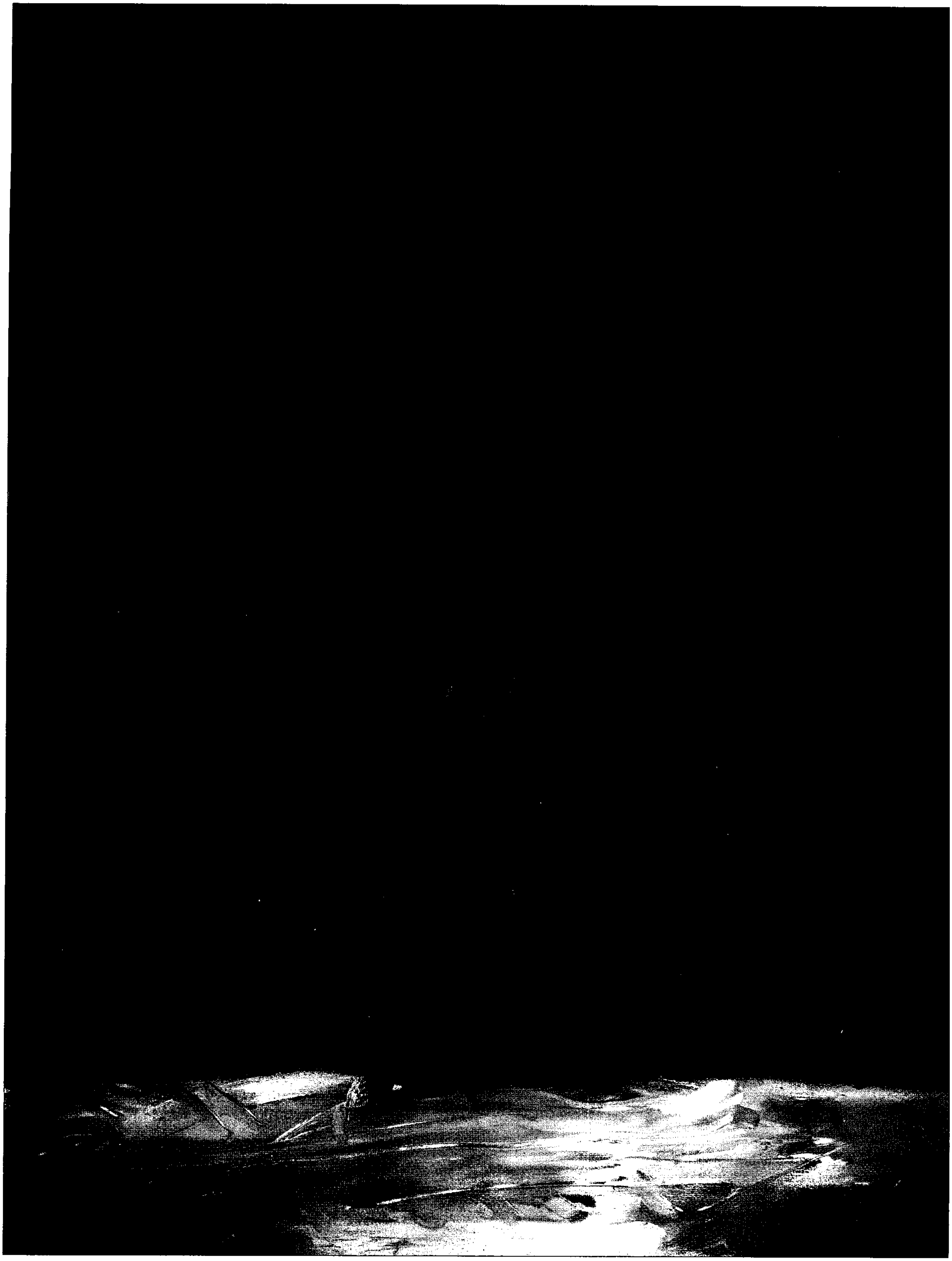

RUSSIAN RUBLETTE

MATTHEW STEVENSON

THE RUSSIAN ECONOMY IS TODAY THE PROVINCE OF OLIGARCHS—GANGSTERS, POLITICIANS, AND INDUSTRIALISTS—WHO USE MONEY AND VIOLENCE TO CONTROL THE GOVERNMENT AS WELL AS THE BUSINESS WORLD. THE PROBLEM IS NOT TOO MUCH CAPITALISM, BUT TOO LITTLE OF THE LEGAL AND SOCIAL INSTITUTIONS NECESSARY TO SUPPORT IT.

