

# Four Possible Directions for Economic Reform in Russia: Will They Constrain the Military?

Lauren Van Metre

**50** Years  
**CNA** 1992

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## MEMORANDUM FOR DISTRIBUTION

Subj: CNA Research Memorandum 92-177

Encl: (1) CNA Research Memorandum 92-177, *Four Possible Directions for Economic Reform in Russia: Will They Constrain the Military?*, by Lauren Van Metre, November 1992

1. Enclosure (1) is forwarded as a matter of possible interest.
2. This research memorandum is one element of a comprehensive examination by CNA of the evolving Russian Navy for the Office of Naval Intelligence. It outlines four possible directions for the reform of the Russian economy—Western-led reform (patterned after an approach to reform prescribed by the International Monetary Fund), Russian-led reform, industry-led reform, and a return to a state-run economy (retrenchment). The paper measures how the military and the defense industries will be affected—in the short- and the long-term—by these courses of reform. Finally, the paper outlines the most likely course for the future of the Russian Navy.
3. The overall Russian Navy Project is directed by Floyd D. Kennedy, Jr., and falls under CNA's Regional Studies Program, directed by Jerome H. Kahan.

A handwritten signature in dark ink, appearing to read 'R. Pirie Jr.', with a checkmark-like flourish at the end.

Robert B. Pirie, Jr.  
Vice President  
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*Strategy and Forces Division*

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## **ABSTRACT**

This research memorandum outlines four possible directions for the reform of the Russian economy—Western-led reform (patterned after an approach to reform prescribed by the International Monetary Fund), Russian-led reform, industry-led reform, and a return to a state-run economy (retrenchment). The paper measures how the military and the defense industries will be affected—in the short- and the long-term—by these courses of reform. Finally, the paper outlines the most likely course for the future of the Russian Navy.

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## INTRODUCTION

### BACKGROUND

In April 1991, the Director of Naval Intelligence requested that CNA undertake a formal study that would define the character of the future Soviet or Russian Navy. In July 1991, we launched the Future Russian Navy project. The study approach employs two phases: the first phase examines current and near-term constraints on the existing Commonwealth of Independent States (CIS, nee Soviet) naval forces as well as potential future foreign policy, economic, and security interests of the Russian state that would support a requirement for naval forces. The findings of phase one inform the analysis of phase two, which evaluates competing interests and constraints and derives a range of possible Russian naval postures and their likelihood.

Just as there exist competing views in Russia on the utility and affordability of naval forces, this study approach allows competing constraints and interests to be explored fully before the range of possible naval forces is derived. Separate CNA research memoranda, therefore, represent separate elements of the overall interactive process to determine the posture of the future Russian Navy. Those elements include historical traditions, precedents and interests, future foreign policy options and interests, residual and future military security interests, future economic interests, economic constraints, and political-sociological constraints. No single research memorandum constitutes the definitive determinant of future Russian naval posture; instead, each research memorandum acts as an input to the final evaluation.

As seen in the historical study of the Russian Navy, "the will of the autocrat" has had the most effect on the Russian Navy.<sup>1</sup> Generally, those in power determined the nature of the threat and whether it justified the construction of a significant naval fleet. In fact, political-economic constraints were not even a factor. That is, the autocratic leadership rarely had to consider the opinion of the citizenry when identifying national spending priorities. What the leadership determined was important was funded. Constraints were only felt when finances ran low, but higher taxes generally resolved the problem.

Today, however, Russia's political-economic constraints (as well as financial) are a key determinant of the future of its Navy. Democracy has forced the government to make budgetary choices based on "the will of the people." Thus, the primary difference between budgetary choices made under autocratic and democratic systems is that the former faced only *financial* constraints, while the latter must confront both *political* and *financial* constraints. This difference is why a study of the economic situation in democratic Russia is more relevant today than it ever was. The military must now compete for resources in a highly constrained economy. Unfortunately, the future policies of a democratic government are difficult to predict, particularly in Russia, where the populace and leadership are in the middle of a debate over the nation's identity. Thus, it is important to

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1. *Russia's Navy From Peter to Stalin: Themes, Trends, and Debates*, by Paul Olkhovsky, CNA Research Memorandum 92-40, June, 1992.

understand Russia's economic future and its impact on the military, but it is difficult to do so given the uncertainty about Russia's future.

