The Coming Russian BOOM

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MOSCOW—A man trades in privatization vouchers to buy stock in the Zil automobile factory.

Richard Layard & John Parker

Whether Russia prospers matters not only for Russians but for the whole world. A prosperous Russia is an important outlet for Western exports and Western capital—and a more peaceful neighbor. And despite the gloominess of most press reports on Russia today, there is strong evidence that the Russian economy will grow rapidly in the future.

Russia enjoys a far better educated population than most countries with comparable incomes. Adult illiteracy is around two percent, compared with over 15 percent in most other countries of similar income. Russian education is particularly strong in mathematics and the physical sciences. While business education is of course primitive, many scientists have abandoned the defense industries, for instance, to reach the top in finance and business ventures.

Russia is still the world's top nation in natural resources. On a per capita basis, Russia produces more than the United States of natural gas, oil, steel, aluminum, nickel, platinum, and many other key resources. In due course, Russia's farmland, the third most extensive in the world, will become a significant asset.

The best economic news is that Russia has privatized faster than any of its East European neighbors. Many avenues for growth have opened up as Russia throws off the shackles of communism and an excessive military spending. Russia will likely grow at a faster rate than mature market countries for many years to come.

From the beginning of Eastern Europe's transformation, the proper speed of privatization has been debated. Everyone agreed that private ownership was the goal, but some people, like the Hungarian economist Janos Kornai, maintained that selling off existing state enterprises was less important than removing obstacles to *new* firms—because fresh competitors would eventually replace many state firms. This policy, a European version of the Chinese model which lets new enterprises gradually grow up in parallel with the old, was largely adopted in Hungary.

Poland and the Czech Republic, in contrast, put higher priority on privatization. As a result, their economies have performed better. The Russian reformers were determined to privatize even faster. They believed the assets of the old state enterprises were of potential value if they could be managed properly by new owners. How to make this transfer?

It was easy to privatize small businesses, which could be sold for cash, often to their workers or managers. But when it came to large firms, it made no sense to simply auction off the companies, because the few parties in the country with enough money to buy them would have made an unreasonable killing. If state enterprises were to be privatized fast, they would have to be given away for nothing—or at a very nominal price.

But the question that had to be answered by Anatoly Chubais, Russia's first privatization minister, was to whom the former state enterprises should be given. Workers' representatives told him he should give the factories to them. Managers made their case. Pensioners and people not employed in state enterprises, such as teachers, doctors, and bureaucrats, demanded that privatization be blocked unless they got their share.

As he looked at the history of privatization in other countries, Chubais concluded that if he wanted to privatize quickly, he had to give enough to *all* the main claimants in order to get their support. He first proposed that workers receive 25 percent of the shares for free and be allowed to buy an additional 10 percent. Managers could buy 5 percent. And Russian citizens would get vouchers which they could exchange for most of the remaining stock.

Workers and managers—and their representatives in the Supreme Soviet—opposed this scheme. So Chubais called it Option I and proposed an Option II, where workers and managers could pay somewhat more and obtain 51 percent of the shares, with each enterprise's work force choosing which option to follow. In the end, most Russian factories were privatized along the lines of Option II.

But there were still many "outside" shareholders who had gotten their shares via vouchers issued to every Russian citizen in fall 1992. Most sold their vouchers for cash at "voucher auctions," or exchanged them for shares in an investment fund. Intermediaries accumulated substantial stakes in companies this way.

Factories began to be privatized at the end of 1992, and within 18 months the "voucher" privatization was complete. Over 80 percent of Russian industry had been spun off, largely thanks to the dogged determination of Anatoly Chubais and his talented subordinates Dmitri Vasiliev, Maxim Boycko, and Pyotr Mostovoy. Shares in many remaining state enterprises—especially in the energy sector, telecommunications, and air transport—are in the process of being sold by the Russian government. In some cases, such as that of Gazprom, the world's largest energy company, share offerings will be made to overseas investors.

