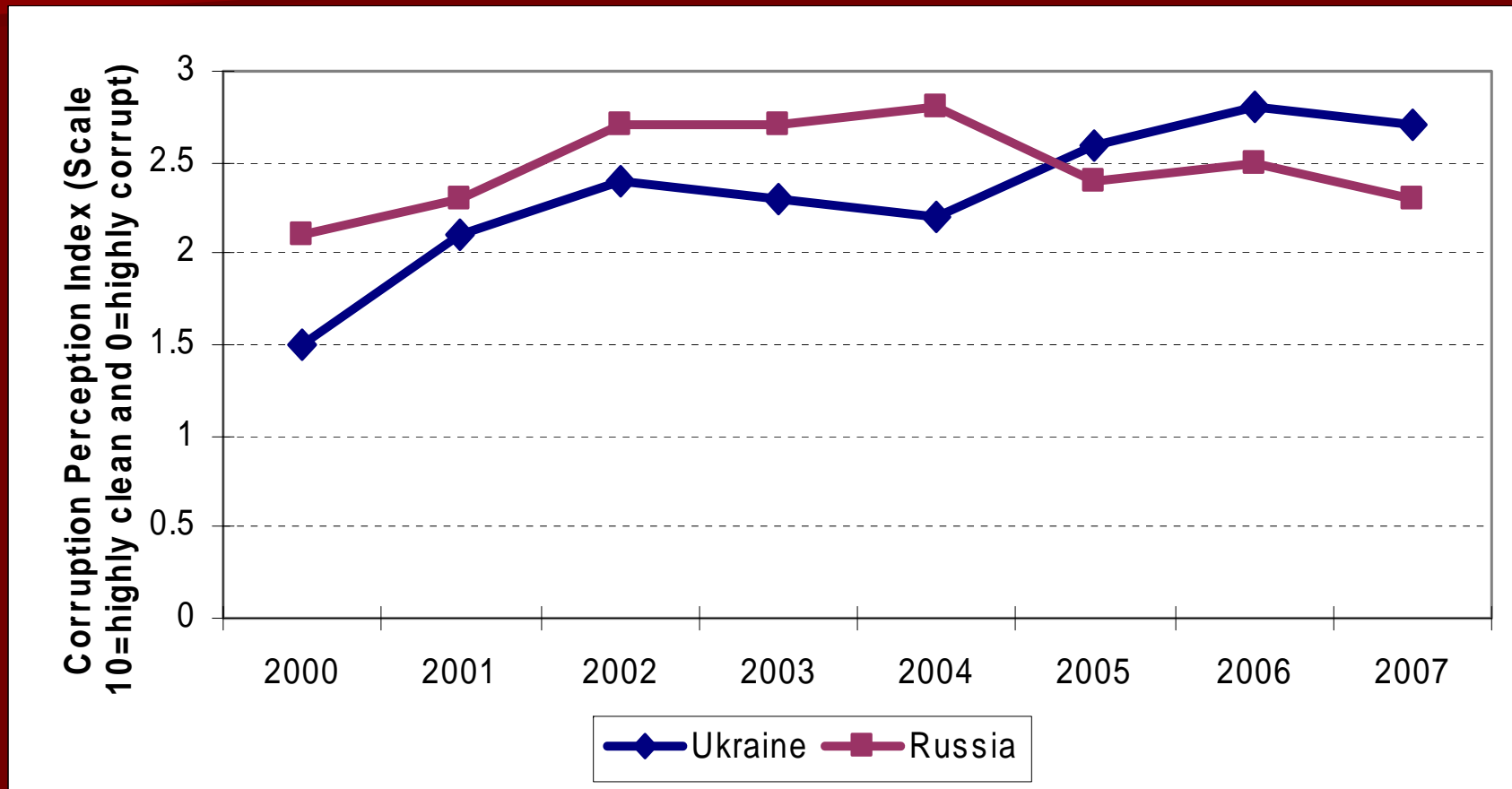
5 Million Russian Enterprises, Rising by 7 percent a year (in millions)



Economic Worries

- Renationalization: Private share of GDP from 70 percent of GDP in 2004 to 65 percent in 2007
- Top-level corruption rising
- Overheating: Inflation rising
- Energy production stagnating

