
MIKHAÏL
GORBATCHEV
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A quarter of a century after the transition to a capitalist economy began, how are the nations of the former Soviet bloc faring? **Peter Boone** charts the failures of communism, the chaos that followed its collapse, the period of liberalisation and growth – and today's unhealthy combination of economic stagnation and political repression.

After communism: 25 years of revolution

The decline of the Soviet empire caused a revolution far beyond the scale of any previous in history. More than 400 million people were affected as the 11 nations of the Soviet bloc quickly became 25 nations. Across most of these nations, banks and industry collapsed in economic depressions while inflation wiped out people's savings and pensions.

By way of comparison, China's communist revolution of 1949 affected 700 million people, but these were largely subsistence farmers in a nation where agriculture and finance was primitive. And the French revolution was comparatively tiny: only 28 million people lived in France in 1789, and most of them were farmers and labourers who were largely unaffected by the urban battles.

The failures of communism

After the Russian revolution of 1917, one of the Bolsheviks' first steps was to raid the banks. Lenin expected to find them full of riches, but instead the cupboards were bare when the soldiers marched in (Mcmeekin, 2009). Over the succeeding decades, the Soviets confiscated all private property and built a system reliant on state ownership of nearly everything.

The failures of this system are well understood. Without the incentives inherent in private ownership, the Soviet bloc failed to keep pace with innovation and growth elsewhere in the world. After several decades of large-scale investment and 'catching up', the communist economies languished and fell behind their western competitors. From the early 1970s, growth slowed and labour productivity lagged. Rising oil prices, and large discoveries of oil in western Siberia, provided a temporary economic boost, but with the post-1980 oil price crash, the respite was over and the Soviet empire faced renewed difficulties.

Yet when the Soviet empire did eventually fall, it caught most people by surprise. As with earthquakes and volcanoes, the timing of revolutionary change is far easier understood after the fact. But economic theory and experience does suggest some warning signs. For example, the Soviets began borrowing heavily in external markets to finance spending at home. And in 1986, President Gorbachev embarked on an anti-alcohol campaign, which caused a sharp drop in tax revenues.

By the late 1980s, the government was resorting to the errors made by many nations over history: it issued unbacked paper money to finance

> The decline of the Soviet empire has been remarkably peaceful and the economic outcomes generally successful

deficits, and that in turn caused the rouble to lose value and trust in money to dissolve. People began hoarding goods, trying to get rid of rouble cash before it lost value. Shops emptied of official goods at fixed prices, and the system of state controls was debased from within.

Government officials did attempt to raise prices and cut spending, but these measures were met with protests. The Communist Party quickly lost credibility and power. As Keynes once wrote, 'There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency'.

Post-Soviet chaos

As the Soviet empire dissolved, the disintegration of communist controls was rapid and complete. Looting and pillage is common during revolutions precisely because the existing systems of police authority and legal enforcement break down.

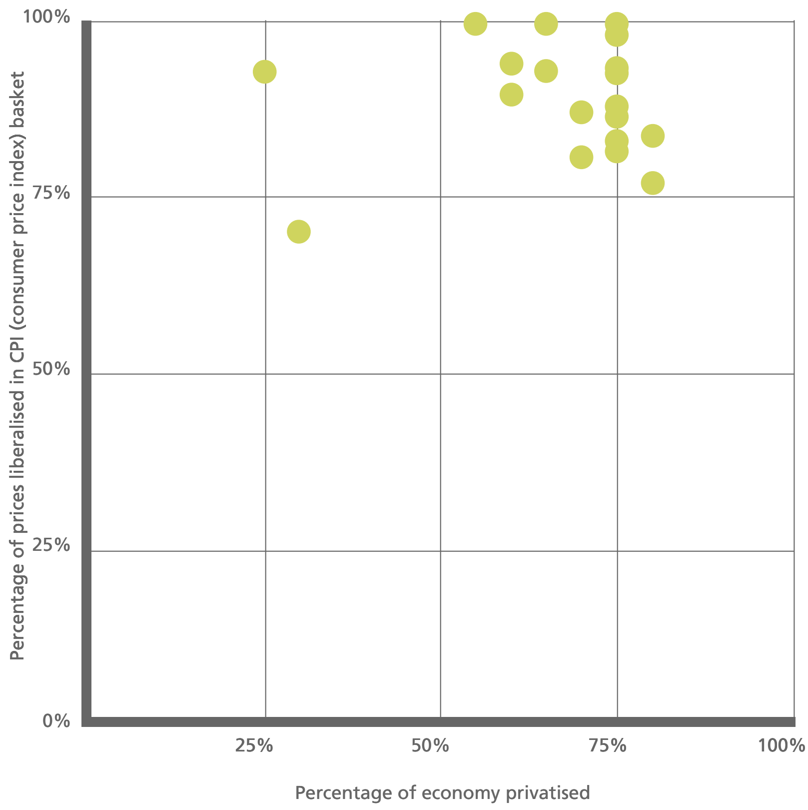
The assets up for grabs were enormous. Russia's oil and gas industry alone is worth several trillion dollars. Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan all have rich mineral and energy assets. Every nation had developed banks and large-scale industry. The regional central banks, located in the capitals of each new nation as well as major districts, started printing money with little control from Moscow.