The speed of this process is uneven. At the end of 1995 there was a big spurt, when some leading banks were given "shares-for-loans" as collateral against loans to the government. This created much public resentment and privatization has slowed, pending the Presidential election in June. A Communist victory in the election could lead to some denationalization. But opposition to this would be strong and in due course privatization would continue in fits and starts, as it would if Yeltsin wins.

By the year 2020, Russian living standards will have outstripped countries like Hungary, Brazil, and Mexico. And China will be way behind.

Will all of this privatization make Russia an economic success? Within Russia, two major complaints are now heard: that inside ownership of Russian firms has led to a bad system of governance, and that many managers have become excessively rich. However, outside owners do play a significant role. In over half the voucher auctions, one bidder purchased at least 5 percent of the shares. And with the shares of at least 200 companies continuing to trade openly over the telephone in Moscow, the process of concentration has continued.

By the end of 1994, the average privatized company had roughly 43 percent of its shares owned by workers, 17 percent by managers, 29 percent by outside investors, and the rest by the state. In two-thirds of all privatized firms, workers held half the shares. These figures overstate the power of workers and understate the power of managers, however, because in most firms the managers exercise the voting rights on state-owned shares, and in some companies most of the workers' shares are non-voting. Still, the overall pattern of ownership is very diffuse. Banks are so far not very important as owners, except in some oil companies through the shares-for-loans scheme. Investment funds and managers are becoming increasingly important.

The new owners of Russian enterprises are beginning to use their muscle. At roughly 10 percent of the first shareholders' meetings, the general manager was sacked. Sometimes it took outside initiative to change the management. Yavoslavi Resino Technika is a large producer of rubber products with 3,000 workers. The Derzhava voucher fund, which owns 39 percent of the firm's shares, called an extraordinary general meeting of shareholders at which it proposed to replace the management with young whiz-kids. Most of the workers supported the proposal, and the management was changed. Last July, Russia's first hostile takeover bid occurred, as Koloss, a food manufacturer, tried unsuccessfully to take over the famous Red October chocolate factory.

Many aspects of the Russian stock market need to be improved. The rights of shareholders are still very insecure. In mid-1995 most Russian companies did not issue share certificates. The only proof of ownership was the "shareholders' registry" held by the company. In some instances a shareholder's ownership has been crossed off unrightfully. In other cases firms have issued extra shares to some shareholders without informing the remaining ones. So far the majority of companies have paid no dividend—ensuring that company revenues mostly benefit insiders. To deal with these problems, the government established in late 1994 a Federal Securities Commission with Chubais as chairman. This commission is creating a central share registry system, with help from the Bank of New York, and will do much to improve the governance of firms.

As for the second complaint against Russia's break neck privatization—that it has led to wealth for small numbers of people—there have been some abuses. For example, Surgut Neftegaz, one of Russia's leading oil companies, offered 40 percent of its shares for tender without proper notice, so that only one tender was received. The sole bidder obtained a major shareholding at a knockdown price.

But these stories of villainy are few. By insisting that most sales take place by auction, Chubais prevented many abuses. And most of the flagrant abuses discussed earlier were eventually corrected. Moreover, without privatization, the managers of Russian companies would have been even less subject to external scrutiny in their accumulations of wealth and control. Many more undeserved Russian fortunes have been created by privileged access to business and trade opportunities—especially the export of raw materials—than by privatization.

Step by step, Russia is moving toward a more law-based society with fewer special economic privileges. It is acquiring an ownership arrangement and a distribution of wealth fairly well suited to economic growth. And through the voucher, Chubais created an interest in market processes that could not otherwise have happened. Russia is now a nation of 40 million shareholders.

"But," say critics, "Russian enterprises are not restructuring. They produce what they always produced. If nobody buys it, they simply pile up debts to their suppli-

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ers. Because bankruptcy procedures are ineffective, there is no mechanism to enforce change." Much of this is untrue. Even in the early days of privatization there were sharp adjustments. In each month of 1993, for instance, 30 percent of all firms increased their output and 40 percent their employment. But until recently these gains were outweighed by losses elsewhere.

