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Preliminary
Comments and Queries
Most Welcome

What I did in Russia

There is considerable misunderstanding of my role as an economic advisor in Russia in the early 1990s. Therefore, I offer this summary of my personal involvement with Russia's economic reforms for anyone who might be interested. I begin with some background on my work in Latin America and Central Europe to help explain my approach to economic advising and the nature of the recommendations that I made with regard to Russia's economic reforms.

Economic Advising in Latin America

In 1985, as a Professor of Economics at Harvard University, I began to combine academic research and teaching with a role as macroeconomic advisor to governments in crisis. This role began in Bolivia in July 1985, when I was invited by former students to make suggestions about how to solve Bolivia's hyperinflation and deepening economic collapse. Later in 1985 I became an advisor to the Government of Victor Paz Estenssoro, who was elected President in August 1985.

In the case of Bolivia, I recommended sharp fiscal actions to end a hyperinflation[1] of more than 20,000 percent, and I recommended a continuing default on external debts as a prelude to a fundamental renegotiation of those debts with foreign creditors. Both of those pieces of advice – strong domestic reforms coupled with aggressive renegotiation of external debt[2] – were controversial, since many reform advocates suggested a gradual disinflation, and the international community, led by the IMF, insisted upon a resumption of debt service payments by Bolivia. I also helped to conceptualize and establish an Emergency Social Fund[3] (ESF), supported by the World Bank, to help cushion the ongoing macroeconomic shocks in poor communities. This fund provided resources to local communities for poverty alleviation projects, for example building local schools, clinics, and infrastructure. All of this was carried out peacefully and under democratic, constitutional rule.

In the end, the combination of reform and deep debt reduction was implemented. Bolivia ended the hyperinflation in the fall of 1985, and then after a brief reversal, definitively in early 1986. Bolivia also successfully negotiated, based on my concepts and advice, a path-breaking elimination of its commercial bank debt at the price of 11 cents per dollar of debt. The ESF ran successfully for several years. Bolivia's fragile democratic and constitutional rule was consolidated.

I ended my active advisory role by the end of 1986, but continued to watch Bolivia from afar. In the years after stabilization, Bolivia enjoyed a restoration of economic growth, low inflation, democratic governance, and improvements in social indicators[4] such as life expectancy and infant mortality. Bolivia's rate of economic growth[5] remained very modest, however, and to this day Bolivia demonstrates a continuing precarious reliance on a few primary commodity exports. Many of Bolivia's economic weaknesses relate to its extraordinary geographical situation as a landlocked[6] Andean country divided between the extreme highlands (4,000 meters) and tropical rainforest lowlands. Bolivia is also an ethnically highly divided society, and for more than a century has suffered from strained relations with one of its key coastal neighbors, Chile, which offers the natural exit to the Pacific (and which Bolivia lost in the War of the Pacific in 1879).

The combination of actions that I endorsed – strong internal reforms, external assistance built around debt relief and additional financing, and an enhanced social program – became guideposts for my reform advice in many other countries. In almost all cases of deep macroeconomic crisis that I have seen, the crisis requires decisive internal reforms (e.g. fiscal restructuring, trade liberalization), much greater external assistance typically including the cancellation of an overhang of bad debt, and an enhanced program of social action, especially in primary education, public health, and access to other basic services such as clean water.

During 1987-89, I was asked by national leaders throughout Latin America to comment on their national reform strategies, and I discussed those reform strategies with government leaders in Argentina, Brazil, Ecuador, and Venezuela. I also wrote a book of recommendations[7] for Peruvian economic reforms, and continued part-time advising for the Bolivian Government.

Poland's Big Bang

In January 1989, I was contacted by the Polish Government, then a reform-minded communist government, with a request that I come to Poland to advise on the management of its external debt. I declined to come on the grounds that the Solidarity Movement, led by Lech Walesa, was still outlawed. I explained that I would be happy to come at a future date, when Solidarity was legalized, and when I could act perhaps as an advisor both to the Government and to the Solidarity movement. By quirk of fate, I was called back several weeks later, to be told that the Solidarity Movement would indeed be legalized in early April 1989. I therefore planned a trip to Warsaw accordingly and arrived on the day of the signing of the so-called "Roundtable Agreement" that legalized Solidarity. The trip to Warsaw was added at the tail end of a three-day visit to Moscow to a conference on Soviet Economic Reforms, hosted by then-Gorbachev advisor Abel Aganbegyan. That was my first trip to the Soviet Union since a tourist trip in 1969.

Starting with the April 5 visit to Warsaw, I began to work closely with a team of economists in the Solidarity movement, as well as meet with officials in the government. The Solidarity economic team was headed at the time by Prof. Witold Tzreciakowski. During this time, I was joined by Dr. David Lipton, with whom I worked closely during the period 1989-91. In May, Lipton and I worked with the Solidarity economists to prepare a request for aid from Western governments in what subsequently became called the "Brussels Project" of Solidarity. Among the participants in that early stage was future Prime Minister Jan Krzysztof Bialecksi. During June and July, Lipton and I had extensive discussions with the Solidarity leadership about a strategy for economic reform. At the request of Jacek Kuron, we prepared a document[8] that, as far as I know, became the first attempt to write down a strategy and timetable for the dismantling of a centrally planned economy and its replacement by a market economy. We presented this blueprint to the Solidarity leadership, including Lech Walesa, in July, and in testimony to a Solidarity-led Senate Commission on economic reform during the summer months.