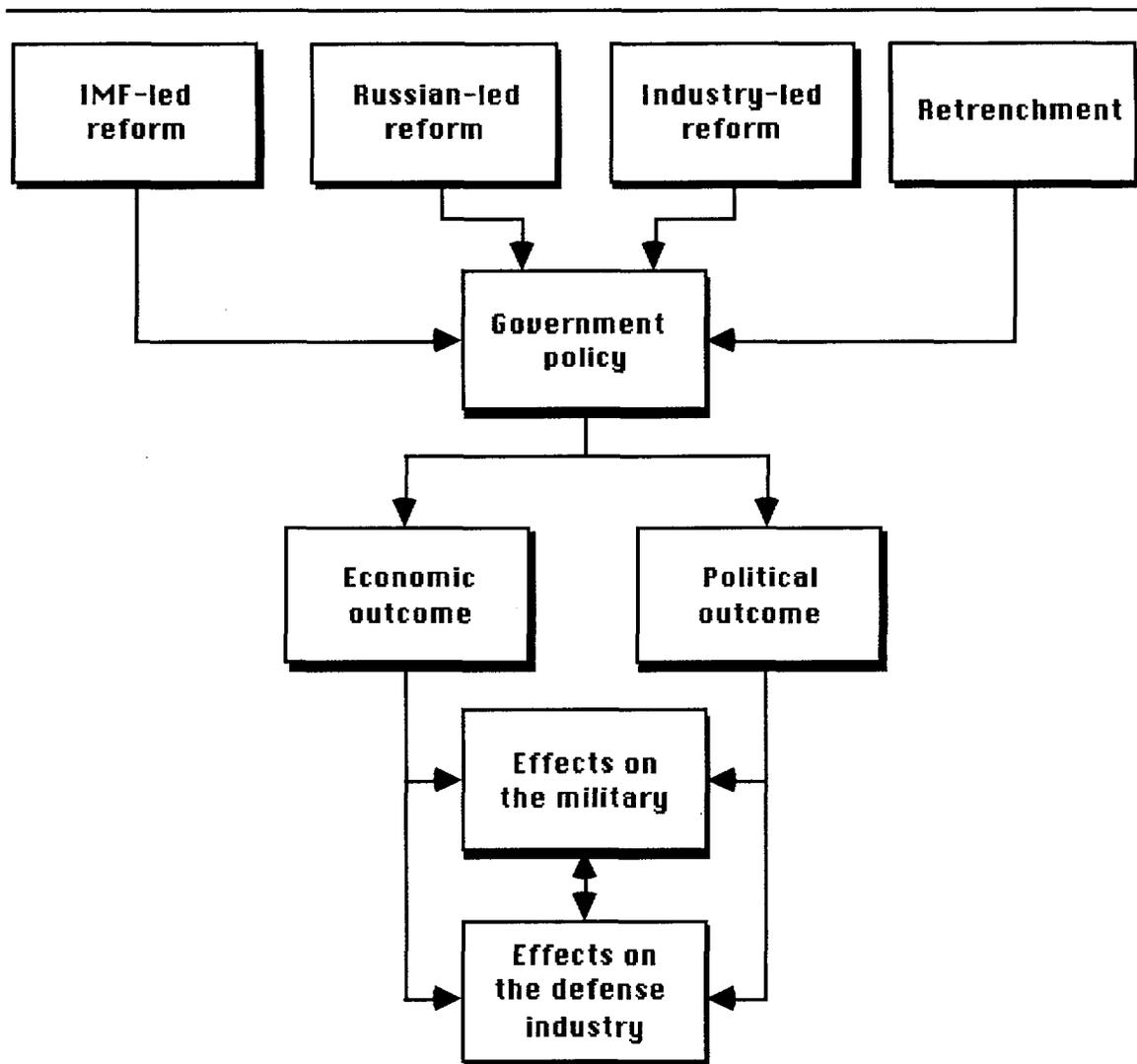
## **PURPOSE OF THE REPORT**

This research memorandum examines the current and future economic constraints now facing the Russian military services and the military-industrial complex. The current constraints are obvious. The decline of the Russian economy and its impact on the military-industrial complex have been well-documented in the press. To predict the Russian military's future economic constraints is more problematic, as it has not yet been determined how quickly reform should progress and what type of economic system Russia will ultimately adopt. Russia is about to embark on an economic upheaval that, whatever the outcome, will leave the military-industrial complex much different.

In this paper, I outline four possible directions for economic reform within Russia—Western-led reform (patterned after an approach to reform prescribed by the International Monetary Fund (IMF)), Russian-led reform, industry-led reform, and a return to a state-run economy (retrenchment). The roots of each can be found in the current economic and political environment in Russia. (For a short summary of the four reform concepts, see the appendix.) For each course of reform, the paper examines: (1) the major economic policies and their objectives, (2) the expected economic and political effects of the reforms, (3) the likely effects on the military, and (4) the likely effects on the defense industry (see the following figure). These analyses are then combined to measure how the military and the defense industries will be affected—in the short- and long-term—by the courses of reform.

In the conclusion, I outline the most likely course for the future of the Russian Navy. Indicators that can help predict which reform path is ascendent are included. This analysis, in turn, will help determine the constraints under which the military and its supporting industries will have to operate.

Of course, I have placed limitations on what I considered when determining the current/future economic constraints facing Russia's military and defense industry. For the purposes of this paper, the future is defined as until about the year 2005. Short-term constraints are considered to be the next 3 to 7 years; long-term are 7 to 15. Also, the scope of this paper is generally limited to discussion of those political events that affect the course of economic reform. This limitation also applies to discussion of economics; my primary concern is with the military-industrial complex.



An approach for determining how economic reform will affect Russia's military-industrial complex

## THE MILITARY-INDUSTRIAL COMPLEX TODAY

During these times of severe economic crisis in Russia, it appears that the Gaydar government's primary objective is to achieve macro-level stability. Two months after his appointment as economic "czar," Gaydar freed prices on basic foods and services. The government has also attempted to reduce state subsidies and the printing of money, and to increase interest rates on state loans. These actions have a common purpose—to reduce the monetary overhang that is fueling inflation. Hyper-inflation is the most potentially destabilizing factor facing the current regime—it could jeopardize not only economic reform, but the position of the current democratic government. These reforms, however, have had severe repercussions throughout the economy. The following subsection addresses their impact on the military-industrial sector specifically. A summary of the status of the military and defense industries is then used as a baseline to determine how the four directions of reform could affect the military-industrial complex in the future.

### THE MILITARY

Cuts in defense spending began two years before the current austerity program. In 1990, the Russian defense budget was reduced to 71.0 billion rubles (R71.0 billion) from the previous year's 77.3 billion-ruble allocation.<sup>1</sup> Little of this funding, however, went directly to the services. According to Julian Cooper:

This figure represents expenditure imputed to the Ministry of Defence; in reality much of the funding is channeled directly to the ministries of defense industry to pay for weapons procurement and for a large portion of the total military research and development.<sup>2</sup>

The determination of the 1991 defense budget was a *battle royale*, pitting the newly empowered Parliament against the Ministry of Defense (MOD). The struggle ended in a defeat for the MOD; its budget was reduced to approximately R63.68 billion.<sup>3</sup> The MOD chose to absorb these losses by making additional cuts in procurement and R&D.<sup>4</sup>

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1. *The Soviet Defense Industry: Conversion and Economic Reform*, by Julian Cooper (New York: Council on Foreign Relations, 1991), p. 2.

2. *Ibid.*, p. 2.

3. There are indications, however, that total defense expenditure was actually R98.6 billion in 1991 and was adjusted to R108.7 billion because of price adjustments that took place that year. In addition, it has been reported from various sources that Gorbachev added R40 billion to the 1991 defense budget immediately before he left office. Yet, even if defense spending rose beyond the limits set by Parliament, the ruble does not buy as much as it used to. As prices rise and the supply infrastructure breaks down, the military, like any Russian institution, will experience an erosion of its buying power. In fact, the CIA estimates that, in 1991, inflation caused a 10 to 25 percent erosion of the military's purchasing power.

4. *Ibid.*, p. 3.

By 1992, it became apparent that defense budgetary priorities were shifting. Expenditures on manpower, once ranked third behind R&D and procurement, became a top priority. There are two primary reasons for this shift. First, in 1988, the defense industrial ministries lost the ability to purchase weapons systems/components from the defense industries. (They could still purchase items from the "civilian" industries, many of which were under their jurisdiction.) The responsibility was given to the MOD to purchase its weapons systems directly.<sup>1</sup> This gave the MOD greater control over procurement and general defense allocations. At the same time, as a result of *glasnost*, social unrest in the services was growing. Servicemen—officers and enlisted—began protesting lack of housing and low pay. The MOD, recognizing the potential for significant unrest in all ranks of the military, sought to address these issues by providing more funds for the social welfare needs of the troops. Because the defense budget in general was declining, additional funding for the servicemen had to be offset by cuts in other categories—procurement and R&D.

This approach to defense spending in Russia has continued in 1992. Recently released government figures reveal that overall defense spending for 1992 will be R384 billion.<sup>2</sup> The CIA estimates that this represents a 50 percent cut in real terms from the previous year's budget.<sup>3</sup> Approximately R80.2 billion will be dedicated to procurement and R55.3 billion to R&D. These figures are higher than those given for 1991 categories of spending; however, in real terms they are lower. Gaydar has revealed that R80.2 billion equates to R11.2 billion in 1991 prices. This represents a 72 percent reduction in spending on procurement for 1992. (The government has not yet revealed what 1992 R&D equates to in 1991 prices, so it is not possible to determine if there have been budget cuts.)

The ground forces will suffer most of the procurement cuts. According to the CIA, in real terms, the number of tanks acquired by the Ground Forces dropped by 45 percent, the number of light armored vehicles by 40 percent, and the number of artillery pieces by more than 45 percent from the previous year. The other forces experienced cuts in their procurement budgets of roughly 20 to 30 percent. For example, naval general purpose purchases have dropped almost 30 percent since 1988, registering a decline of 20 percent last year. The delivery of major combatants and submarines dropped significantly. Procurement spending for strategic offensive forces has also fallen roughly one-third since 1988, including a decline of 25 percent last year. Strategic defense forces, however, have managed to avoid the same level of reduction—their spending has fallen less than 10 percent since 1988.<sup>4</sup>

It appears that this downward trend will continue in 1992. Conventional arms procurement will be 72.9 percent lower than last year's. Strategic arms are scheduled to be

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1. From IDA conference, January 15, 1992.