Faced with the disappearance of guaranteed buyers, most factories altered their products. In the first two years of the reform, 39 percent of all plants offered new product lines. For example, GAZ added a lightweight truck, which Russia had always lacked, to its production of Volga cars. Uralmash, which produces oil rigs, earth-moving equipment, and foundries, found that as investment finance for the oil industry declined, Russia's oil drillers were demanding reusable oil rigs they could move from well to well. Uralmash obliged. Though it has cut employment by over half, it now has a joint venture with Caterpillar and National Oil Wells to produce much more useful equipment.

Another popular criticism is that Russia is handicapped by too many big, monopolistic firms. Actually, Russia's 20 largest companies are only one-fourth the size of the 20 largest U.S. firms (in terms of employment). Russia's problem is not too many large firms but too few small ones: While over a quarter of Americans work in small firms of under 250 workers, only 6 percent of Russians do. This lack of small businesses causes a shortage of seedlings for the great businesses of the future.

Many things are needed to encourage more small busi-

I'M PLAYING ROULETTE IN RUSSIA by James Jameson

I own a small aerospace company that has recently qualified some of its electrical components for use on new Ilyushin airliners that the Russians hope to sell in competition with Boeing, McDonnell Douglas, and Airbus. In addition, I have made, along with a small group of entrepreneurial friends, an investment in the oil and gas industry in Siberia. In the process of making these commercial ventures, I have travelled to Russia and made Russian friends and watched the unfolding of Russia's political and economic evolution.

For me, Russia's first and most profound characteristic today is anarchy. There is little order, and few clear boundaries. Each transaction is a new, time-consuming negotiation in which many hands are outstretched seeking favors. Whether it is trying to get goods cleared at customs or calculating corporate taxes, there are no established definitions.

This same anarchy operates more darkly in the form of crime and racketeering. The young landlord for our aerospace office died unexpectedly and mysteriously not long ago. A friend from San Francisco recounts traveling quickly to his pencil manufacturing facility in Siberia to deal with the unexpected deaths of three key employees. "They didn't teach me about this at Harvard Business School," he notes. One of my friends in the oil and gas investment was threatened at a cocktail party by a member of the mafia demanding $100,000. He was rescued by the intervention of another (higher paid) intermediary who brushed the first assailant aside.

Russia's wealth is no longer being stolen by the Party, nor so much squandered by central planners. The "thieves" now are the opportunists and newly costumed insiders from the previous Communist *nomenklatura* who will go to almost any length to obtain previously state-owned wealth. How does a 24-year-old Russian become the managing director of a company with $300 million in annual sales and close to 100,000 employees? Similar examples abound.

Russia's second major reality for a business person is that the economy has almost no "above ground" liquidity—no money to pay bills. There is very little money for investment, especially state-sponsored investment in things like infrastructure, and little for maintenance. The lack of liquidity has dampened the whole economy. Payrolls are late, or permanently deferred. The cash that does exist seems tied tightly to the (thriving) underground economy.

My third observation is that Russians want foreign help, but only to a point. Once technology or skills have been transferred they move to "Russianize" the activity. It is clear that national pride and traditional xenophobia exist. There is a desire to catch up with the West, but the instinct to be autonomous and self-sufficient often blocks economic progress.

One might prudently ask, "Why invest in Russia today?" The simple answer is that large potential markets and profits draw entrepreneurs like me. In aerospace, it is assumed that the Russians will eventually piece together a functional commercial industry. All existing Russian airliners will need replacing over the next ten years, and much of this will be with locally manufactured airframes. Further, there is a continuous effort by the United States and the Russians to maintain a Russian presence in space. In oil and gas, the country is rich and needs only investment and technology transfers to become one of the world's biggest suppliers. Given the treasure of natural resources available, there is a strong possibility that independent oil and gas companies will be established and thrive in Russia.

These opportunities are balanced against real risk. At the moment, in fact, the risks are mostly outweighing the potential rewards. It will be up to the next government to establish a rule of law and bring discipline to the society and the economy. If this does not happen, I and other legitimate entrepreneurs will likely fade into the haze of Russian history, and Russia's economy will continue to operate in the chill of Lenin's shadow.

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