In August 1989, I was invited to speak to the Solidarity Club (OKP) of the Parliament on the day of the installation of Central Europe's first post-communist government, headed by Tadeusz Mazowiecki. I shared the podium on that day with then-Senate majority leader Robert Dole, who was visiting Warsaw to offer congratulations and support to the new Government on behalf of the U.S.

In my speech, I outlined the basis of a rapid transformation of Poland to a normal, market-based European economy. I urged the Solidarity leadership to abandon visions of "market socialism," and to go for a market-capitalist economy. My argument, in a nutshell, later spelled out in the 1991 Robbins Lectures at the London School of Economics (published as *Poland's Jump to the Market Economy*, MIT Press, 1993)[9] was that Poland had a natural place as member of the Western European economic area, and indeed as a member of the European Union (then the European Community). I believed that the slogan of Poland's revolution, "the Return to Europe," should also be the guidepost for economic reforms.

As was central in my thinking, I believed that Poland would need a combination of factors to achieve success, including relief from an overhang of unpayable debt. As of mid-1989, Poland was suffering from hyperinflation[10] and economic decline. There were massive shortages in the retail outlets, and widespread fears of hunger in the cities. Many people thought that Poland would descend into civil war. Moreover, there were real fears of a Soviet crackdown at some point, given the long history of aborted reform movements in communist Central Europe in the post-war era. The situation was fraught with uncertainty, risk of panic, and extreme deprivation in many Polish households.

My recommendations in Poland contained the following major points: (1) a quick liberalization of prices, to allow supply and demand to operate, and to end the acute shortages afflicting producer and consumer markets; (2) an immediate opening of the economy to trade, for several inter-connected reasons: to relieve extreme shortages of consumer goods, to relieve shortages of key producer goods, to establish competition for Poland's heavily concentrated basic industries, to "import" a rational relative price structure to replace the decades-long pattern of bureaucratically set prices, to attract foreign direct investment, and to begin the process of integration of Poland into the Western European economic area; (3) the development of market-based commercial law in conformity with Western European law; and (4) the mobilization of large-scale support from the West to ensure the consolidation of democracy, to avoid social chaos, and to facilitate macroeconomic stabilization without undue social hardship. I put off the issue of privatization of major state-controlled industries in my early recommendations, since I did not have much of a detailed strategy, but I warned that it would take several years, perhaps around five, to complete. (For some of this early thinking, see the essay "What is to be Done," *Economist Magazine*, January 1990).[11]

In my first meeting with Prime Minister Tadeusz Mazowiecki on August 24, 1989, I suggested the need to adopt rapid and decisive economic reform measures. He responded by saying that he was "looking for his Ludwig Erhard," making reference to the post-War German economic architect. He found his Ludwig Erhard in the person of Leszek Balcerowicz, who became the leader of Poland's reforms. Lipton and I met Balcerowicz in early September 1989. He showed us outlines of his plans for reform and for organization of the economic team, and he asked us for continuing help as advisors. We of course gladly accepted this request. During September 1989, we worked closely with Balcerowicz and his team, helping to prepare the outline of an economic program to be launched on January 1, 1990, based on the principles of rapid stabilization and transformation to a market economy. We helped to prepare a memorandum for circulation in Washington at the Annual IMF/World Bank meetings in September 1989, which would explain Poland's reform intentions and its need for international assistance. We returned to Washington with Balcerowicz, and provided further assistance during those meetings.

I had an important role in formulating the international assistance strategy. It was based on four components: (1) a continued suspension of debt servicing, to be followed by a partial cancellation of the debt burden[12]; (2) an emergency $1 billion Zloty stabilization fund[13] from the major countries, to provide Poland with foreign exchange reserves to help back the currency after a depreciation and introduction of current-account convertibility at the start of 1990; (3) an IMF standby loan to begin at the start of 1990; and (4) increased balance of payments support and commodity assistance (e.g. emergency food aid) at the start of 1990. The debt cancellation ideas were highly controversial at the start. Policymakers in the U.S. Government and Bretton Woods institutions told Polish officials that the ideas were dangerous and unrealistic, and warned them not to listen to me. Fortunately, the proposals were in fact sound financially and politically, and Poland did indeed achieve a 50 percent reduction of its debts by 1991. So too, IMF officials initially opposed the Zloty Stabilization fund, claiming that it would be impossible to raise the funds. I met with Senator Dole, National Security Advisor Brent Scowcroft, and others to describe, explain, and justify the request for the fund. In the end, the U.S. Government endorsed the proposal, and eventually other leading countries did as well, so that the $1 billion was raised by the launch of Poland's program.

The Polish program was launched on January 1, 1990. Despite huge controversy, deep fears, and great intellectual and political debates, the program proved its worth.[14] The high inflation subsided within a couple of months; macroeconomic balance was restored, ending decades of chronic shortages within weeks; the currency was made convertible and stable from January 1, 1990 onward; and hundreds of thousands of small businesses began to form – some emerging from the black market, and others forming for the first time. Poland experienced a "transformational recession" (a term later coined by Prof. Janos Kornai) in 1990 and 91, though the depth of the recession is unclear even till today. Official data recorded a decline of 11 percent of GDP in 1990 and 7 percent of GDP in 1991, followed by economic growth thereafter. Several studies have argued, however, that the actual size of the decline was much less, the difference reflecting problems of over-measurement of declining sectors and serious under-measurement of rising sectors (such as services). In any event, Poland was growing solidly by 1992, and by the mid-1990s Poland was one of the fastest growing countries in Europe (in some years the fastest) and in the world.