Watching the collapse of the Russian economy, I have decided that many in the West were more comfortable when the country was locked away in the prison yard of the Soviet Union. At least when the Politburo ran things, you could get someone on the hot line with the power to release hostages or break off an invasion.

On talk shows and the evening news, I hear expert after expert conclude that Russia is dying of an overdose of market forces. Commentators use the same tones of sorrow and delight in which Bob Woodward described the last temptations of John Belushi. The descriptions of Russia's market excess are as familiar as the empty pill vials on the bathroom floor at the Beverly Hills Hotel.

Yet in my seven years of Russian travel, I have seen few signs of free enterprise. To be sure, it is possible to trade shares on Moscow's exchange, and competition has spawned new restaurants and software companies. But shareholders no more decide the fate of their companies than did the electorate invest Prime Minister Yevgeny Primakov with authoritarian powers. Nor does supply and demand matter when the state's chief means of revenue is defaulting every few years on its loans.

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THE GOVERNMENT GAVE EVERY CITIZEN A VOUCHER THAT COULD BE REDEEMED FOR SHARES IN STATE INDUSTRIES. THESE COUPONS WERE WORTH MORE THAN A TYPICAL MONTHLY WAGE, SO MOST RUSSIANS BARTERED THEIR SCRIP FOR MARLBORO CIGARETTES AND GEORGIAN CHAMPAGNE.

Instead of a market economy, what Russia has is Communism with a consumerist face. On loan applications to the International Monetary Fund and in pitches to foreign investors, the government promotes the classless society of stock exchanges and market equilibrium. But when it comes to paying dividends or interest due, the Russian economy, rather than wiring cash, offers up variations on the five-year plan. The dictators of the proletariat still control the means of production.

I started traveling to Russia in winter, 1991-92, after the aborted coup against Mikhail Gorbachev had the unintended effect of putting the Soviet Union into receivership. Then as now, there were reports in the western press about Russia "not lasting through the winter," as if the entire country were huddled in tents on the German front. Western governments were sending aid packages to Russia, and on one of my early trips to Moscow, I hoped to arrange a deal in which a western country would give large quantities of meat to the Russians.

Riding in a taxi from Sheremetyevo Airport into Moscow, on one of the city's broad boulevards that suggest an empire of tenement housing, I fancied myself part of the relief effort, maybe a spiritual heir of Herbert Hoover, whose American Relief Administration resupplied a hungry Europe after World War I. I was not visiting the Soviet Union that had killed the kulaks or executed Polish officers in the woods at Katyn, but the Russia that, as America's ally, had unloaded Liberty ships in Murmansk and driven the trucks of the Marshall Plan north from Teheran.

I decided that the best chance to give away the food was to establish a connection with the newly formed government of Boris Yeltsin. Business contacts had arranged a meeting with a deputy minister of economics, and after several days in Moscow I found myself in a taxi heading toward the Russian White House, a figure in one of those diplomatic memoirs that inevitably have a chapter entitled "Mission to Moscow." Needless to say, I got no closer to meeting Boris Yeltsin than would a Russian visitor to the American White House get the chance to give beets to President Clinton.

The so-called Russian White House is actually a towering federal building, admittedly white, that would look more at home in Fritz Lang's *Metropolis* than in Mr. Smith's Washington. In 1991, Boris Yeltsin defended it from a Communist restoration. Two years later he turned his own guns on the Duma, housed within, and set it ablaze as if it were a rebel stronghold in a breakaway Caucasus republic.

The conscript at the front door, not more than eighteen years old and thinking only of his next cigarette, flipped through my passport back to front, as if it were in Arabic. A secretary collected me from the lobby, and I ascended the monolith in a creaking elevator. Our meeting took place in a cavernous conference room where it was easy to imagine a subcommittee of the 19th Party Congress voting on production quotas. But the delegation gathered there was not made up of gray party men with flat shoes and Andrei Gromyko hats. Instead there huddled before me at one end of the plenum-sized table what looked like a university seminar. The minister, who wore a flannel shirt and hiking boots, reminded me of a teaching assistant. Around him sat a group of young men, all in their early twenties, whose idea of a collective was probably to pass around a copy of *Policy Review*.

