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DEMOCRACY IS NEVER FOR FREE

Let me say this from the outset: because I have worked in the executive branch of the Russian government for a total of seven years, I share a personal responsibility for the serious financial crisis which has befallen Russia today. But it is precisely because throughout the years of the Russian reform I belonged to the circle of people who did their best, step by step and inch by inch, to promote liberal reform in Russia -- it is precisely for this reason that I want to take a long hard look at the causes of the crisis that broke out in my country.

The view prevalent among the broad public is that the Russian financial system was buried when the pyramid of so-called GKO's, or government treasury bills, collapsed. The bills were used by the government since late 1995 to borrow in the internal market in order to cover budget expenditure. And indeed, on August 17 this year Russia had to admit that it was unable to perform its obligations to Russian and Western creditors in order to serve its internal debt and has had to resort to the procedure of restructuring its internal debt, a procedure that is painful to all the parties concerned. On the face of it, everything is clear. The diagnosis has been declared: life on borrowed money sooner or later ends with a court bailiff appearing on the debtor's doorstep with all the consequences that entails.

But I ask myself and my imaginary opponents this question: Why did the Russian financial system collapse as late as August 1998? How did we, a country which had inherited an economy in which 87 percent of all factories worked for the Soviet military-industrial complex - how did we manage to stay afloat for a such a long time? Why didn't the economy crash in early 1995 when the country became embroiled in that costly adventure called the war in Chechnya? Or in 1993 when the parliament building was on fire and Russia avoided a national-patriotic coup by a miracle? And why not in 1992 when we were on the brink of hyperinflation and prices were growing at 2,800 percent a year?

My answer is: because in 1992 and 1993 Russia simply didn't have a modern financial system. In those years it was not yet being born, it was being conceived beneath the rubble of the collapsed Soviet command economy. And let it be noted that it was not being conceived in sterile conditions and so it carried in it broken genes and inevitable deformities.

Why didn't the economy collapse in 1995? Because at the end of 1995 we managed to stop inflation and achieve financial stabilization as a result of which the citizens of Russia who as late as early 1995 were losing 200 out of every 1,000 rubles they earned lost just 40 rubles out of every 1,000, that is, five times less. How did we do it? In 1995 we were faced with a choice: either to continue printing more money that was not backed by any real assets or adopt the civilized practice of internal and external borrowing to cover our current budgetary expenses. Were we aware that life on borrowed money was an extremely dangerous thing? Of course, we were. Especially if you remember that in previous years -- ever since the second half of 1992 when the first government of Yegor Gaidar was dismissed -- Russian industry had lived on borrowed money. Yielding to the pressure of the powerful lobby representing the interests of the Soviet military-industrial complex and communist plant managers, the Central Bank printed money to issue credits to them. As a result, the brunt of the inflationary tax was borne by ordinary citizens as rubles became devalued every day.

The creation of the system of GKO's lifted that plunderous inflationary tax, enabled national capital to be formed, and the middle class -- the social base of market reform -- to lift its head if not yet to get up on its feet. It made possible the first timid steps to switch an inherently militarized economy to a civilian and market-oriented track. I would say more. If we hadn't made these steps in 1995, if we hadn't achieved financial stabilization the communists would have won the 1996 presidential elections and the Soviet regime would have been restored in one form or another. Let me remind you that in December 1995 the national-communist opposition gained two-thirds of the seats in the lower house of the Russian parliament in the elections for the State Duma. So, by renouncing an inflationary tax on citizens and adopting the practice of government borrowing in the securities market the reformers bought time to carry out the costliest part of liberal reform -- restructuring of the economy which came to a halt at the end of 1992.

After Boris Yeltsin's victory in the 1996 elections a window of opportunity seemed to have opened in Russia for serious market transformations. What was the agenda? First and most important, a balanced budget, that is, living according to our means. How to achieve a balanced budget? In theory, everything is clear: to give up populist expenditure, introduce highly unpopular measures that would lower the social safety net for citizens, allow incompetent production to go bankrupt, eliminate protectionist laws that prevent the influx of foreign capital (in particular, foreign direct investments) to Russia.

In practice it meant the following. A reform of government, that is, abolishing sector ministries which lobbied the interests of old and mostly unproductive sectors of the Soviet economy. The reform of the military-industrial complex, that is, bankruptcy of two-thirds of the factories geared to the production of weapons and related products. The reform of the housing and utilities sector without which the state could not reduce the colossal costs of covering the utilities accounts of the rich and poor citizens alike. The reform of the natural monopolies -- Gazprom, RAO UES, the Railroads Ministry -- whose lobbying in parliament and executive government made it possible to redistribute the budget in favor of a narrow group of interests in a way that often ran counter to the interests of society as a whole. The reform of the social sphere, adoption of a policy of targeted assistance to the most vulnerable social strata. The list could be continued. All these reforms had to be carried out in 1992 and 1993. But the reformers at that time had to fight against heavy odds with a Supreme Soviet that was a hangover of the Soviet times. They lost. It was not until 1997 that the early steps in that direction could be made.