As the Communist Party dissolved and no alternative 'supervisor' came to take its place, an enormous 'free for all' was launched, permitting the most aggressive groups to grab these trillions of dollars in assets and cash flows. In the early 1990s, it was very common to read about private militia surrounding valuable enterprises or assets, so that they could physically take control.

This chaos did not come about by chance. The late Boris Fedorov, one of Russia's leading economists and finance minister in the early 1990s, argued that chaos and lack of transparency served the purposes of many in power who were, whether inside or outside government, attempting to grab assets. It was far easier to rig privatisations or simply steal assets when the laws were unclear and enforcement was impossible (Boone and Fedorov, 1997).

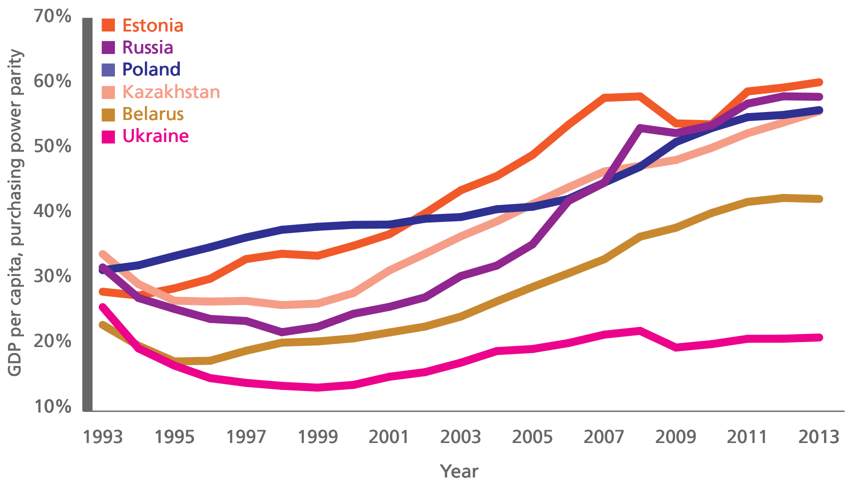
Fedorov's insight was often missed

Figure 1:
Privatisation and price liberalisation in nations of the former Soviet empire



As the Soviet empire collapsed, the assets up for grabs were enormous

Figure 2:
Per capita GDP in the former Soviet bloc as a percentage of high income OECD countries



abroad. Economists and journalists supposed that politicians had enough control that they could choose the pace and extent of reforms. Many suggested that Russia should turn back the clock, and slow down its pace of reforms to match China. But sitting in the capital city, no well-intentioned politician could manage the enormous anarchic forces that were tearing apart the old communist controls.

Most nations did manage to pass privatisation laws during these periods. The hope was that by specifying property rights clearly, the owners of the new assets could manage them more efficiently or sell them on to the highest bidders who could best manage them. Such laws did guide some asset transfers, but the underlying battle over resources was still brutal. The legacy of this opaque period still hangs over attitudes towards privatisation – and the 'oligarchs' who emerged – across the region.

The period of chaos ended within a decade. In most of Eastern Europe and the Baltic states, where nations hoped to join Europe, this experience was shorter or mostly avoided. In Russia, most of the assets had been grabbed by 1999, and there was growing awareness among the winners that they were better off with rule of law, and a system where they had incentives to build and invest their winnings, rather than attempt to grab more. President Putin came to power at this decisive moment.