Poland's overall growth performance is easily the best of all transition economies in Central and Eastern Europe and the Former Soviet Union.

I remained as a part-time advisor to Poland during 1990 and 1991, but my involvement was somewhat less intensive than in 1989. I continued to work closely with the government in international negotiations, in monitoring macroeconomic indicators, and in discussions on privatization strategy. The privatization strategy was not agreed at the start of the Polish reform effort, since the focus was initially on stabilization, liberalization, commercial law reform, integration with the European Community, and the fostering of a new small business sector. (To see my own uncertainties surrounding privatization, see my Economist article at the beginning of 1990.)[15] The debate over privatization intensified in the middle of 1990. I began to support the idea of national investment funds (NIFs) as methods of creating private ownership combined with adequate corporate governance for the large enterprises (for the smaller enterprises, I supported direct sales and auctions, as was successfully carried out). The proposal for a limited program of NIFs was adopted, but implementation was very slow and controversial. In the end, the NIFs played only a small role in Poland's privatization program. I don't know whether or not the NIFs were a good idea under the circumstances, but they surely were not *necessary* to the success of Poland's reforms. I think it fair to say that since the NIFs were both unnecessary and highly experimental, it is probably a good thing in the end that they were not adopted on a large scale.

Based on the experience in Poland, I was asked by many other governments in the region to offer short-term technical assistance, though nowhere near the level of involvement as in Poland. The last Federal Prime Minister of Yugoslavia, Mr. Ante Markovic, asked me for advice in November 1989, and I worked with him to design a last-ditch stabilization attempt. The early results of the stabilization program, between January and June 1990, were highly successful. However, Europe and the U.S. denied any aid to Yugoslavia, and Milosevic, then head of Serbia, took extraordinary steps to bring down the Federal Government, which he succeeded in doing during 1990-91. After the breakup of Yugoslavia, I became an advisor to the first post-Communist Government of independent Slovenia in 1991, and helped to design[16] the introduction of the new currency, the Tolar, and the early reform measures. These reforms helped to put Slovenia on a path of financial stability and economic growth that has also been exemplary in the region. I also helped Estonia[17] to design and introduce its new national currency, the Kroon, which has proven to be the most stable currency in the whole Former Soviet Union (FSU), helping to make Estonia's economy a great success story of the FSU.

The Beginning of My Russian Involvement

Poland's big bang attracted worldwide interest, and of course very intense interest from within the Soviet Union. Mikhail Gorbachev's advisors were famously divided between gradualists and radicals, and the experience of the Polish reform – especially the dramatic end to shortages and inflation – was a major boost to the radical faction. The economist Grigory Yavlinsky went to Poland early in 1990 to observe the Polish experience. When he tried to telex a favorable report back to the Kremlin, it was blocked by the Soviet Ambassador in Warsaw. Undaunted, Yavlinsky assembled a team of young Soviet reformers, to begin to draft a program of radical reform. This first was proposed as the 400-day plan in mid-1990, and then later as the 500-day plan[18] in early 1991. I met Yavlinsky and his team when that group took a trip to the United States in the fall of 1990. We discussed the practicalities of radical reform in the Soviet Union. I agreed to provide whatever support I could.

I did not know the Soviet economy very well, but I did fully understand that the task would be vastly more difficult and complex than in Poland. This was obvious, and I never doubted it for a moment, nor did I ever fail to point this out in my speeches and writings. There were several critical and quite obvious reasons for this concern:

- Russia's economic mainstay, oil and gas production, was plummeting by the late 1980s
- Russia was entering into an acute external debt crisis as a result of heavy external borrowing during the Gorbachev years

- Russia's economic structure was far more distorted than in Eastern Europe, with a vast proportion of Soviet industry producing "negative value added" (output worth less at world market prices than inputs such as energy and other raw materials)
- The size and complexity of the Soviet Union, with 15 republics and 150 million people stretched over 11 times zones, was incomparably greater than the complexity of Polish or Czech or other Central European circumstances
- The Soviet region utterly lacked the history and practice of market economics and democratic governance

Indeed, a constant theme[19] of mine was that the transformation was going to be so difficult and harrowing that the Soviet Union (and later Russia) would need vast Western aid for success. Far from preaching a miracle cure, I was trying to preach realism to the United States – that market reforms could not, by themselves, solve deep structural and societal problems, and that large-scale help would be needed from the West.

I am often accused of having been naively optimistic about Russia. This is not correct, and is belied by all of my writing at the time. If anything, I was somewhat darkly pessimistic though I firmly believed that there was a successful way forward. The situation in Russia was dangerous and difficult. Nobody on the ground could believe differently. So why did I choose to get involved? I got involved because the urgency of Russia's economic and financial situation called for the best possible steps, even if the chances for success were low. Of course from a PR point of view, many people would shy away from being involved in something so likely to fail or fall short. That is not my approach in general. I have repeatedly accepted highly complex tasks, even when the chances of successes were not high. In Russia I tried in my small way to help Russia have the best chances for economic success even as the dangerous and confused events of 1991 onward unfolded.