2. "Arms Procurement Reportedly To Be Cut by 62%," *Yomiuri Shimbun*, March 29, 1992, p. 1, printed in *Central Eurasia: Daily Report*, FBIS-SOV-92-065-A, April 3, 1992, p. 3.

3. "CIA Analysis: Moscow's Defense Spending Cuts Accelerate," *Inside the Navy*, June 15, 1992, p. 15.

4. "CIA Analysis: Moscow's Defense Spending Cuts Accelerate," p. 16.

cut by "only" 39.3 percent. Again, these funds will be used primarily to support strategic defense: R1.4 billion for missile air defense systems, and R83 million for missile ground launch facilities.<sup>1</sup>

Inventory maintenance also seems to be an acute problem. For example, the Pacific Fleet's main repair base, Dalzavod, announced in mid-March that it could no longer service naval vessels. Evidently, naval payments for 1992 were in arrears R100 million.<sup>2</sup> In early April, the CIS Armed Forces remitted some funds to Dalzavod and naval support was resumed.<sup>3</sup> It is doubtful that these funds will continue to materialize as the problem appears to be widespread. Captain Aleksey Nikolayev, deputy chief of the CIS Navy for personnel affairs, has stated that only half of the CIS naval ships have the revenue for routine maintenance.<sup>4</sup>

It is more difficult to assess the impact of cuts on R&D. The CIA believes that "the most visible R&D activities generally continued last year, [although] anecdotal evidence indicated that financial support was withdrawn by varying degrees at R&D facilities."<sup>5</sup> Certainly, statements in the Russian press indicate that the government expects to cut R&D significantly due to the impoverishment of military personnel .

The government will dedicate the lion's share of the defense budget to personnel, although even in this area not all requirements are currently being met. Recently, the Main Directorate for Military Training released its 1991-1992 winter training results. Due to low personnel levels and lack of critical resources (such as fuel), the armed services carried out only 50 percent of their planned divisional tactical exercises and 24 percent of scheduled battalion tactical exercises. The military was more successful in implementing its regimental tactical exercises—93 percent of scheduled exercises occurred.<sup>6</sup>

The military, however, cannot even find the funds for its first priority—social welfare. For instance, in some regions, servicemen are not even receiving pay. The military newspaper *Krasnaya zvezda* has reported that sailors of the Northern Fleet have often gone without pay for several months. In some cases, aircraft loaded with rubles have left for the Northern Fleet, the Leningrad Military district, and the Kamchatka peninsula, but have often not carried enough money to cover all payments owed.<sup>7</sup> In addition, the military

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1. "Arms Procurement Reportedly to be Cut by 62%," p. 1.

2. "Repair Base Refuses To Service Pacific Fleet," ITAR-TASS, March 18, 1992, printed in *Central Eurasia: Daily Report*, FBIS-SOV-92-053, March 18, 1992, p. 38.

3. "Far East Shipbuilders Receive Funds From CIS," ITAR-TASS, April 2, 1992, printed in *Central Eurasia: Daily Report*, FBIS-SOV-92-064, April 2, 1992, p. 11.

4. "Navy Decries Lack of Funds for Maintenance," *Interfax*, April 13, 1992, printed in FBIS-SOV-92-072, April 14, 1992, p. 14.

5. "CIA Analysis: Moscow's Defense Spending Cuts Accelerate," p. 16.

6. "Winter Training Results Reviewed," *Krasnaya zvezda*, June 9, 1992, p. 1, printed in FBIS-SOV-92-114, June 12, 1992.

7. "The Economy has its Laws, but for the Servicemen Prices are Exorbitant" by Major A. Stasovskiy, *Krasnaya zvezda*, June 6, 1992, printed in FBIS-SOV-92-113, June 11, 1992, p. 30.

housing shortage continues, causing more frequent demonstrations by homeless servicemen.

Unfortunately, this grim situation does not promise to improve in the near future. The Russian government assumed, when it arrived at its figure of R384 billion for defense, that the other CIS members would contribute to this account, as they had agreed at the CIS meeting in Minsk. Most republics, however, are reneging on their commitment, claiming that they are already supporting the troops on their territory.<sup>1</sup> It was hoped that the May CIS meeting in Tashkent would resolve this controversy, but an agreement on contributions to defense was never concluded. Also, Russia, at the Tashkent meeting, pushed for reimbursement for its 1992 first quarter defense contribution; it paid all the military's expenses during this time. Again, the other republics refused to comply with these demands.<sup>2</sup> Until this issue is resolved, if ever, Russia will have to pay the bulk of the former Red Army's expenses.

Because the military cannot satisfy its most basic requirements, it is considering other alternatives to support its troops. The military leadership appears to have embraced two programs designed to mitigate the negative effects of defense cuts. First, the commercialization of the military appears to have been sanctioned at the highest levels. The most prominent program of this type is the Navicon venture established by the Russian Navy. Approved by Admiral Chernavin, the Russian Navy's Commander-in-Chief, Navicon is designed to sell/rent naval assets in order to raise cash for service needs. Navicon has signed a joint venture agreement with the American firm Technogrid. The two firms intend to sell naval ships for scrap, construct scrap yards in Russia, and use base facilities as oil and ferry terminals.<sup>3</sup> The funds acquired from these activities will allegedly be used for housing; however, the CIS Command has begun questioning the legality of these dealings. There have been accusations that the top military leadership is skimming the profits to fund their own retirements.

In fact, a very critical memo issued by the CIS Joint Armed Forces Administration of Affairs to CIS Commander Marshal Shaposhnikov, in February, supports these charges. The author, Lt. General Ivashov, accuses the Navy leadership of rather conspicuous "cronism"; the leadership has appointed its top leaders to administrative posts in these commercial ventures. He goes on to identify those officers involved in questionable commercial activity: "Vice Admiral Mahonin, deputy commander of the Navy and chief of Naval Rear Services, is the President of Navicon; Admiral V.G. Yegorov, commander of the Baltic Fleet, and Major General Ye.P. Karabanov, chief of the Navy Main Engineering Directorate, are vice presidents of the RussoBalt joint stock company."<sup>4</sup>

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1. "Who Should Pay for Collective Security and How Much?" by Lt. Col. V. Astafyev, *Krasnaya zvezda*, May 14, 1992, p. 1,3, printed in FBIS-SOV-92-099, May 22, 1992.

2. Ibid.

3. Telephone interview with Nicholas Reisini, President, Technogrid.

4. "Legality of Military Business Activity Viewed," *Komsomolskaya Pravda*, April 1, 1992, p. 1, printed in FBIS-SOV-92-067, April 7, 1992, p. 9.

Soon after the circulation of this memo, Marshal Shaposhnikov and other CIS high-ranking officers attempted to crack down on this type of activity. In early April, the collegium of the CIS high command decided to ban the participation of military command bodies and units in any commercial organization. The collegium also prohibited the sale of military property by armed forces units and organizations. It did, however, encourage "special" commercial organizations within the military to continue conducting business as long as they complied with the law.<sup>1</sup> Essentially, this order did nothing to prohibit commercial activity in the military. Not only was the directive vague—it banned activity by some, and sanctioned it for others—it will do little to deter servicemen stationed far from Moscow, who are desperate for food and housing.