Needless to say, all these reforms met with massive resistance on the part of influential interest groups. Indeed, the financial stabilization of 1995 did not proceed without a hitch. The government met with powerful resistance on the part of exporters -- oil, gas and steel industries and so on -- for whom the introduction of the currency corridor spelled losses of billions of dollars. It was as a result of that showdown that yours truly was forced to resign in January 1996.

I assume that the US Congress is well aware of the cost of converting military production to civilian purposes. The United States faced that problem after the end of the Cold War when it had to shut down some production and research facilities, for example, in the Silicon Valley. To give you an idea of the scale of the Russian problem let me remind you that 80 percent of all Soviet industrial output was geared to military purposes, 100 percent of the output of non-ferrous metal, 60 percent of that of the steel industry were geared to the needs of the military-industrial complex which in one form or another occupied 64 million hectares of land (military bases, factories, divisions, test ranges and so on).

Ready cash was required to restructure the economy. Part of the money was provided by Western creditors and the rest had to be raised by selling government property. And when that was not enough we borrowed in the internal market.

But the dire legacy of the Soviet economy was just one factor that impeded reform. The Russian government was faced with a problem that has been thoroughly described in American political literature. The problem is called "divided government".

As a result of the parliamentary election of 1995, and later in the course of 1996 gubernatorial elections, the opposition gained a critical majority both in the lower and upper houses of parliament. That opposition pumped populist money into the budget, billions of unsupported money for which it bore no responsibility and for which the government had to pay.

Simultaneously the State Duma successively refused to approve:

- The efficient Law on Bankruptcy which would have made it possible to shut down unprofitable enterprises in the realm of the rule of law;
- The Law on Land which would have drawn money away from the speculative financial market and attracted investors; and
- the new Tax Code which would have alleviated the tax burden on industry and given a chance to small and medium business that had been crushed by the monopolies.

As a result the government had to adopt, year in and year out, an unrealistic and unbalanced budget. In 1995 the budget deficit (calculated according to the IMF methodology) amounted to 4.7 percent of the GDP, in 1996, to 7.2 percent, and in 1997 to 6.7 percent.

Let me be frank. Voices were heard which called the executive branch to put an end to the problem of divided government in a drastic way, by dissolving the opposition State Duma. In other words, to renounce the principle of the separation of powers and to implement economic reform in an authoritarian way, drawing on the resources of the presidency. Would this have facilitated the implementation of the tasks facing the government? Undoubtedly so.

Would it have helped to consolidate democratic traditions in Russian society? The answer is a definite no. So, the executive branch was faced with a dilemma: either to pay for democracy out of its own pocket or to put it on hold until better times. Where was money to come from? From industry? But labor productivity in Russia is 10-12 times lower than in developed countries. It stands at 8,000 dollars per worker per year. By gathering more taxes? But government in the country was still extremely weak. It was engaged in endless fights on several fronts: with the opposition Duma, with lobbyists for the military-industrial complex and with the oligarchs who demanded special terms and privileges for themselves in exchange for their political support of the government. As a result, the placing of government securities in the internal borrowing market was not being reduced as rapidly as necessary.

Even so in 1997 annual inflation in Russia was down to 11 percent and the expected annual inflation for 1998 based on the results of six months, to 6 percent. The effect was not slow in manifesting itself: in June-October 1997 the treasury bill rates fluctuated between 19 and 22 percent. Simultaneously 1997 saw a groundswell of interest of foreign investors in Russia. Russian banks had become strong enough to be able to attract major Western credits to the country. In 1996-1997 the Russian securities market witnessed an intensive growth of capitalization which reached the level of \$150-180 billion. The credits of Western investors were poised to move from the speculative market into the production sector. At the end of 1997 there were, for the first time in the years of reform, signs, albeit very small, of economic growth.

The crisis in Asia and the tumbling oil prices hit the Russian budget which, as in the Soviet times, relied largely on oil sales for revenues. In the winter of 1997 and 1998 the Russian government became aware of the gravity of the errors it committed earlier. Namely, restructuring of the economy had not been carried out in 1992-93 and Russia was still totally dependent on oil exports. But we were not going to surrender. While in early February -- after the second wave of the crisis -- GKO rates jumped to 39.5 percent, they gradually went down to 26 percent by March. It appeared that we had almost overcome the second wave of the crisis. But in January-March 1998 \$2 billion invested by South East Asian businessmen fled from the Russian market. The Russian financial market -- weak as it was -- could not withstand the blow.

It became clear that Russia could not do without the assistance of international financial institutions. Unfortunately, we can now say that we dialed the 911 number too late. The ambulance arrived when the patient was almost dying.

Misinterpretation and misunderstanding of my words by LA Times triggered speculations about the \$22.6 billion IMF loan to Russia. I must say emphatically that the government of Sergei Kiriyenko was fighting until last. Although the State Duma had cut by two-thirds the revenues that could be obtained as a result of the anti-crisis program the government made some strong decisions in order to implement the program agreed with the IMF. But the market did not believe us. As a result by mid-August a situation emerged in which Russia was in danger of exhausting its gold and currency reserves. That is why we had to introduce the measures announced in the government enactment of August 17 as a result of which the Russian government had to admit that was unable to meet its obligations to Russian and Western creditors on its internal borrowing.