I knew the Russian people were suffering food shortages and believed that my offering of government surplus meat would be welcome. It had sat too long in freezers to rate a spot on the counters of Zabar's or Covent Garden, and contained more fat than Martha Stewart would approve of, but they could do with it as they wished and pay in the future with a surplus of their own. I assumed that all we would discuss was freight forwarding and cold storage. To my surprise, the minister answered me with a lecture on price inelasticity and the conclusion that food relief was not compatible with the doctrines of Friedrich von Hayek.

My first thought was that the Russians were again to starve in the interests of ideology. The minister and his acolytes, however, lacked the fervor of either commissars or penny-stock investors. In their judgment, Russia was better off making a go of market economics than cultivating a dependence on Western assistance. As if reading from Jack Kemp's playbook, they made the point that Russia had survived hard winters before, that state intervention had failed for seventy years, and that sooner or later only the markets could set Russian tables with meat and potatoes.

I had come thinking I was bringing food to a church supper. Instead I had walked into a symposium in which Laffer curves had replaced the tired fare of Marx and Lenin. Although I left with my meat unsold, I was comforted to learn that Russia wanted to get along without handouts. It cheered me to think the country would open itself to market ideas. But in our optimism both the minister and I failed to notice that the Party wasn't over.

In 1992, despite the market optimism of certain cells within the Yeltsin government, central planning still had a bear-hold on the economy. Delegations from ministries, such as that of ship-building or telecommunications, roamed the West, looking for orders to replace those no longer issuing from Moscow. The market was another word for the budget allocation that would pay workers or keep the sanitariums open on the Black Sea. In meeting after meeting, I heard plant managers plead for clothes for their workers.

Most confusing of all, with state holding companies in liquidation after 1992, was determining who owned what. Officially the Moscow bureaucracy had title to the oil in western Siberia, the diamonds of Yakutia, and the gas in the Barents Sea. But regional governments treated these claims like the demands of czarist bondholders. Assets in the ground and production in the mills were declared local property. As in America, management treated itself to stock options and divided what was left as if it were a sewer contract in Baltimore.

The government pumped trillions of rubles into inefficient state enterprises while working on market plans to put them in the hands of ordinary citizens, much the way that American corporations occasionally reward their shareholders with a non-profitable division, dressed up as a special dividend. To play lotto with Russian industry, the government issued to every citizen a voucher that could be redeemed for shares of Russia, Inc. These coupons had nominal values of about $20 in 1993, more than a monthly wage for most Russians who, rather than buy shares, bartered their scrip for Marlboro cigarettes and Georgian champagne. Crafty merchants sent minions into the streets to acquire voucher positions that were exchanged for blocs in privatized ventures.

The program succeeded in redistributing state assets, but not the wealth. Voucher shareholdings contributed no capital to enterprises that needed equity in the amounts that Michael Milken once trafficked. But voucher trading established the rudiments of a stock exchange. Companies began issuing stocks and bonds, and the Russians embraced speculation as if losses were covered by the Federal Deposit Insurance Corporation. Certain mutual funds even began advertising on television, and their collapse became as inevitable as the cancellation of daytime serials. When MMM, an early fund, went down with the savings of widows and orphans, its promoter sought not the protection of bankruptcy court but the immunity of elective office.

After 1994, returns on the stock exchange routinely exceeded 100 percent. Certain industries, like oil, telecommunications, and financial services, attracted strategic Western partners, who saw values at a fraction of their Western prices. A barrel of Lukoil's proven oil reserves cost $0.25 in 1995 while the same barrel, valued in the common stock of Shell, cost $5. In 1996, Arco completed the purchase of 8.8 percent of Lukoil for $340 million.

Those gambling in the Russian stock market overlooked that they were drawing from a house of cards. One ignored quirk was that share registries—the list of shareholders—were kept at the companies themselves, not at banks or independent third parties. Consequently, unfriendly shareholders could be struck from the ledger, like dissidents once dispatched to Siberia. Another problem was the financial statements, which painted pictures of robust companies in the spirit of socialist realism. On most balance sheets, assets were overvalued, while the liabilities were stubbornly real, such as salaries for workers who otherwise would starve.