Severe Corruption, Getting Worse



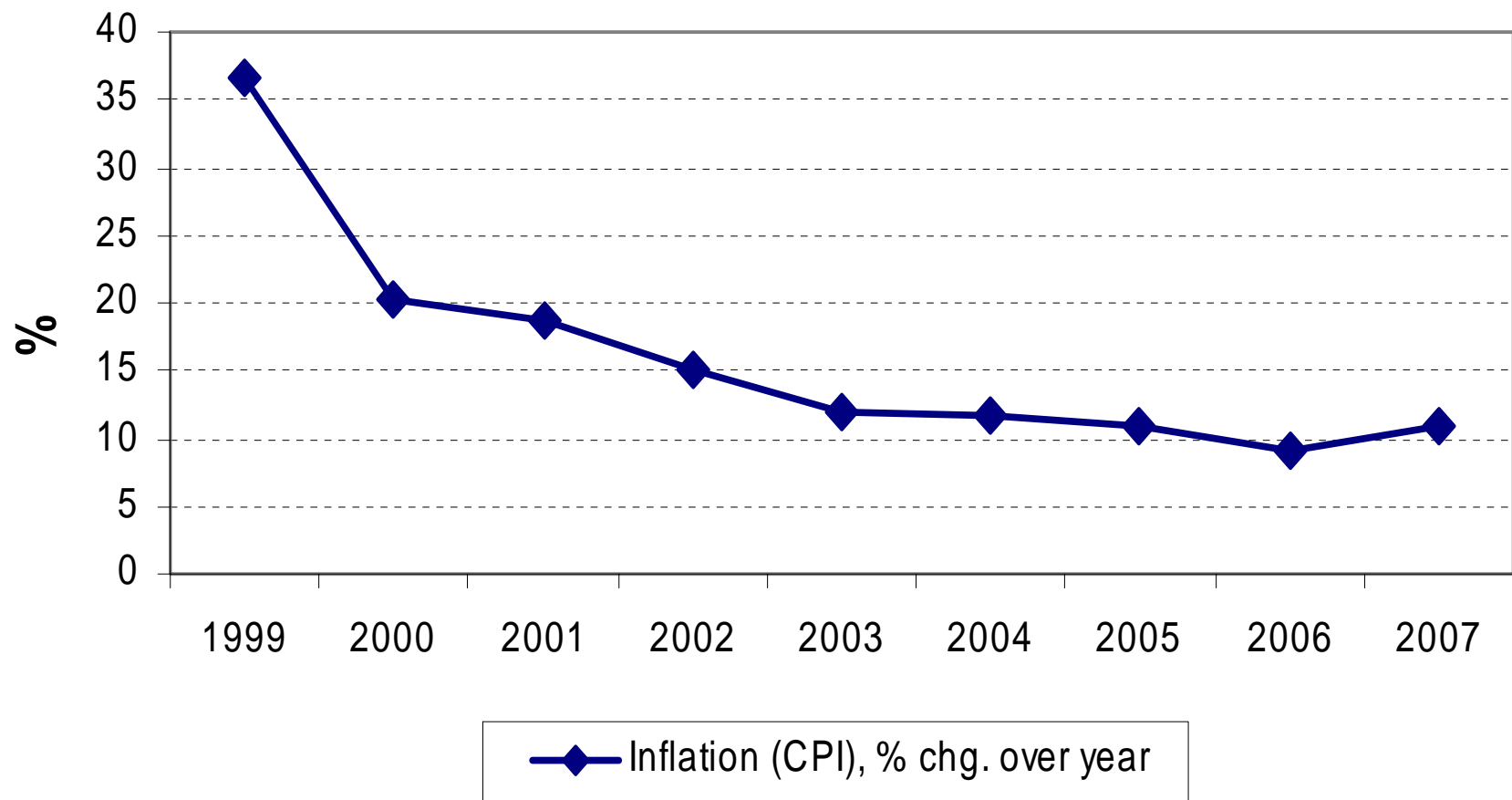
Source: Transparency International (2006).

Systematic Corruption

- Corporate raiding by law enforcement
- Extortion of major private companies
- Concentration of vast fortunes of top KGB men from St. Petersburg

How much can they steal without damaging the economy?