Curiously, even the traditional Soviet Communist bureaucracy wanted to discuss economic reforms. Lipton and I were invited to give a one-week "class" to the senior officials of Gosplan (the Soviet State Planning Committee) on the economics of reform, based heavily on Poland's experience. I met with Gosplan chief and Politburo candidate Yuri Maslyukov, together with Gorbachev advisor Abalkin, to discuss reform strategy and to initiate the Gosplan training course. This was undertaken in spring of 1991.

That Spring I also worked on a Harvard-based project, led by Graham Allison of the Harvard Kennedy School of Government and Grigory Yavlinsky, to design a package of Soviet and U.S. actions to facilitate democratization and economic reform, backed by a large-scale infusion of Western financial and technical assistance. The project took on the nickname of the "Grand Bargain,"[20] and a short book[21] was published by the team in the summer of 1991. My estimate, which became somewhat notorious at the time, was that the Soviet Union (and later the successor republics) would need an infusion of Western aid (envisioned as grants and highly concessional loans) of around $30 billion per year[22] over five years, or $150 billion in total. That is still a number that I would endorse. Alas, nothing like that ever materialized.

Mikhail Gorbachev was in contact with Yavlinsky while the latter was at Harvard, hopeful that a grand bargain could indeed be assembled. Gorbachev actually traveled to the G7 Summit in Houston in search of aid.[23] He was famously rebuffed by the G7.[24] This denial of financial support would continue even after the fall of the Soviet Union. Gorbachev's failure to win backing from the G7 raised the ante in Moscow, and likely contributed to the timing of the attempted putsch[25] against Gorbachev in August 1991.

In October 1991 I received a call from Moscow, telling me that Yegor Gaidar[26] was likely to become the head of Yeltsin's economic team, and that Russia would launch radical market reforms with or without the rest of the Soviet Union. By this time, of course, the Soviet leadership had lost all power and initiative, and the break-up of the Soviet Union was increasingly expected. The Bush Administration, however, was still dealing almost exclusively with the Soviet Government, at least in the economic sphere. There was virtually no contact between Gaidar's emerging team and the rest of the world's officialdom.

I was asked by Gaidar to come to Moscow to help with the planning of economic reforms. This was now almost two years to the month following the launch of Poland's reforms, which were widely seen at that point to be working exceptionally well. I would be able to provide lessons and insights from the Polish experience, and maybe some pointers as well as to how to mobilize large-scale Western assistance, as I had been successful in doing in the case of Poland. I was eager to try to help.

From the beginning, my focus was on stabilization of the Russian economy, meaning the attempt to end high inflation, create a working currency, and end the devastating and intensifying shortages. During the entire period of my advising, I had only a tangential role in the plans for privatization of major industries. In late 1991 I briefed Anatoly Chubais, the incoming head of the State Property Commission, about alternative strategies for privatization. I believed that small shops should be privatized through auctions, with a bias towards the internal workforce. For small and medium enterprises, of which there were tens of thousands, I supported a voucher approach. For the largest enterprises, I supported delay for the time being, especially for the natural resource sectors, for which I saw no urgency at all in privatization. For the oil and gas sector, the core of the Russian hard currency earnings, it was critical for the Russian Government (and Russian society) to continue to reap the income stream from these resources, either by selling them eventually in world markets for tens of billions of dollars, or holding them in state hands, with the attendant direct fiscal resources. Andrei Shleifer, a colleague on the Harvard Faculty, and a Russian-American, became the key Western advisor on privatization, and he insisted on his own turf. I mostly stayed away, aside from a meeting every three months or so with Chubais to catch up on general reform issues. I was not invited to participate in any detailed strategizing on privatization, nor did I try.

Dismantling the Soviet-era system seemed to be a mission of great moral rightness. I certainly hoped, and rather expected, that Russia would feel a wave of elation at the new freedom. In this I was somewhat mistaken. The period of elation was remarkably short, and the period of political civility was even shorter.

I worked with Gaidar's team at a Dacha outside of Moscow for about one week, and agreed to return to Moscow for a briefing of President Yeltsin in the first half of December 1991. Two meetings with invited foreign economic advisors took place with the President, on December 11th and 13th. President Yeltsin was extremely coherent and engaged in these two meetings, asking detailed questions and taking extensive notes. I was asked by the group of external advisors to serve as the spokesman for the group, laying out our understanding of the reform tasks facing Russia. Until the start of the first meeting we still did not know the status of Russia vis-à-vis the Soviet Union. In a remarkable moment, President Yeltsin entered the room and began with the announcement that the Soviet Union was no more – specifically that in a meeting with the Soviet military leadership, he had reached agreement with them concerning the dissolution of the Soviet Union.

In the meetings with Yeltsin, I laid out the reform challenges as I understood them (and as per agreement with the broader external advisory group). The main themes[27] were:

- The transformation would be very difficult and would last for several years
- Russia should aim to become a "normal" market economy, based on private ownership
- The first and most urgent necessary actions were macroeconomic stabilization,[28] liberalization of markets, and the establishment of the legal infrastructure of open trade and private contractual relations
- Macroeconomic stabilization should begin with the elimination of price controls (as in Poland) to end the crippling shortages, backed by strong fiscal policies to maintain a low budget deficit, and by tight monetary policy, to prevent the one-time rise in prices from turning into a wage-price-money spiral
- Privatization would be important but would take a considerable amount of time
- Large-scale Western assistance would be needed, along the lines of the Polish experience. Rather than a $1 billion stabilization fund, Russia would need approximately a $5 billion stabilization fund. Rather than a few billion dollars of aid, Russia would need around $15 billion of assistance (grants and highly concessional loans) per year for many years. Russia would also need deep debt relief from the inherited Soviet-era debt. This financial assistance would provide a financial and social cushion for the Russian people, making possible the provision of large-scale social services to help support and sustain the reform process

This basic approach was summarized in an article[29] that I contributed to *The Economist* magazine in December 1991.