Another way for the military to receive additional funding is to provide technical support for foreign military sales. The Russian government has set up a military-technical support regime that will allow the services to compensate somewhat for the severe cuts in defense. In mid-May, President Yeltsin issued a decree, based on the recommendations of his government, that established a military-technical support administration and defined each member institution's responsibilities. The institutions participating in the new Interdepartmental Commission on Military-Technical Cooperation Between the Russian Federation and Foreign Countries are: the Foreign Ministry, the Ministry of the Economy, the Ministry of Industry, the Ministry of Foreign Economic Relations, the republic's various Intelligence Services, and the Ministry of Defense with the General Staff. The military will be invited by the MOD to assist foreign militaries in mastering the use of exported equipment, lease transportation equipment to foreign clients, send military specialists abroad, and so forth. The military will then receive payment for its participation in these programs.<sup>2</sup> The possible gains from this activity are already evident. Russian Minister of Defense Grachev is currently discussing the possibility of selling infantry fighting vehicles to the United Arab Emirates. If the deal is consummated, military specialists will travel to the UAE to conduct training on the use of this equipment.<sup>3</sup>

There is no longer any doubt that Russia's armed forces will be reduced. There is, however, a debate as to whether this downsizing can produce a leaner, meaner Russian military. To accomplish this, the military must have an overall reduction plan and leadership with enough authority to implement what will be an unpopular policy. Until March, it appeared that the Russian military was sinking deeper into chaos. The December Commonwealth agreements placed Russian republic forces under the CIS Unified Armed Forces, commanded by Marshal Evgeni Shaposhnikov. The CIS High Command spent most of 1992 attempting to remain unified as the republics began establishing their own militaries/militias from the general purpose forces stationed on their territory. The first months of 1992 found Shaposhnikov shuttling to each of the republics, trying to keep this collection of troops united.

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1. "High Command Bans Army's Business Operations," ITAR-TASS, April 4, 1992, printed in FBIS-SOV-92-066, April 6, 1992, p. 13.

2. "Military-Technical Cooperation Decree Released," *Rossiskaya gazeta*, May 15, 1992, p. 2, printed in FBIS-SOV-92-095, May 15, 1992, p. 29.

3. "Grachev Discusses Arms Sales with UAE Officials," ITAR-TASS, June 5, 1992, printed in FBIS-SOV-92-109, June 5, 1992, p. 19.

By March, the Russian government realized that its own troops were suffering from a lack of leadership; CIS commanders were preoccupied with other matters. Also, the growing number of independent republican militaries indicated that a CIS unified military was not likely. In April, Yeltsin announced the creation of a Russian Ministry of Defense. After serving as Defense Minister, he appointed Army General Pavel Grachev as his replacement. Grachev has recently announced plans for the "restructuring" and downsizing of the military. His directives indicate that he plans to dismantle the current "army division" organization and establish a new corps brigade system that will be supported by smaller, "more compact" administrative organs. The new Russian military will emphasize airborne assault combined units, military transport, and Army aviation. All services will be supported by mobile service units capable of moving among different sectors and theaters of operation.<sup>1</sup> The military's downsizing will occur in two stages: 700,000 troops will be cut by 1995 and another 600,000 by the year 2000. These cuts will leave the Armed Forces with approximately 1.5 million troops in 2000. Grachev hopes to begin the move toward a professional military during the years 1993-1995, but admits that this will be a complicated process. Until professionalization is complete, the military will use a mixture of conscripts and volunteers.<sup>2</sup>

While Russia's military is in a nearly impoverished situation, little able to assert control over its widely dispersed assets, there are some small signs that this may be changing. The Russian government appears sympathetic to the sufferings of servicemen and understands that military uprisings are likely if the services are neglected. Yeltsin has repeatedly promised increased wages to servicemen, and military housing is a national priority. In addition, the military now has a power base (the MOD) within the government through which it can promote its causes. The new Defense Minister is a popular and trusted Yeltsin protégé: Grachev was a loyal supporter of the democratic government during the coup. It is possible that conditions in the military may improve, but there is no doubt that the services, under the Yeltsin government, will be dramatically cut and restructured throughout the nineties.

## THE DEFENSE INDUSTRIES

The almost complete cessation of state orders for military equipment has left the defense industrial sector without work or funding. Furthermore, this sector cannot even calculate future military equipment needs because the Armed Forces have yet to publish a military doctrine. Grachev's recent statements this year are the first indication of future military requirements. Defense First Deputy Minister Kokoshin (who is in charge of defense industrial matters) has also, in recent weeks, called for an MOD industrial policy that supports a defense industrial base, although not the policy now operating in Russia. Kokoshin is critical of the current structure, calling it "an anachronism for they rely too heavily on the experience of the First and Second World Wars and do not pay sufficient

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1. "Grachev Details Armed Forces Creation Concept," *Krasnaya zvezda*, May 26, 1992, p. 1, printed in FBIS-SOV-92-101, May 26, 1992, p. 24.

2. "Grachev on Army's Sweeping Changes, Threats," ITAR-TASS, June 1, 1992, printed in FBIS-SOV-92-106, June 2, 1992, p. 14.

attention to progress in science and technology."<sup>1</sup> Kokoshin wishes to support only those industries that can support a "new," defensive military. Although a new doctrine has not yet been adopted, Kokoshin has speculated that rapid reaction forces, which Russia is likely to have, will require categorically different equipment. Certain weapons systems, such as tanks, will no longer be the core of the Russian Army. Neither will the factories that produce them be the core of industry. Unless these enterprises can convert, they will become obsolete.

This has left industry free to pursue its own survival strategy. Until recently, however, the defense industry sector also received little government support. The policies of the Gaydar government do not offer much in the way of compensation. Gaydar has attempted to cut government subsidization of industry, require higher interest rates on loans, and support high commercial tax rates. Although the government has recently softened its positions,<sup>2</sup> its overall policy is clearly anti-state industry. For example, the government has recently agreed to provide cheap credit and lower tax rates, but Yeltsin then introduced a strict bankruptcy code (by Presidential decree) that will endanger many state-run enterprises.<sup>3</sup>

The defense industries, like most of the state sector, became extremely vulnerable when the union ministries were abolished. Yeltsin preserved some of these ministries under the new Russian Ministry of Industry, but their staffs and responsibilities were cut. Industry Minister Titkin has stated that this Ministry now operates with only 2,500, whereas the old union structure employed 40,000. Furthermore, the Ministry's 20 departments no longer distribute materials and financial resources as the old ministries did, nor does the Ministry own enterprises.<sup>4</sup> The demise of the ministries has left enterprises with no anchor in the government. Yeltsin's recent appointment may again provide the defense industries with advocates within the government, although, at the moment, these officials may only be able to shield them from the worst effects of the reform. It is doubtful that they will be able to reinstate the industries to their former advantaged positions.

The result of all these changes has left enterprises near bankruptcy. Inter-enterprise debt is astronomical. In March, the debt was estimated at R700 billion. The state sector also owes enormous debts to banks as well—around R500 billion. It is clear that enterprises are surviving by using a combination of impractical methods—bartering, and the nonpayment of debts and loans.

The defense industries are trying to compensate for the effects of the government's austerity policies. First, they have banded together in a number of industrial lobbies. Probably the most prominent lobby is the Russian Union of Industrialists and

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1. "What Should the Russian Defense Doctrine Be?", by Andrei Kokoshin.

2. For example, the Russian government has recently allocated 45 billion rubles to the defense industries to support their conversion effort. The credit terms are extremely soft—the money can be repaid after 6 years at a rate of 56 percent (the Central Bank has been requiring 80 percent).

3. "The Case for Yeltsin," *The Economist*, June 20, 1992, p. 15.