High Inflation Rising Again

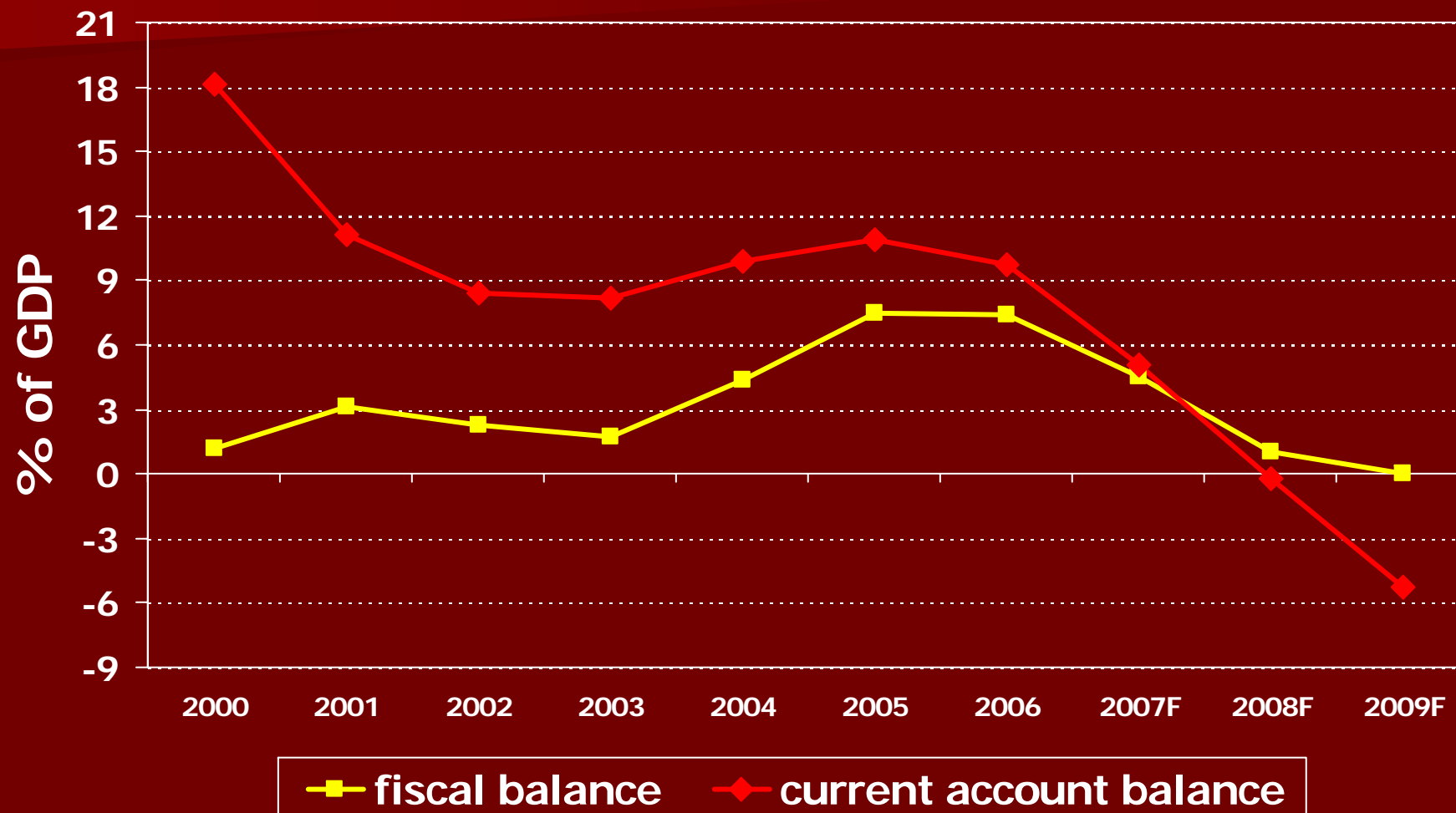


Causes of Rising Inflation

- Loose monetary policy
- Declining fiscal surplus
- Large capital inflows
- Current account surplus (declining)