President Yeltsin received the two briefings with great interest and asked the group to continue to work with the Russian Government as economic advisors. We were given the ultimate measure of trust in those days: a permanent pass ("proposk") to the Council of Ministers building and a few offices inside for our permanent Moscow-based employees. I planned, as I had with Poland, to commute to Russia approximately once every six weeks, for a few days at a time.

The Period as Economic Advisor, December 1991 to January 1994

Prices were decontrolled on January 2, 1992. Gaidar rightly feared that with the collapse of central planning and the lack of incentives for delivery of food supplies from rural to urban areas, the cities might even be without food unless price controls were quickly lifted. There was not an option to stand still, to move gradually, because the political power and threat of sanctions that stood behind central planning was gone (and indeed had progressively broken down during several years). Either the economy would move to markets based on supply and demand, or it would face devastating shortages, with massive black markets and corruption as insiders "arbitraged" the differences of official and black market prices. With or without development aid, Gaidar rightly insisted, it was necessary to end pervasive price controls that could not be policed but could do considerable damage.

As in Poland, this price decontrol led to a large one-time jump in price levels because of repressed inflation. I had suggested to Gaidar some possible steps to moderate the effects of this one-time elimination of the overhang of money, but he felt that anything other than a simple straightforward elimination of price controls would be politically impossible. Goods began to return to the shops within days, and after a few weeks the surveys of goods availability carried out for the Government showed that extreme shortages were being eased. But the similarities between Russia and Poland ended at that point, both for me personally as an advisor, and in the course of the economy itself.

In Poland during 1989-91, I had worked closely with the team of Leszek Balcerowicz,[30] and found most of my suggestions were highly consistent with Balcerowicz's strategy and were usually adopted in one form or another. In Russia during 1991-93 this close and successful advisory relationship was not the case. The reformers in Russia could make little political or economic headway. Politics was highly conflictive. As a result, even when I had the ear of a reform-minded official, few of my suggestions were ever adopted.[31]

There were several reasons why Russia's reform trajectory was so much harder than Poland's. In Russia, the political scene was vastly more complicated than in Poland, the existing bureaucracy much more deeply entrenched and hostile to reform, the cabinet politics vastly more byzantine, and understanding of market economics among the political elites an order of magnitude lower. Poland had a national consensus based on the "Return to Europe." Russia, by contrast, experienced a deep and continuing struggle for power, with no ideological or practical consensus on almost any matter, even the basic idea of transformation to a market economy. The three main areas where my advice went unheeded were the following: (1) the need for large-scale financial assistance[32] for Russia, which I deemed (and still deem) to have been essential to molding a political consensus around reforms, and to bolstering the financial situation enough to achieve a modicum of success in the fight against hyperinflation; (2) the need for strong monetary and fiscal policy to achieve a rapid end to inflation[33]; and (3) the urgency of establishing a social safety net[34], especially in health care and pensions, to ensure an adequate social and political base for societal transformation and democratization.

The fate of Western assistance was grim and was my greatest frustration[35] during late 1991 and 1992. The early days were inauspicious to say the least. When the G-7 deputies came to Moscow in late November 1991, just a few days after Gaidar had come to power as head of Yeltsin's economic team, the main focus of the G-7 message was the urgency that the Soviet Union should continue to service the external debts at any cost. There was no discussion of the upcoming economic reforms, and no realism among the G-7 deputies about the extreme desperation of the economic scene. Gaidar was warned by the assembled powers that day that any suspension of debt payments would result in the immediate suspension of urgent food aid, and that ships nearly arrived at the Black Sea ports would turn around. Russia in fact continued to service the debts for a few more weeks before completely running out of cash by February 1992.

In December 1991 I had continuing discussions with the IMF about Western assistance for Russia. The IMF's point man, Mr. John Odling Smee, who lasted for a decade as the head of the IMF's efforts, was busy telling the G-7 that Russia needed no aid, that the "balance of payments gap" as calculated by the IMF was essentially zero. I believe that the IMF was simply parroting the political decisions already decided by the United States, rather than making an independent assessment. This is just a conjecture, but I make it because of the very low quality of IMF analysis and deliberations. They seemed to be driving towards conclusions irrespective of the evidence. The IMF's approach was in any event just what the rich countries wanted to hear. The technical methodology was primitive beyond belief.

To summarize a long saga succinctly, Russia never received much in grant aid, stabilization support,[36] or debt relief. What little did come was far too late to save the collapsing initial momentum of reforms, as most of the reformers were long gone from the scene or at least from the center of power. A very senior U.S. official, Lawrence Eagleburger, told me bluntly in the spring of 1992: "Jeffrey, you must understand. Assume for the sake of argument that I agree with you. It doesn't matter. Do you know what this year is? It's an election year. There will be no large-scale financial support."