4. Printed in *Central Eurasia: Daily Report*, April 10, 1992, p. 23.

Entrepreneurs, which was established in 1989. Headed by Arkadiy Volskiy, a high-placed defense industrialist under the Communist regime and now a high-ranking leader in the Civic Union, the Union's members include enterprises and other institutions that produced 65 percent of Russia's 1991 industrial production.<sup>1</sup> The Union played a key role in the events of the recent Congress of People's Deputies. There are rumors, which Volskiy has denied, that he helped Khasbulatov write the Parliament's alternative economic reform program, the program that prompted the Yeltsin government to resign during the opening days of the Congress. These rumors, however, are difficult to dismiss. The Union was originally established as a Parliamentary lobbying group and its ties with this institution are strong.

The policies of Yeltsin's Councilor for Questions of Conversion, Michael Maley, have also gained distinction in the last few months. Maley recognizes that the government cannot afford to subsidize defense industries, let alone fund their conversion.<sup>2</sup> He proposes that the industries themselves finance conversion through arms sales abroad.<sup>3</sup> Maley is quick to add that these sales will be conducted within a legal framework. Arms will not be exported to "pariah" states, such as Libya or Iraq, and certain types of weapons will not be sold. Maley's proposals appear to have gained favor within the government. Yeltsin recently formed an intergovernmental task force to monitor and approve foreign military sales and technical support (discussed above) and he has granted special permission to the Tula region to conduct sales negotiations directly. In fact, Yeltsin articulated support for this policy in a meeting with defense industrialists in May. He emphasized that a prospective way to resolve the problems facing the military industrial complex and conversion would be arms exports, which do not fall under the category of weapons banned by international agreements, to countries free of sanctions imposed by the international community.<sup>4</sup>

Like the military, the defense industries are in a state of crisis, but have recently rallied. The appearance of industrialists in Yeltsin's cabinet and Yeltsin's approval of Maley's policies are positive signs for them. It is not yet certain, however, that these events will ensure their long-term success. Legally conducted foreign military sales are a legitimate activity for the defense sector, but there is no guarantee that these sales can fully support this sector and its conversion. First, the need to sell arms is driven by employment, that is, plants wish to sell arms to prevent large personnel layoffs. Therefore, plants may continue to produce weapons not actually in demand in the international market. Second, Soviet arms were attractive in the past because clients rarely had to pay hard currency and, when payment was made, it was usually well below market value. Can Russia, at this time, sell weapons in large amounts for hard currency and at market value?

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1. "The Revolt of the Industrialists," by Joseph Diskin, *Politics of Soviet Reform*, February, 1992.
  2. Maley has estimated that conversion will cost \$150 billion.
  3. "The Defense Complex Should Not be Destroyed, But Built Up, Mikhail Maley, State Counselor for Conversion Issues Is Convinced," by Vyacheslav Shchepotkin, *Izvestiya*, April 1, 1992, p. 2.
  4. "Yeltsin Meets With Military-Industrial Leaders," *Interfax*, May 13, 1992, printed in FBIS-SOV-92-094, May 14, 1992, p. 29.

Third, Russia does not have a spare parts infrastructure to support foreign sales. Will other countries risk buying this equipment, knowing that they will have difficulty maintaining it? Finally, Russian defense industries and the military will compete directly for foreign sales of equipment. There may be insufficient demand to support both these institutions.

## HOW TO EVALUATE REFORM

Probably the most important factor affecting the military-industrial complex in Russia is the complete breakdown of horizontal and vertical relations among republics, regions, and institutions. As described above, the precipitous economic decline and the attempts at reform have had a tremendous effect on every sector. Yet, there can be no real recovery until economic relations at all levels have been re-formed. For some time, the military and defense industries avoided the general social disarray caused by Gorbachev's attempts to dismantle elements of the command system (*perestroika*) and promote democratic traditions (*glasnost*). In August 1991, however, Gorbachev was about to enact a policy that would mean the disintegration of large portions of the military-industrial sector. The President had negotiated and pledged to sign the union treaty, which would give the republics more autonomy from the union. To protect their power base, leaders of the military and defense industries joined with the Communist Party to launch what is now known as the August coup. Its failure has left this sector vulnerable to the general collapse of the Communist political and economic system.

As a result, individual military commands and defense enterprises are now functioning primarily to survive. Furthermore, many of the leaders of these two institutions have been discredited; the defense ministries have been stripped of power; and the military is divided by political loyalties. This has changed the character of politics and economics at the local level dramatically. The vertical links between Moscow and the countryside have broken down, and until they are re-established, the individual enterprises and military commands are making their own decisions about how to endure the economic and political crises.

As described above, the military is having difficulty housing, feeding, and securing supplies for its troops. The military has been buffeted from many directions. The state has dramatically cut defense spending. Inflation has eroded the military's buying power. Many units are now stationed in increasingly hostile republics whose governments are seeking their return to Russia. Desertions and draft-dodgings are rising.

As of yet, "Moscow's" prescriptions (as described above) have not provided the lower ranks of the military with even the basic survival funds and resources. To preserve unit solidarity and protect their subordinates, local commanders are turning more and more to the local community for support. Despite Shaposhnikov's edicts concerning commercial activity, commanders are exploiting opportunities in the local economy that allow them to feed and house junior officers and enlisted. They are advertising in *Krasnaya zvezda* for

meat, milk, and other food products.<sup>1</sup> They are selling equipment, harvesting crops, and, in Moldova, renting their tanks and weapons to civilian militias.<sup>2</sup>

Recently, interaction between the military, local governments, and industry has risen to a qualitatively new level. Local leaders from all sectors are now joining in investment projects designed to enhance the development of the entire community. In Kaliningrad, the base commander, the mayor, the Yeltsin-appointed regional governor, and leaders of local industry have laid plans to commercialize the naval base. Its oil terminals will be rented to private ventures; a passenger ferry service now runs from the base to other Baltic ports.<sup>3</sup> This type of activity has short-term benefits for the military—it will support its current critical needs. The high command's concerns are legitimate, however. Local commanders' preoccupation with this type of commercial activity reduces readiness, but more significantly, it subverts the very nature of the military.

Also, the policies of the central government (as described above) have not been entirely supportive of individual defense enterprises. Instead, defense industry leaders, like the military, are turning to local governments for sustenance. At the same time, these governments are relying on defense industries to improve the local economy. The Moscow oblast government, for example, plans to fund the conversion of its enterprises that are capable of producing for its constituency. Those enterprises that cannot convert will not receive oblast funds.<sup>4</sup> Pent-up local demand has pressured many enterprises to use free space on factory floors to produce basic consumer goods. Many enterprises have yet to accept that they will not be receiving sufficient orders for military equipment and are simply trying to employ workers until the hoped for orders appear. It is likely that enterprises will grow more and more dependent on the production of consumer goods. At such a point, their conversion will be complete. This type of "spontaneous" conversion on the part of the enterprises is likely to be the trend of the future. From this perspective, it may not matter what policies Moscow attempts to implement in order to "save" the defense industrial complex. The defense industries may cease to be part of an interconnected process able to take orders from above and produce accordingly. Instead, they will become integrated into the local economy, and they will rely on that economy for a market for their goods and supplies.

It should be noted that the general economic upheaval has also severed horizontal links between institutions. Russia's economic catastrophe has, in a sense, highlighted the estrangement between the military and the defense industry. *Glasnost*-inspired revelations have shown that the military and defense industry ministries did not necessarily enjoy a

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1. "Shortage of Funds for Defense Food Supply Program," *Krasnaya zvezda*, February 20, 1992, p. 2, printed in JPRS-UMA-92-009, March 11, 1992, p. 24.