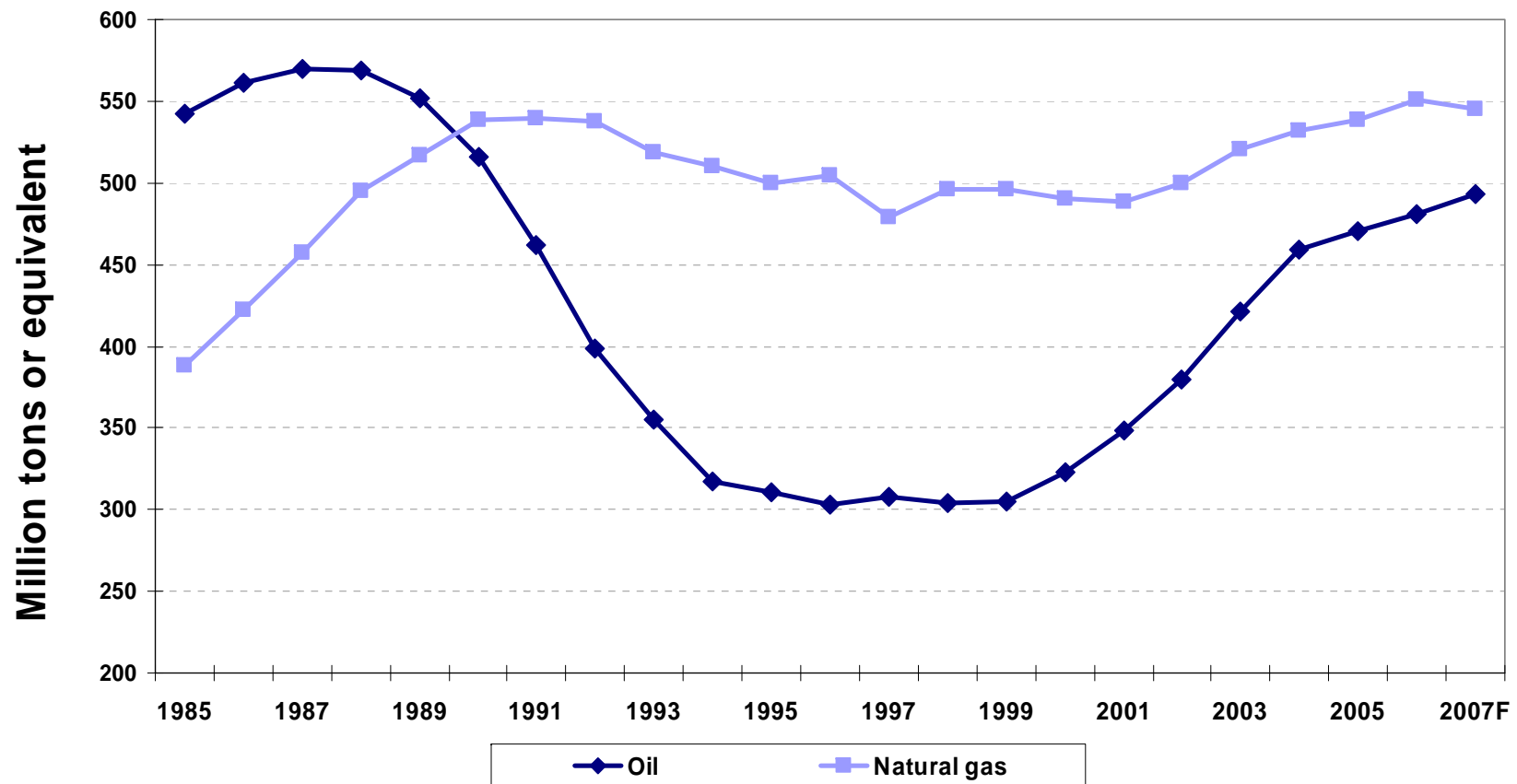
Politics: No tightening likely before March—inflation 15 percent?

Fiscal and Current Account Balances: Strong but Declining



Source: JPMorgan

Oil and Gas Production, 1985–2006



Source: BP Statistical Review of World Energy, 2007; UBS

Russia's Future: Democracy

- Too rich, pluralist, and educated to be so authoritarian (Lipset)
- Only source of legitimacy: economic growth and stability
- Corruption main issue in all democratic East Central European elections

Renewed democratization likely

Conclusions

1. Too great a contradiction between sound economic development and anachronistic political system
2. Russia's market economy seems secure.
3. A new wave of democratization is likely.

What Should the West Do?

1. Promote economic integration:
Admit Russia to the WTO and
OECD!
2. Do not count on political
stability!
3. Tell the truth!

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