Economic reform and growth

As Figure 1 illustrates, today the nations of the former Soviet empire have liberalised prices, privatised most of industry and created the essence of liberal market economies.

Some great companies have emerged from this battle. Metinvest (Ukraine), Severstal, Sibneft, TNK, Yukos and many others have emerged as world leaders in their areas. Ruthless corporate leadership focusing on efficiency and growth, partly explained by their emergence from that tough world of the 1990s, makes them appear far more capitalist than comparable firms in the West. There has also been rapid growth of private banks and small and medium-sized enterprises, filling in all the voids of services and consumer items that the communist system never satisfied.

The expectations for this new capitalist system have been borne out to a certain extent. Once the new pattern of asset ownership was staked out, participants turned to 'growing their assets' rather than fighting over ownership. This led to a productivity boom and a period of catch-up, so that most of the former Soviet bloc nations closed their productivity gaps with advanced nations.

As Figure 2 shows, over the last 20 years, productivity levels have generally risen rapidly, bringing national income levels from around 20% of advanced nations' incomes in 1994, to near 60% of western levels by 2013. These rapid productivity gains, along with the birth of many impressively managed firms, have put an end to early concerns that 'Homo Sovieticus' might simply not respond to the incentives provided by a capitalist system. The broad failures of

The broad failures of the Soviet system, which led to its collapse, have largely been resolved

The problem today is entrenched regimes suppressing democracy and hindering economic catch-up with the West

the Soviet system that were the first impetus for its collapse have now been, largely and rapidly, resolved.

Stagnation and repression

But for many nations, we are surely not at the end of this revolution. The period of productivity booms appears to have prematurely ended after 2008. In its latest *Transition Report*, the European Bank for Reconstruction and Development uses recent growth trends, as well as fundamental factors, to draw the pessimistic conclusion that many of the nations of the former Soviet empire are on course to stagnate near current relative income levels (EBRD, 2013). The desire to catch up with the West, a precursor for the collapse of the Soviet system, appears, as in communist times, to be stymied. Why?

For nations seeking to join Europe, the answer is fairly simple. Ageing populations and low savings rates mean that there is too little investment to generate rapid growth. These nations will benefit from foreign investment, but it may take many decades to close the income gaps.

The real troubles lie in nations where there is no outside force, such as the European Union (EU), guiding them towards better institutions. In Russia, for example, growth has slowed sharply in recent years, and following substantial falls in the oil price and the value of the rouble, forecasts for 2015 suggest that GDP will decline, perhaps considerably.

Russia's problems appear rooted in its ageing political regime. The team surrounding President Putin has evolved to give priority to members of the Soviet security apparatus. Their stated desire to build a strong state through renationalising and combining 'national champions' in the energy sector bears the hallmarks of pure power mongering. Some of the best-managed private oil companies, such as Sibneft, TNK and Yukos, have been confiscated or repurchased by the state. Hopes that Gazprom, a large and poorly managed firm, would be broken up and privatised have been dashed. And the banking system has become, to some extent, a cash cow for officials' benefit.

Similar problems of poor institutions plague resource-rich nations in central Asia. The new political model in Azerbaijan, Belarus, Kazakhstan, Russia, Turkmenistan and Uzbekistan is simple: leaders closely guard the commodity-rich enterprises for revenues, and they use the former communist security apparatus to suppress opposition.

Economic research suggests that nations with large commodity endowments tend to be less democratic, in part because leaders can avoid the broad consensus needed to raise revenues through wide-reaching taxes (Tornell and Lane, 1998). The power obtained through resource revenues, along with control of related companies and news media, are enough tools to keep the same elite in power for decades.

Less democratic nations tend to have weak rule of law and poor regulatory and investment climates. This may reflect the fact that under such a system, a narrow elite can manage policies and economic institutions to reap benefits for themselves at the expense of the nation as a whole. Such environments reduce incentives to build businesses and invest. Russia's current outcomes appear to fit that prediction well, and much of Central Asia likewise.