2. For a comprehensive analysis of military activity at the local level, read "The Future Russian Navy: The Human Factor," by Jeanette Voas, CNA Research Memorandum 92-107.

3. Conversation with Gordan Feller, International Economic Development Corporation and Kaliningrad's representative to the World Bank, July 7, 1992.

4. Conversation with Moscow oblast officials (Anatolii Dolgolaptev, Anatolii Tyazhlov, Vladimir Klimentko), September 14, 1991, Moscow.

mutually supportive relationship, but that the defense industries, especially under Defense Minister Ustinov, dominated production decisions. This is not surprising under an economic system that was supply-driven. The military "customer" often had to accept deliveries from the defense industry "producer," regardless of its needs. It is becoming more and more apparent that the military had more limited input concerning the quality and types of weapons produced. Under the old Communist system, therefore, military-industrial collaboration was something of a myth. The military-industrial relationship now appears near severed.

Thus, relations have not only broken down from Moscow to the regions, but also among institutions such as defense industries and the military. The greatest impact that the four courses for reform—Western-led, Russian-led, industry-led, and a return to a state run economy—can have is their ability to: (1) improve the general economic situation, and (2) reestablish a common (national) basis for economic activity. Until the nation operates within a common economic framework, healthy economic activity and growth cannot occur. At the moment, economic relations are ill-defined; speculation, extortion, and other criminal activity are the "norm." Local governments are beginning to fill the vacuum left by the demise of the central government and to dictate commercial rules. As this occurs, trade barriers may soon exist between cities, and businesses may not even be protected when engaged in commercial activity in other regions. If the different "reform" venues cannot reunite these local/regional markets, they cannot hope to improve the economy at the national or local levels. Therefore, it is important to evaluate how each direction for reform can accomplish the above goals.

Such an evaluation is especially important when trying to assess the future status of the military and defense industries. These two institutions require a regionally integrated economy. Imagine the difficulties of feeding troops in Moscow with food from southern Russia if there are barriers to trade. The same is true of a defense plant that relies on sub-components from an institution located outside its "economic" region. Of course, regions may move to greater autonomy by establishing their own militaries and defense industrial bases, which will only further the economic and political disintegration of Russia.

## FOUR DIRECTIONS FOR ECONOMIC REFORM

This section outlines four possible directions for economic reform in Russia. Of course, when reading this section it is important to understand that certain reform directions are more likely to be followed than others. For example, the Western-led reform direction has been almost completely discredited in Russia. Yet, it is important to include a description of this direction for two reasons. First, it is the basis from which all future reform directions appear to be evolving. Either a reform direction tries to modify the elements of this program (Russian-led) or it rejects them (Industry-led). Either way, the other reform directions are responses to the program outlined in the Western-led reform package. Second, it is possible, although unlikely, that Russia may eventually return to this reform program when its economy is more stable and much of the old central system has been dismantled.

A discussion on returning to a state-run economy is included for similar reasons. Industry-led reform is largely based on the preservation of large segments of the old system. Therefore, although it is unlikely that this will be a reform direction for Russia, it provides a general understanding of where industry-led reform will eventually lead and what it is trying to accomplish. Furthermore, as the economic crisis increases, there will be calls for a return to the old system.

The indicators given at the end of each section may provide some basis for understanding which reform direction is currently being pursued, and what reform direction is being most strongly advocated and by whom.

### WESTERN-LED REFORM

In October 1991, Yeltsin announced, to the fifth Congress of Russian People's Deputies, his intention to head the government. In that address, he also outlined his economic program. Generally known as the "Gaydar Program" (after Yegor Gaydar, the current head of government and Yeltsin's preeminent economic advisor), this approach advocates austerity measures similar to those implemented in Poland and prescribed by the International Monetary Fund (IMF).<sup>1</sup> The program described by Yeltsin in October contained the following basic elements:

- Tight fiscal policy (no deficit spending in 1992)
- Tight credit policy (little industrial subsidization)

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1. The Polish reforms were largely shaped by the American Jeffrey Sachs, a well-known Harvard economist. (For Sach's own description of his activities in Poland, see *Scientific American*, March 1992.) Sachs' program for economic reform is similar in many ways to the IMF's programs. There is, however, one area where Sachs is critical of the IMF. He believes that the IMF is wrong when it insists on full repayment of external debt. Often, debtor countries are forced to divert resources to service their debt to such a degree that economic growth becomes nearly impossible.

- New tax administration system (to collect revenue)
- Freeing of prices
- Privatization
- Tight monetary policy (control over the printing of money)
- Work with the IMF and other international financial institutions
- Attract foreign capital.<sup>1</sup>

The last two bullets are important because they demonstrate the importance the Gaydar program places on Western private and institutional investment. Gaydar has argued repeatedly in the press the advantages of IMF/World Bank funding:

One can relate in various ways to the IMF. One can criticize it for seeking uniform approaches to the most diverse countries. One can complain about the arbitrariness and heartlessness of the bureaucrats of the IMF. But there is one thing one cannot deny. The IMF is the pivot of the modern world financial system. And it is not simply that the IMF grants large-scale credits, at an interest rate below the Libor. The point is that the stance of the IMF and the institutions associated with it—the World Bank and the International Development Association—exercise a determining influence on the decisions adopted by nearly all international economic institutions....

And finally, private investment. It is no secret to anyone that however you relate to the IMF and the World Bank, cooperation with them is a very powerful signal to private business that money can be invested in this country. Each dollar of credit from the IMF and the World Bank, as a rule, attracts at least several dollars of private capital investment.<sup>2</sup>

The Yeltsin government understood last fall that Western investment in Russia was critical for two reasons. First, Western investors would provide much needed capital. There was very little capital available in Russia for investment. Most industries were heavily in debt and personal savings were being rapidly eroded by inflation. The

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1. Yeltsin's speech on economic reform was made to the Fifth Congress of Russian People's Deputies in Moscow on October 28, 1991. It is printed in its entirety in *Soviet Union: Daily Report*, FBIS-SOV-91-209, October 29, 1992, p. 45 - 54.

2. "Gaydar Addresses Deputies on Entry Into IMF," Russian Television Network, May 22, 1992, printed in *Central Asia: Daily Report*, FBIS-SOV-92-101, MAY 26, 1992, p. 26.

Communists had pilfered the government's gold and hard currency accounts and the banking system had dispersed money to industry while requiring little if any loan repayment. These industries generally used these loans more for wages and less for investment purposes. Many industries, therefore, have jeopardized their potential for growth and cannot repay the loans.

Second, Western investors would also provide the nascent Russian entrepreneurial sector with needed "market know-how." Yet, the government also knew that Westerners were reluctant to invest time and money under chaotic conditions. Therefore, it set about to provide a stable environment for investment and a legal basis for business, and more important, to gain the approval of Western financial institutions that would guarantee Western investment. It is no coincidence that the Gaydar program incorporates many traditional IMF/World Bank requirements. For example, the World Bank, in its most recent *World Development Report*, listed the following conditions for support:

- Moderate public spending
- Raise adequate revenue (taxes)
- Control public borrowing (credits)
- Control the creation of money
- Free prices
- Define and protect property rights
- Create an environment where commerce can flourish
- Reduce or eliminate protection for domestic industry
- Open the market to imports and foreign investment.<sup>1</sup>

The Gaydar program was initiated in large part to attract the support of the West in both political and economic terms. Yet, Gaydar's program was also created when economists and political leaders were still enthralled by the Polish "success." Clearly, Gaydar based his program on the Polish shock therapy.