While I continued as an advisor to the Russian Government during 1992 and 1993, it is fair to say little of my advice was taken during that two-year period. This was nothing personal. After the first days of 1992, following the initial freeing of prices on January 2, the reform process was mostly paralyzed by a bitter struggle for power between the Duma and the President. Gaidar made little headway. Ruslan Khasbalatov, the unstable head of the Duma in early 1992, called for the Government to step down just a week after the start of reforms. To the extent that outsiders had any influence at all, that influence was wielded by the IMF. I would meet with Gaidar every several weeks, for an hour or two, but mostly this was to commiserate with Gaidar's waning influence, or to reiterate the growing list of urgent but stalled reforms, or to review the state of negotiations over Western assistance, or to try to plan stratagems for overcoming resistance from the Duma and the Russian Central Bank. Almost all such attempts to break the deadlock failed. By April, Gaidar had lost control over the economic team (symbolized by Yeltsin's abrupt firing of the Energy Minister, Vladimir Lopukhin), and by June he had lost control of the Russian Central Bank, with the return to power of the disastrous Viktor Geraschenko, whose inflationary policies killed the chances for early stabilization.. By December, Gaidar lost his job entirely, replaced as Prime Minister by Viktor Chernomyrdin.[37]

The IMF advisory process was dangerously narrow and misconceived.[38] Not only did the IMF technical staff, led by John Odling-Smee, argue against the requisite Western assistance to support stabilization, but the IMF played a disastrous role by pressing Russia to maintain a common currency[39] among the successor states of the former Soviet Union. As long as the 15 new countries, each with its own central bank, continued to use the Soviet ruble as currency, each central bank had the incentive to issue ruble credits, thereby enjoying seignorage gains (the benefits of money issue) while imposing inflation on all the others. This point obviously suggested the urgent need to adopt national currencies. For inexplicable reasons, the IMF championed the continuation of the Soviet ruble zone, rather than a system of 15 national currencies with flexible exchange rates between them. I argued strenuously[40] with the IMF over this point, and as always, lost the argument. The IMF contributed to more than a one-year delay in the introduction of national currencies, and thereby to a significant delay in achieving stabilization[41]. The IMF staffing was incredibly thin in 1992, with (as far as I know) not a single resident advisor, yet because of their influence over Western aid, this team remained highly influential.

The other great macroeconomics debate[42] in the second half of 1992 was with the Central Bank. Mr. Viktor Gerashchenko, former Chairman of Gosbank (Central Bank) in the Soviet days, somehow returned to power as the new Chairman of the Russian Central Bank. Gerashchenko's return was basically mandated by the Duma, which controlled the appointment under the Constitution. I doubted Gerashchenko's ability to manage the Bank from the very first meeting I had with him. He declared, unbelievably, that the Russian problem was too little money growth, not too much money growth, and that he planned deliberately to increase the money supply by around 30 percent per month in order to get the factories moving again. This, he assured me, would increase the output supply, put more goods on the markets, and thereby reduce prices (!). I strenuously disagreed with him, but to no avail. To this day, I do not know whether this policy was the result of massive corruption (channeling resources to cronies), macroeconomic ignorance, or a combination of the two.

I somewhat famously referred[43] to Mr. Gerashchenko as "the world's worst Central Bank governor" at the time. What he accomplished was to fuel a high inflation[44], and to bring Russia to the brink of outright hyperinflation. As usual, the reformers, myself included, received all the blame for this wrong-headed policy. The critics claimed that the high inflation resulted from the fact that we had unleashed uncontrollable monopoly power on society. In fact, it resulted from the failings of monetary policy.

Throughout 1992 I warned everybody that I could that the reform process was dangerously blocked, that the IMF was making one mistake after another, and that Western assistance was vital.[45] I worked with the U.S. Ambassador, Robert Strauss, in trying to mobilize greater conditional assistance, but the efforts were in vain. I did not meet again with Yeltsin all during 1992, except at a couple of social events (including a soccer game played by the Government senior officials!), so that almost all my advising went through then-Acting Prime Minister Gaidar. Yeltsin seemed to have no detailed interest in the economic issues. When Gaidar lost his position in December 1992, I also planned to leave immediately my own role as advisor. I had learned sadly during 1992 that I could contribute little or nothing to turn the tide against hyperinflation, lack of Western interest, and the growing mismanagement of microeconomic issues (such as trade restrictions which were promoted by highly corrupt vested interests in the natural resource sectors).

My brief stint as advisor would have lasted twelve months in total but for a phone call that I received while on Christmas vacation at the end of 1992. Boris Federov, a very tough-minded reformer from Yavlinsky days, had suddenly been appointed Finance Minister in the new Chernomyrdin Government. Federov called me to ask for my support. This was a ray of light in an otherwise dark panorama.

I agreed to meet with Federov in Washington in the first days of January 1993. When we met, he declared his intention to fight the Russian Central Bank with all vigor, and to insist on a rational macroeconomic policy within the cabinet. He asked me to stay on as an advisor to him, and indeed to open an analytical center in the Ministry of Finance that became known as the Macroeconomics and Finance Unit (MFU), which I co-directed with my friend and colleague Anders Aslund. I also harbored hopes that the incoming Clinton Administration would be different from the outgoing Bush Administration with regard to assistance and to formulating a broad policy of Western engagement.

My hopes were soon dashed. The year 1993 was even more dreadful than 1992. When the incoming Clinton Administration declared "It's the Economy, Stupid," they meant it. Foreign policy issues were remarkably low on the radar screen. There was absolutely no interest in a significant assistance plan for Russia, nor did key officials on Russian policy have any knowledge of economics. At that point the Treasury Secretary was Lloyd Bentsen, and neither he nor his deputy Roger Altman had any interest or knowledge of this issue. Larry Summers, who might have, was just getting started as an Undersecretary of Treasury. Key foreign policy campaign advisor Michael Mandelbaum refused to join the Administration in part because he realized that Clinton indeed would not support a major Western assistance effort to Russia.