Even the presence of Western auditors preparing statements provided little comfort. Before it failed, Tokobank, which had the European Bank for Reconstruction and Development among its shareholders, received a clean bill of accounts from Coopers & Lybrand. When the Russian stock market collapsed, beginning in November 1997, shares gave up most of their gains from the market era. The *Moscow Times* Index fell from 500 to 50. In less than a year, Lukoil's market capitalization fell from $20 billion to $2 billion, even though its proven reserves are more than those

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of Mobil and Chevron combined. As Marx and Engels put it in the *Communist Manifesto*: "Pauperism develops more rapidly than population and wealth."

What triggered the panic of 1998 was the collapse in the market for Russian government bonds, which in turn brought down the banking system, one of the government's largest creditors. In the aftermath, large bank holding companies such as Oneximbank, Most-Bank, and Menatep, merged operations, perhaps in the hope of confusing the depositors lined outside their respective headquarters. Other large banks, such an Inkombank, closed, as did a golden era of banking speculation.

Between Lenin's arrival at the Finland Station and Gorbachev's departure for Sochi, the Soviets used banks to distribute the state budget. Big banks were established around various industries, like petrochemicals and aviation. Ruble credits were transferred from the central government to the banks and then to state enterprises. Loans were repaid, not from profits, but from an allocation from the successive budget or by a Soviet insurance fund. In America, the analogy would have involved the loans of a Tobacco Bank repaid from next year's subsidies to the growers.

Just as Aeroflot dissolved into hundreds of regional carriers after the Communist collapse, so did the banks spin into the hands of their local directorates. For example, Promstroy Bank, with a branch in every city to lend money for Stalin's industrial dreams, broke into more than 200 pieces, as if all the branches of the Chase Manhattan Bank were to declare themselves independent.

In the last seven years, I have visited many of these new banks, including one in Ufa, near the Urals, with potatoes for sale in its lobby. In the early years, most bank buildings looked like Brooklyn warehouses or empty subway stations, down to the faded marble and worn tiles. Accounts were often kept by hand and the filing was stacked in corners. At a major bank in Moscow, I had to step over two sleeping dogs to enter the elevator.

In the liberalized economy, especially after 1993, new Russian banks flourished because they paid little if any interest on deposits, thus prompting a large transfer of wealth from the industrial sector to the banks. Large ruble fortunes were made on these interest-free deposits, which attracted factories, unions, even nightclubs, to apply for banking licenses. Soon Russia had more than 3,000 banks, some even in glass-tower headquarters, although I remember one that set up shop in the back of a Mexican restaurant. A few banks practiced the habits of thrift and provided their customers with automatic teller machines and MasterCards. But many paid interest by raising new deposits, a system of asset and liability management perfected by Mr. Charles Ponzi. The unscrupulous washed dirty money or skipped town with depositors' money. Shareholders in banks routinely borrowed more than the capital they had invested.

Beginning in 1994—when interbank rates in rubles reached 200 percent per year, and 25 percent in U.S. dollars—Russian banks moved their deposits to the gaming tables of government securities, known locally as GKO. The government became the banks' biggest borrower, issuing paper that allowed investors to double their money in a year.

Not content simply to risk local depositors' money in these get-rich-quick schemes, the Russian banks raised additional money from syndicates of Western banks. On the assumption that the ruble was a stable currency and that the Russian government would make good on its obligations, ruble assets were funded with dollar liabilities, which made both Western creditors and Russian debtors hostage to the ruble's fortune.

Western banks and investment funds also threw dice toward Russian markets. Financiers invested in GKO or Russian shares, or issued letters of credit against goods still in country, with the confidence that Russia was now an emerging market, where, it was hoped, they paid more dividends than bribes.

When the Russian government defaulted on its loans and the banking system failed, Western creditors were left holding a bag they had hoped was worth $70 billion. Add previous unpaid debts, some dating to Soviet times, and the amount of the Russian default approaches $200 billion. Among the banks, Credit Suisse had exposures that exceeded $1 billion. Bankers Trust and Smith Barney, among the U.S. investors, counted their losses at $350 million each. German banks had more than $30 billion on the table, although most of it was insured by their government.

Not counted in the initial loan losses were open foreign exchange contracts, estimated at another $10 billion, or certain syndicated loans yet to mature. Nor is it known if western banks will be allowed to seize collateral that includes, in one case, a strategic interest in AO Yukos, a large oil company.