Now, however, the Polish effort has stalled; unemployment is high, industrial output is low, and large sectors of heavy industry remain state-owned. In addition, the economic situation has caused a government crisis. Many opponents of the Gaydar program question whether they want to endure what Poland has. The Polish experience, in fact, will considerably influence the course of reform in Russia. Throughout history, Russia has often watched reform movements in other countries before electing to implement them at

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1. A synopsis of this World Bank report was provided in *The Economist*, October 12, 1992, p. 41.

home. In many cases, the Western experience has caused Russia to reject or modify its approaches to political or economic reform. Thus, a failure in Poland will leave a lasting impression on Russians. In fact, much criticism of the Polish "shock therapy" model was raised recently at the Sixth Congress of People's Deputies held in Moscow in early April. Many deputies appealed to the Russian government to limit the austerity program and consider social welfare. The government and legislature reached a compromise that is the basis for the second reform scenario—Russian-led reform.

### **Likely Political Outcome**

Criticism of the IMF/World Bank program is increasing. Russians have always been sensitive to class disparity, resenting those who "exploit" others for their own profit. The current reforms are creating different classes of people and, unfortunately, many of those doing well today are high ranking officials from the old regime. After all, these are the people with financial means, connections to the West, and a network of contacts throughout the former Soviet Union. Privatization and the lack of any legal structure are allowing the "upper" classes to benefit further. Unfortunately, these circumstances are combined with the view that the West is dictating the terms of Russia's reform. As this view becomes stronger, the Yeltsin government will be in jeopardy unless it distances itself from this seemingly unjust program. If Yeltsin proceeds with shock therapy, support for his government will dwindle. Yeltsin will have to choose between economic expediency or political survival. It should be pointed out, however, that if Yeltsin is removed/forced from office, the reform effort will likely be further delayed or even halted.

### **Likely Economic Outcome**

Many economists have harshly criticized the IMF/World Bank and their reform programs. One of the central complaints is that these institutions place too much emphasis on macro-economic stability at the expense of economic growth. For example, the typical IMF program calls for increased tax revenues and restrictive credits. IMF opponents argue that this program absorbs domestic resources that might otherwise be used as investment. Critics also argue that IMF reforms increase disparity among economic classes. Reductions in government/public spending often mean reductions in support for the poor. At the same time, privatization programs provide those with money the opportunity to increase their wealth.

The IMF has argued that these criticisms are invalid for a number of reasons. First, the IMF does want to increase tax revenue, but this does not necessarily mean higher taxes. The IMF often recommends that countries lower their taxes, but become more diligent when it comes to collecting them. Second, the IMF and World Bank realize that the disenfranchised suffer more under an austere reform program. Therefore, they have tried recently to incorporate social welfare programs into their loan packages.

The experience in Poland has also shown that shock therapy causes tremendous economic dislocations. The cost of economic stability is high unemployment. In addition, certain sectors of the economy, such as heavy industry, have been hit extremely hard. It is likely that unemployment in this sector will remain extremely high for a long period of

time. The situation in Russia will likely be worse under shock therapy. The industrial sector makes up a larger portion of the economy and many regions of the country are isolated from economic "centers." The economic conditions in these remote regions would be very bad.

### **Effect on the Military**

The results of shock therapy on the military and defense industrial sector are rather obvious in the short-term. These two sectors depend heavily on the government for funding. As the government cuts its expenditures, their budgets will continue to become smaller. When this occurs, the military will not be considered an attractive profession for young recruits. The military's numbers will continue to decline as well as its ability to purchase weapons and services.

In the long run, the military can only benefit if the government provides a stable atmosphere for economic growth and creates a physical and social infrastructure. A healthy economy can provide the state with additional revenue for defense. Lower inflation will allow the military more ruble purchasing power. A healthy infrastructure (roads, communications) will make it easier to conduct the military's day-to-day activities. Thus, the military will be able to concentrate less on how it will feed its troops and more on how it will train and operate them. The influx of imports will provide the military with additional ways to feed, clothe, and house troops.

Finally, the demise of the state industries and the growth of private industry will, for the first time, allow the military more choice and flexibility in procuring its weapons systems. In a demand-driven economy, the military will be able to dictate more of the procurement process. In addition, exposure to Western goods and increased domestic competition will improve the quality of the arms produced. A market system also encourages the growth of technology in order to increase production efficiency and make the product more competitive. The military will benefit from the growth in the country's technological base.

### **Effects on Defense Industry**

Shock therapy will have the most impact on the defense industries. After all, one of the program's primary aims is to dismantle the state industrial sector. The policies prescribed by the IMF/World Bank will squeeze the defense industries by insuring that they pay taxes and interest on loans. At the same time, these industries, as demonstrated in the first quarter of 1992, will lose their government subsidization. Those that survive bankruptcy will be faced with an increasingly competitive market for their products due to imports and a growing private sector. These industries will also have to compete with private industry for people and resources. Furthermore, many of the remaining enterprises will be "encouraged" to privatize. In essence, the entire structure within which these industries operate will be dismantled. It is likely that most of these state-run enterprises will not survive this transition without government support. If this support is not forthcoming, the short-term future for these industries is grim.

In the long run, the defense sector in general can gain from economic reform, although the existing enterprises may not. The transition to shock therapy will largely destroy the current system. A new, more robust sector could emerge as a result of a growing economy, however. First, a healthy economy generates increased government revenue that can be spent to purchase equipment for the military. Second, a demand-driven economy will place more emphasis on quality and efficiency in production. In this atmosphere, the defense industries will have access to higher quality components and, if the country's infrastructure is enhanced, defense plants will be able to take advantage of improved services. Access to Western markets will provide additional clients, and exposure to Western goods will improve the quality of domestic production and allow these companies to compete on the international market. The defense sector may become a robust sector of the economy, but this transition will take time. In the interim, shock therapy will create a harsh economic environment for those employed in this sector.

### **Likelihood of Implementation**

Russia is unlikely to use shock therapy for reform. Shock therapy has some ugly side effects. It increases class and regional disparities, and the likelihood of high unemployment in exchange for financial and monetary stability. These are not tradeoffs most Russians are willing to make, given their highly ingrained opposition to class societies. There appears, therefore, to be a serious mismatch between the ordinary citizen's economic expectations and the goals of shock therapy. Thus, the economic dislocations that occur under shock therapy may be enough to undermine Yeltsin's political legitimacy and his efforts to implement democratic reform. In other words, democracy is still too fragile in Russia to expose it to public outrage at government-sanctioned economic hardship. Political concerns now dominate economic ones. In addition, there is growing resentment that the Western governments are attempting to dictate the terms of economic reform in Russia. If Yeltsin appears to be only a puppet to their demands, this will also erode his legitimacy. Therefore, for the sake of political expediency, Yeltsin will likely reject this reform course.

### **Indicators of Future Implementation**

Since shock therapy is essentially the "Gaydar Program," a key indicator that this particular reform program is being implemented is that Gaydar remains in a position of authority within the government and that the position he is in is more powerful than other government offices. This is an important subtlety. Gaydar may remain in the top governmental position, but if his policies (described above) are not being implemented, clearly he does not enjoy the power of his position. Therefore, it is not enough that Gaydar holds the preeminent position in government. Other indicators that this direction of reform is being implemented are the following.