I traveled to Moscow about a half-dozen times during 1993 to meet with Federov and to lead the MFU. I tried, and failed, to get the World Bank to focus on the growing social crisis, especially health. It was quite obvious that there was a critical shortage of drugs, medical equipment, and other basic health needs, and that this would spill over into a public health crisis. Indeed, various epidemics (diphtheria, multi-drug resistant TB) broke out, without any Western attention or help. The World Bank did not deliver a loan to relieve the growing crisis. I met with the head of the "health mission," but discovered that the World Bank planned to take its time to get help to Russia, since there was apparently a need for the Bank to study the situation for some years first. In the meantime, the MFU staff of young Russian and Western economists continued to churn out detailed and highly competent analyses of Russian inflation, monetary and budget policy, and structural issues relating especially to international trade, but to little avail. Federov's hold on power and influence in the Chernomyrdin Government was tenuous. Federov very rarely saw or spoke with Yeltsin, who was even further removed from economic policy, and I had no chance during the entire year to speak directly with President Yeltsin. All my advice in 1993 went through the Finance Minister.

With regard to privatization, I had almost no engagement in its implementation in 1993, which involved the auctions of small retail outlets, and the initiation of the voucher approach. I weighed in just one time in 1993, in a meeting at the Duma, to argue against giving an excessive proportion of power and shares to the entrenched management of the medium-sized enterprises. I agreed with the idea of giving some shares to the management, to create an interest among them in the process, but I insisted in the discussion that the share to the management team should be below five percent, since anything larger would be grossly unfair and politically and socially unwise. In the end, of course, the privatization process was rather grotesquely tilted towards the interests of the managers, something that I believe to have been a huge mistake.

Russia came to blows in October 1993, when the Duma leaders led an attempted putsch against President Yeltsin. War raged in the streets. Power struggle and political turmoil utterly consumed the scene until the end of the year. In the December 1993 elections, the reformers did badly. Chernomyrdin strengthened his hold on power. I resolved immediately to resign from any advisory role at that point, had no further inputs at all, and announced my resignation[46] publicly in January 1994 together with Anders Aslund. I stated at the time that I viewed the Russian prospects with great fear and that I deeply bemoaned the lost opportunities of the preceding two years.

In fact, it is correct to say that my role had really come to an end as early as the start of 1992, after the ideas from Poland's successful reform program had helped to launch the Russian reforms. I had accomplished little since then. My disdain for the IMF had grown by the day. My worries about Russian corruption were growing steadily. The loss of initiative and power of the early reformers was obvious. I helped to train dozens of young Russian economists, and I am very proud of that. I also helped to inject some sensible ideas into the Russian discussion (e.g. the role of monetary expansion in Russia's inflation) but to little practical avail. It was surely time to leave the scene, especially since every bad event was blamed on reform, not on the absence of reform.

After I resigned from being a government advisor in January 1994, I did not burn all bridges with Russia. I suggested to the Ford Foundation in 1994 to help set up an independent, non-governmental research institute in Moscow, which became the Institute for Economic Analysis (IEA). For a year I served as Chairman of the Board of the new center. Both the Ford Foundation and I left our support of the center in 1995, after policy disagreements with the Russian management. The Center continued its operation. I was in Russia about four or five times during 1994 and early 1995, and did not participate at all in policy advising with senior Government officials.

During my final trip to Moscow in early 1995, the infamous "loans-for-shares" deal was just getting underway. This deal involved a massive and corrupt transfer of natural resource enterprises to the Government's cronies, disguised as a collateralized loan to the Russian Government by Russian banks. The arrangements were blatantly corrupt from the start. I spent my final visit in Moscow visiting Western officials to warn them about what was happening. I felt that my antennae were pretty sound at that point, and that my perspective would be helpful to head off a disaster. I was stunned by the obtuseness of the response, from the IMF, an OECD visiting mission, and later from very senior U.S. officials, including Larry Summers. Nobody wanted to look closely at the abuses, and certainly nobody wanted to blow the whistle. I believe today that the hyper-corruption surrounding the massive giveaways of the oil and gas sectors were linked to the campaign financing for President Yeltsin's re-election. Tens of billions of dollars of natural resource assets were given away, and hundreds of millions were collected in return as campaign contributions. It was a pretty lousy and inefficient way to finance an election campaign, but this linkage perhaps (who knows?) explains the remarkable reticence of the U.S. Government and the IMF in responding to this flagrant corruption – a level of corruption that easily outpaces anything seen in other parts of the world in recent years. It is notable that this transfer of oil and gas assets took off in 1994 and especially 1995, after Gaidar and Federov had been removed from power.

From 1995 onward, I wrote and spoke extensively about the growing corruption, and even ran a lecture series about it at the Harvard Russian Research Center, subsequently published as The Rule of Law and

Russia's Economic Reforms[47] (Westview Press). I never once recommended the privatization of the oil and the gas sector by vouchers, or giveaways, or loans-for-shares deals, and to this day regard these actions as abominable missteps.

Reflections on the Meaning of "Shock Therapy"

Ever since my work in Poland I have been described as a practitioner of "shock therapy." I've explained repeatedly that a two-word phrase cannot and should not summarize the rich details and historical specificity of economic reform measures and distracts attention from the major differences of reform policies across countries.