Even if the amount of the Russian default reaches $200 billion, Western governments and financial institutions will be able to cover their losses, if not their pride. But such provisions will virtually sate their appetite for Russian investment, denying capital to markets that had their previous dose before 1917. For a while anyway, Russia will live in a hermetically sealed financial world, with barter again the preferred method of payment. Even the

International Monetary Fund, despite its habit of dumping billions into lost economic causes, recently held back $4 billion in committed loans to Russia, perhaps wondering whether to demand steel or vodka in return.

An irony of the Russian economic collapse is that it has tied the country's fortunes yet again to the ruble, a currency that should circulate only among collectors, much like postage stamps from Pacific islands. During the reform era, all large transactions were measured in U.S. dollars, hordes of which can be found literally under mattresses in $100 bills. But the policy of the recently reorganized central bank is to break this dollar standard, the effect of which can only be to keep Russia in the gulag of nations with non-convertible currencies.

In the Soviet era, the ruble was scrip, accepted at the company store but having no value on world exchanges. Little of the country's wealth was stored in the currency. By paying its workers with near-worthless money, the Party maintained all the options. Following the fall of the Soviets, the government printed rubles to subsidize industry and pay workers. The ruble turned into "Monopoly" money. During the great inflation that followed, those in the ruble world stayed on Baltic Avenue, while anyone with dollars advanced to Marvin Gardens.

In 1992 the Russian government organized a Moscow currency exchange, at which a few banks could trade rubles for dollars. In a limited way, the ruble became a convertible currency. But nearly every day from 1992 into 1995, the ruble depreciated against the dollar by the amount of the prevailing rate of inflation, falling from R85 = $1 in 1992 to R5,000 = $1 in 1995.

To support the ruble, the Russian government did its best to restrict the money supply, even if that meant using monetary smoke and mirrors. The central bank canceled older ruble notes. Executive orders were issued to mandate the conversion of oil profits into rubles. More recently new bank notes were issued without the last three zeros, to give the currency an air of respectability.

For more than two years, the ruble was hailed as a stable currency. The government used hard currency reserves to maintain its value. The stock market soared, and the government stoked its budget deficit with dollars from oil exported at $20 per barrel and industries privatized at lofty multiples. By 1998, however, the government's money had vanished. The price of crude oil had fallen to $12. The country was importing grain. Taxes were uncollectible. Reserves had dwindled to $11 billion. The crack in Asian markets made further privatization impossible and forced hedge funds in the West to bail out of their Russian positions.

To raise revenue, the government had few options: it could print money or renege on its obligations. It decided to do both. In August 1997 it defaulted on its public debt and declared a moratorium on the country's corporate borrowings, hoping to horde cash for the long winter. Nor could it continue to use

THE MAFIA IN RUSSIA IS CALLED ONE OF CAPITALISM'S MUTANT GENES, BUT ITS ORIGINS LIE IN THE PARALYSIS OF COMMUNISM. BREZHNEV-ERA DISTRIBUTION NETWORKS, RESPONSES TO THE FAILURES OF CENTRAL PLANNING, DRIFTED INTO EXTORTION, DRUGS, AND MONEY-LAUNDERING.

hard currency to defend the ruble, which fell more than 100 percent against Western currencies. Those who needed to convert rubles to pay off dollar loans suddenly found that their debts had doubled. To stabilize the banking system and meet payrolls, the government decided to print new money. For the third time in ten years, those holding the ruble found their assets, in effect, nationalized. Ruble gold had been spun into straw.

With the ruble's recent collapse, logic would suggest making the dollar legal tender, much as South American coins circulated in post-revolutionary America, when there was little confidence in the Articles of Confederation. With at least a stable currency, Russia could avoid the instability of inflation and trade more easily in the community of western nations. Instead, the Yeltsin government has discouraged the circulation of dollars and bet the bank on the ruble, ignoring that its value is pegged to political confidence.

The successful people in Russia today used to be the life of the Communist Party, which gave them the opportunity to travel, learn English or French, and to have the contacts that now allow them to deal in oil products or Scotch as once they delivered reports *On the Solidarity and Fraternal Relations of the Peoples of Tadzhikistan*.