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Prospects for change in Belarus, Russia and Ukraine

Ukraine and Belarus stand out in a different manner. As Figure 2 illustrates, these nations have had the least success in catching up. Here too the underlying problems appear political, although not driven by a large resource base. Ukraine's pivotal position between Europe and Russia has endowed it with the power to win financing from these competing interests. Its government has swung regularly between 'pro-Russian' and 'pro-EU' stances. The Ukrainian elites have proved adept at auctioning their alliances for financial handouts. President Lukashenko in Belarus has built a strong police state, replacing communist controls with a self-described capitalist dictatorship.

But it is hard to imagine that these nations, where the revolutions are now failing to permit catch-up, will simply stagnate without more turbulence. The recent Maidan square protests and civil war in Ukraine's east suggest how major regime change can occur. Opinion polls show an overwhelming majority of Ukrainians would like to join the EU, including a majority of the Russian-speaking minorities in the east. In essence, most Ukrainians are telling their leadership: 'Our revolution is not over yet, we want to catch up with the West'. President Lukashenko should pay attention.

Change in Russia is more daunting. Large street protests, unheard of since the 1990s, have occurred in Moscow recently following unfair elections and policies towards Ukraine. Yet Putin's inner circle seems highly unlikely to give up control without a violent fight. In most of the former Soviet Union, those losing power fear punishment from those who come next. The lack of safe exits for existing leaderships remains a major stumbling block for regime change without violence.

A surprisingly peaceful transition

Perhaps the most puzzling aspect of these 25 years of revolution is precisely this lack of violence. Despite the enormous wealth transfers and a large power vacuum at all levels of society, there have been few deaths and no violent military-led coups or expansive civil wars (with the exception of former Yugoslavia).

Perhaps the reason for this is that there were easier non-violent means for the 'aggressors' to get what they wanted. Lenin was faced with a strong military opposition to his revolution, so he was forced to fight a civil war. But when the Soviet empire collapsed, the vast majority of the population was pleased to see the Communist Party defeated.

Across these nations, the security apparatus and military fragmented, as the more aggressive individuals within them struck out to stake out claims on assets. In that environment, there were no concentrated foes that could start battles. Today that has changed: the former security apparatus has consolidated again, and once more become an important tool of maintaining power for a narrow elite.

But history tells us that revolutions are often followed by major or minor counter-revolutions before lives become normalised. The French revolution was largely a fiasco for early French democracy and European peace: after 10 violent years, a military dictatorship under Napoleon took power. The Chinese revolution was followed by a large-scale famine and the renewed disaster of the cultural revolution of the 1960s.

Compared with these events, the decline of the Soviet empire has been remarkably peaceful and the economic outcomes have been generally successful. But we are now embarking on a new phase, where entrenched regimes are again suppressing democracy and their policies are hindering economic catch-up. These regimes may be more prepared to fight to maintain power than were the former communists.

When Zhou Enlai, the former Chinese premier, was asked for his views on the impact of the French revolution, he is said to have responded 'it is too early to say' (though he may have thought the question was referring to the 1968 student demonstrations rather than 1789). The final outcomes in the aftermath of the fall of the Berlin Wall are similarly 'too early to say'.

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He served as a resident technical adviser to the finance ministry in Poland in 1990-91 and the Central Bank of Mongolia during 1991. Between 1991 and 1993, he worked in Russia as an adviser to the plenipotentiary for negotiations with the IMF and the World Bank, as well as an adviser to the Russian finance ministry. And from 1997 to 2003, he was managing director of research at Brunswick UBS, a Moscow-based investment bank.

Further reading

Peter Boone and Boris Fedorov (1997) 'The Ups and Downs of Russian Economic Reforms', Chapter 6 in *Economies in Transition: Comparing Asia and Eastern Europe* edited by Wing Thye Woo, Steven Parker and Jeffrey Sachs.

EBRD, European Bank for Reconstruction and Development (2013) *Transition Report 2013*.

Sean Mcmeekin (2009) *History's Greatest Heist: The Looting of Russia by the Bolsheviks*, Yale University Press.

Aaron Tornell and Philip Lane (1998) 'Are Windfalls a Curse? A Non-representative Agent Model of the Current Account and Fiscal Policy', *Journal of International Economics* 44(1): 83-112.

The most puzzling aspect of 25 years of post-communist revolution is the relative lack of violence