What was the main mistake of the reformers?

First of all, they underestimated the weakness of government power in Russia. In the former Soviet Union in which we all grew up we were used to a strong state that crushed everything under its weight. We underestimated the fact that it was a colossus on feet of clay: as soon as the main totalitarian institutions -- the KGB and the Central Committee of the CPSU -- were removed from the former structure, the whole system collapsed. The building of state institutions in new Russia took an unpardonably long time and has not really been completed. But nature abhors a vacuum. It was occupied by powerful interest groups. On the one hand, these groups succeeded in securing the adoption of protectionist laws, especially in the banking sphere, that shielded them primarily from Western competition and on the other hand, they prevented medium and small business from getting up on its feet. Medium business found itself under a double press: on the part of the newly-formed groups of oligarchs and the extremely irrational tax system.

Our second mistake was that we did not take into account all the risks inherent in the liberal democratic regime. Not only was the reform government unprepared for a divided

government situation, but in its calculations it failed to take account of the lack of liberal traditions in society.

Finally, yet another error -- which was probably inevitable -- consisted in very slow progress of rule of law in Russia. The concept of the supremacy of law was never an inherent part of Russian political culture. This accounts for an extremely corrupt bureaucracy and all the branches of power, an unwillingness of the new Russian businessmen to obey common rules of economic life, a reluctance that is rooted in the illegal business in the former Soviet Union.

Such are the causes of this, the gravest crisis to hit post-Soviet Russia since it embarked on the road of reform.

2. What, then are the results of the first era of early liberal reforms in Russia which is drawing to a close as communists are making a comeback to government?

Yes, the country's financial system is on the brink of bankruptcy. Yes, the opposition parliament may force the government to change economic course.

But some achievements can be reported.

First, the recent battles between the executive and legislative branches, for all the negative outcomes, have proved that the principle of the separation of powers exists in Russia. Political freedoms have become a reality in Russia -- freedom of expression, freedom of the press and political parties never existed in Russia before.

Second, the past seven years have seen a change of the Russian economic system. Private property and the middle class have emerged. The middle class, upholding its economic and political interests, will not readily relinquish the gains of the reforms years. A whole stratum of people have emerged who have something to lose if a restoration of the communist regime in Russia is attempted.

Third, the two years of financial stabilization, the abundance of goods, freedom of choice and movement enjoyed by the broadest social strata have probably given a taste for the

(admittedly relative) civilized life to the young generation which, I hope, would not like to see the clock turned back.

Not much, you might say. Well, it depends. Not if you remember that just 11 years ago Russia had political prisoners and political zones in prison camps; that government censorship of the media was abolished only ten years ago. And the first presidential election within a multi-party system and real and not "virtual" contest between diverse political forces and views and the mixed economy only became a reality in Russia two years ago, in 1996.

3. What is in store for Russia? This is pure guesswork considering that the government has yet to be formed and its program has yet to be published.

It is obvious nevertheless that the financial crisis, the resignation of the highly professional government of Sergei Kiriyenko and the advent to the executive branch of people who mentally and in terms of their attitude gravitate toward the past pose a real threat to the liberal democratic regime in Russia.

The country may be thrown two or three years back. I wish I am proved wrong, but the political forces which, because of their incompetence, the propensity for populism and political expediency have prevented the implementation of a normal economic policy and to some extent provoked a crisis. The first statements of the new head of the Central Bank, Viktor Gerashchenko, in favor of printing more money, do not give grounds for optimism. The exhortation to address the needs of the national industry that one hears on television prompts sad thoughts.

There is a real danger that things will develop in the following way. The printing of a lot of money to defuse social tensions and meet the populist demands of the left-wing majority in the Duma. Hence the threat of hyperinflation, the rationing of prime necessity goods, final bankruptcy of the middle class, and adoption of protectionist laws that isolate Russia from the rest of the world. That scenario is so bad I wouldn't like to elaborate on it.

But I would like to hope that another option is open. The crisis may turn out to have a favorable impact on the economic and political development of Russia. The bankruptcy of oligarchic groups to some extent clears the decks for small and medium business which was

previously downtrodden by these groups. In that case it may strengthen the middle class which, barring irreversible mistakes by the government, will strengthen the liberal political forces in Russia.

4. How should the world community view the possible negative changes in Russia?

It should view them rationally. It should realize that attempts to isolate Russia would merely strengthen negative trends in Russia. Therefore the West will have to seek ways to cooperate with any regime in Russia save the most extreme regime. Such cooperation, like financial assistance, need not and cannot be hypocritical, but clear-cut conditions should be set for it. Politically, the condition must be the preservation of civil and political freedoms and respect of the basic human rights. Economically, continued commitment to integration in the world economic market. I am absolutely convinced that strategic development of Russia and its economic recovery are impossible without wide-scale foreign direct investments.

But it is equally obvious to me that Russia's problems can only be resolved by the efforts of Russia herself and her authorities.