Just like Wharton and Stanford MBAs, graduates of the workers' paradise learned little about contract law or warehouse operations, but a lot about how to reach a certain minister on the phone. A generation that expected to stoke the furnaces of the central plan now controls banks and nightclubs, and pays in cash for vacations in the south of France. Are these new men a mafia? The appellation is one of choice today in Russia. To many older Russians, anyone making money selling used cars or running a hardware store is mafia. The word also describes muggers, bodyguards, political officials, and conglomerates as diversified as Time Warner.

The mafia in Russia is billed as one of capitalism's mutant genes, but its origins lie in the paralysis of the dying Communist system. Distribution networks were spawned in the Brezhnev era when the central economy failed to plan for such items as sugar, flour, shoes, and blue jeans. Some of these groups drifted into extortion, drugs, money laundering, and drive-by shootings while others used their talents for overnight delivery to set up supermarkets or distribute the ornaments of the duty-free lifestyle.

On the streets, especially in Moscow and St. Petersburg, the mafia plays a Russian version of numbers and protection. Even Western businessmen operating locally whisper about guardian angels and godfathers as if they were investment-tax credits. In his book about the Russian mafia, *Comrade Criminal*, Stephen Handelman makes the point that Russia need not fear a counterrevolution from the Communist Party because so many of its former members are now millionaires. Heard in the market are apocryphal stories of this minister's links to gas or that group's stranglehold on liquor. Several years ago the personal guards of Boris Yeltsin donned ski masks and beat up security agents in the lobby of Most-Bank. The American equivalent would involve the Secret Service, in disguise, roughing up the guards of Citibank or J.P. Morgan.

Aside from extortionists and racketeers, the Russian mafia consists of trusts: combinations of political, military, and economic interests that control this mining region or that bank. Wealth is concentrated in the hands of members of parliament, oil chiefs, or regional governors who manage their spheres of influence as Huey Long ran Louisiana. For example, during privatization, banks such as Menatep and Oneximbank leveraged their influence to buy, at steep discounts, blocks of shares in the largest oil companies. In these incarnations, Russian capitalism has less in common with the thought of John Stuart Mill than with the reality of Mussolini's Italy. The economy is the province of oligarchs, who use a combination of state power, violence, and industrial strength to control votes in parliament or the distribution of Heineken beer. As Machiavelli advised his prince: "It cannot be called talent to slay fellow citizens, to deceive friends, to be without faith, without mercy, without religion; such methods may gain empire, but not glory."

Oligarchy is not new to the Russian experience. In the nineteenth and early twentieth centuries, Russia failed to develop either a constitutional monarchy or a broad middle class. The ruling nobility shared the wealth of the nation only among itself. A hundred years later, the country's assets are as closely guarded as the jewels in the Kremlin. The market economy has proved little more than a Potemkin village, set up in Western conference rooms to coax easy money from such unsuspecting lenders as hedge funds and the International Monetary Fund.

Nor have the lessons of market illusion been lost on the commissars. When Gennady Zyuganov assumed the leadership of the Communist Party several years ago, he was asked if he planned to change its name. Maybe the old brand name had lost its appeal in the market? Maybe a new one referring to Labor or Social Democracy might find more customers? But with little hesitation, the new chief executive officer answered: "If you bought Coca-Cola, would you change its name?"

GERMANY GOES AMERIKANISCH

DISCO, DIVORCE, IMMIGRATION, INFLATION, WELFARE DEPENDENCY, AND NEW CHANCELLOR GERHARD SCHRÖDER.

CHRISTOPHER CALDWELL

The way Helmut Kohl's election posters were defaced towards the end of his campaign was a sign that time was running out on him. At bus stops, in subway stations, on billboards in traffic islands, Kohl squinted out at passersby over an extended index finger. The pose was stern and minatory, and a hectoring slogan—"World-Class for Germany"—made the message plain. Kohl and his Christian Democratic Union (CDU) party had not only run the country capably since 1982; they also had the ear of the world. In Bonn, in Cologne, in Berlin, Kohl's opponents doctored the posters by sticking a ball of chewed bubblegum on the very tip of Kohl's finger. The Chancellor of German Unity, the last political survivor of the Reagan-Mitterrand-Thatcher generation, the leader of the most powerful nation in Europe for almost a third of its post-war history, was thereby transformed into a quizzical boob passively contemplating a gigantic, wet, just-picked booger.

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