The term shock therapy is misleading because it has been used to convey two extremely different meanings. In one meaning, shock therapy refers to the rapid end of price controls in order to re-establish supply-demand equilibrium in a context of pervasive rationing and blocked trade. One important element of such a rapid liberalization may be the trade in foreign exchange, to allow for free convertibility of the currency for purposes of international trade in goods and services. In its second meaning, shock therapy refers to the dismantling of all government intervention in the economy in order to establish a "free-market" economy. This second variant of shock therapy is also sometimes called "neoliberalism."

I have occasionally been an advocate of the first kind of shock therapy (notably in Bolivia, Poland, Russia, and some other post-Communist transition economies), always in the context of specific conditions of mass rationing and high inflation. I never have been an advocate of shock therapy in its second, neoliberal context. I regard a pure "free-market" economy as a textbook fiction, not a practical or desirable reality.

Consider, for example, shock therapy in Poland. My idea, and much more importantly, the idea of the Polish leadership and people, was "the return to Europe." Poland's goal was never to create a free-market economy, since such a free-market economy does not exist in Europe. Poland's goal was to become a normal country in Europe. This can be verified, many times over, by reading my early lectures on Poland's reforms, *Poland's Jump to the Market Economy* (MIT Press, 1993). I put it this way:

> Poland's goal is to be like the states of the European Community. Although there are many submodels within Western Europe, with distinct versions of the modern welfare state, the Western European economies share a common core of capitalist institutions. It is that common core that should be the aim of the Eastern European reforms. The finer points of choosing between different submodels – the Scandinavian social welfare state, Thatcherism, the German social market – can be put off until later, once the core institutions are firmly in place.

What then was the essence of shock therapy as I actually practiced it, not as critics have interpreted my advice after the fact? The key initial steps to ending a hyperinflation and mass shortages have been: (1) an end to most price controls; (2) a quick convertibility of the currency for current-account transactions; (3) an end of the budget deficit; (4) stability of the newly convertible currency, backed by a stabilization fund if possible; and (5) bolstering of the social safety net, through compensatory transfers, and often through a standstill on external debt servicing. These steps were designed to end shortages, create market price signals, end high inflation, and provide social protection, and they accomplished that task. They were not designed to create a pure free-market economy.

Financial Aspects of My Involvement with Russia

I have always regarded it as both prudent and ethical to carry out my country advisory activities as part of my University activities, rather than as a privately paid consultant. I did not earn a penny as advisor to Russia, directly or indirectly. Claims that I "got rich" on Russia are outlandish, false, and defamatory. I follow two strictures in all of my activities:

1. Never invest or undertake any business dealings at all in a country in which I have an advisory responsibility, so that there is absolutely no conflict of interest;

2. Never accept compensation other than my academic salary.

My early work in Poland was supported by the Open Society Institute, which covered travel costs and staff, and I received no salary.

During 1990-92 my work in Central Europe and the former Soviet Union was supported by the United Nations University, Helsinki. I was on academic leave and the UNU supported my academic time.

During 1992-93, my advisory team in Russia was supported by[48] the Ford Foundation, the Swedish Government, and briefly by USAID (for two summer months of academic salary). During this entire time, I earned my academic salary and no more.

The Shleifer Debacle

In mid-1995 I became Director of the Harvard Institute for International Development (HIID). The HIID was a Harvard program to support advisory work and field research in developing and transition economies. HIID operated as a collegial enterprise, in which Harvard faculty in addition to HIID permanent staff, could initiate projects and manage contracts through the institute. When I became Director, there were about 60 projects around the world, including the ongoing privatization project in Russia, managed and directed by Professor Andrei Shleifer. I was not involved in the project. The normal HIID administrative apparatus – financial office, contracts office, human resource office, auditors, and central administration – oversaw the project as usual. Various HIID officials visited the project to check on management, organization, and finances.

As it turned out, Prof. Shleifer was investing in Russian securities while leading the project, in violation[49] of HIID and US Government conflict-of-interest rules. He kept this secret from HIID management, including from me, as well as from USAID. During 1996, the U.S. Government Accountability Office audited the project, given its large scale, and did not turn up any information that led me or any other senior management at Harvard to suspect any inappropriate behavior by Prof. Shleifer. When the behavior ultimately came to USAID's knowledge, and I was notified about it, I moved immediately to remove Shleifer from the project. After a lengthy investigation, Harvard and Shleifer ended up paying hefty fines as the result of Shleifer's misbehavior.

Conclusion

My brief role in Russia has often been enlarged in the media to mythic, indeed horrific, proportions, and to this day I am sometimes blamed for every ill that befell Russia. Compared with that, a more accurate rendering of my actual role is found in Yegor Gaidar's memoir, *Days of Defeat and Victory*, in which my name does not appear once, not even in a footnote! I believe that my role was bigger than nothing, but hardly of the magnitude or scale for which I am often castigated. My main role came at the start: the idea of how to shift from Soviet-style central planning to a market economy, guided by the successful case next door in Poland. It was indeed Poland's success that led to my brief engagement in Russia. As an actual advisor, however, during two tumultuous years, 1992 and 1993, I had a front-row seat to an extraordinary revolution, but I had very little influence if any. My specific ideas were adopted neither by the West nor by Russia. Much time was lost. Much that could have been accomplished quickly in stabilization, social support, and the start of a new Russian economy was sadly postponed for many years.

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