First, if Gaydar is able to cut federal spending and tighten credits, many state industries will declare bankruptcy, which will trigger high rates of unemployment. Gaydar will also continue to advocate free prices as a way to achieve macro-economic stabilization and avoid hyper-inflation. Therefore, prices will be higher than before, reflecting the

goods' true value in the market. On the other hand, if Gaydar is able to continue his reforms, inflation will be low and Western aid will be readily available.

## **RUSSIAN-LED REFORM**

The sixth meeting of Russia's Congress of People's Deputies in April 1992 was the first real challenge to the Gaydar government. A large number of the deputies, who were elected before the August coup attempt, were conservative holdouts from the previous administration.<sup>1</sup> Many had voiced their displeasure over the government's chosen paths for economic and political reform. The two points of contention—the government's economic reform program and the new constitution—were obvious before the Congress even began. Before the opening session, Yeltsin made changes in his government to deflect the deputies' criticism of his advisors and their programs.<sup>2</sup>

Yeltsin approached the opening session with a number of goals:

- To maintain temporary control of ministerial appointments
- To be able to reorganize the government in the short-term without legislative interference
- To retain the newly created positions of state councilors and presidential representatives<sup>3</sup>
- To remain as premier for three months until nominating his replacement
- To emerge from the Congress with at least the basic elements of the Gaydar reform program intact.

It was important for Yeltsin to control administrative appointments; this gave the President enormous leverage over the course of reform. Likewise, if the Gaydar government could emerge from the Congress with even partial support for economic austerity, they could continue to launch at least partial elements of its program until year's end.

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1. According to Alexander Rahr in an article in a May 1, 1992, issue of *RFE/RL Research Report*, Peoples' Deputies can be divided into two groups: Communists and democrats. The groups control approximately the same number of deputies; 40 percent are democrat, 40 percent are Communist. The other 20 percent are uncommitted.

2. Gennadiy Burbulis and Sergey Shakhrai resigned their positions as deputy premiers in the government, but maintained their positions within the Presidential apparatus. At the same time, Yegor Gaydar resigned his post as finance minister and Aleksandr Shokhin his position as minister for labor and wages. Both officials kept their positions as deputy premier.

3. Yeltsin had been given these temporary "emergency" powers in November following the coup. Many of the deputies were eager to rescind what they considered unconstitutional executive power.

Did Yeltsin achieve his goals? Yes and no. The Congress did not remove Yeltsin's special powers to reorganize the government and create positions within the presidential apparatus (such as the state councillor or presidential representatives) solely on the basis of presidential decree. Moreover, the Congress failed to generate enough votes to pass a constitutional amendment giving the Supreme Soviet the right to approve the President's appointment of the premier and ministers. Therefore, Yeltsin still has the temporary *de jure* power to appoint government leaders without legislative interference.<sup>1</sup>

On the other hand, the Congress did enact a law stating that within three months Yeltsin had to nominate a new premier. The Congress also requested (and Yeltsin agreed) that he include a number of industrialists in his government so that their interests were well-represented during the reforms.<sup>2</sup> (The effect of this demand is discussed in the next section.) Moreover, the Congress attempted to pass its own economic reform agenda in the early days of the Congress. The main points of this reform are as follows:

- To overcome the monopoly of state structures in the spheres of production and distribution
- To step-up production of consumer goods
- To reduce the burden of taxation (in order to provide incentives for the development of the leading sectors of the economy)
- To implement real targeted social welfare for the public
- To privatize by including broad groups of the population
- To prevent consumption levels from falling
- To support budget-maintained sectors, including health care, science, culture and education
- To increase the printing of money to resolve the current currency shortages
- To refine price policies and state regulation of prices for fuel and resources.<sup>3</sup>

For the most part, the Congress's reform platform incorporates many elements of the Gaydar program (e.g., privatization, price liberalization, and de-monopolization). Each platform emphasizes different points, however. The Supreme Soviet evaluates the reform

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1. *Yeltsin's Struggle to Create a Strong Presidential Apparatus: A Guide to Russia's Executive Branch*, FBIS, May 15, 1992.

2. "Congress Results, Recommendations Viewed," ITAR-TASS, April 22, 1992, as printed in *Central Eurasia: Daily Report*, FBIS-SOV-92-080-S, p. 31.

3. "Text of Congress Decision on Economic Reform," ITAR-TASS, April 15, 1992, printed in *Central Eurasia: Daily Report Supplement*, FBIS-SOV-92-074-S, April 16, 1992, p. 10-11.

process in terms of social welfare, that is, social dislocations (or their prevention) should determine the pace of reform. Gaydar uses economic stability to measure the reform effort's success. This disagreement is significant. Parliament's social welfare programs attack the core of the Gaydar program, which is macro-economic stabilization based on a fiscal austerity program. After all, it will be difficult to curb fiscal spending when expanding social welfare programs. The deputies also insisted that the Central Bank continue printing money so that state enterprises could pay workers' wages. Their insistence undermines Gaydar's attempts to tighten the control over monetary policy—another basic tenet of the government's reform program.

In addition, Ruslan Khasbulatov, the vocal Chairman of the Supreme Soviet, criticized the Gaydar team for "succumbing" to Western institutions and their reform programs. According to the Chairman, institutions such as the IMF and the World Bank have little regard for the needs of the Russian people and require economic stabilization at the expense of Russian citizens.

It is probably the intention of a number of conservative deputies to derail reform completely. Yeltsin's popularity, however, makes it difficult for them to attack his reform program fully. Instead, these conservatives attempt to undermine his efforts by appealing to popular sentiment. This strategy, however, forces Yeltsin's opponents to accept certain elements of the reform and forge compromises with the government. The "tug and pull" between government and parliament will lead to the appearance of "tacking" toward a market economy. It is reasonable to expect that the government will push austere aspects of the reform, and then soften its stance somewhat in the face of parliamentary/social pressure. After all, this is the way democracies work to achieve a balance of interests that strive to benefit the most people.

During the conclusion of this particular congressional session, the government and legislature reached a compromise on economic reform. Yeltsin himself maintained that, while the Sixth Congress had managed "to preserve the strategic course towards radical reform," the deputies had not removed "artificial obstacles ... for land reform and economic reform as a whole."<sup>1</sup> It is clear that the government will have to consider additional spending for social welfare, including unemployment benefits, health care, education, etc. As a result, the government will have difficulty controlling spending and the printing and distribution of money. At the same time, the government appears determined to proceed with other aspects of its reform program, including privatization<sup>2</sup> and bankruptcy codes.

In the end, these efforts alone may be enough to satisfy the IMF, World Bank, and other Western institutions and businesses. The IMF has already announced its willingness to advance \$1 billion to Moscow even before it has reached an agreement with the Russian

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1. "Strategic Reforms Course Preserved," ITAR-TASS, April 22, 1992, printed in *Central Eurasia: Daily Report Supplement*, FBIS-SOV-92-080-S, p. 19.

2. It appears that the first round of government-sanctioned privatization will begin October 1, 1992. Russian citizens will be issued vouchers that will be used to buy shares in a number of state-owned enterprises.

government on economic reform.<sup>1</sup> Clearly, the IMF is under pressure from the Western governments, who don't want to be seen as unsupportive of the new democracy, to provide aid for Russia's transition.<sup>2</sup> Therefore, Russia may well be in a position to dominate the negotiation process with the IMF and World Bank. If so, the Russian government will have more latitude to garner political and social support by foregoing or delaying some of the more severe elements of reform, while still remaining eligible for IMF/World Bank funding.

### **Likely Economic Outcome**

The primary objective of this type of Russian-led reform is to achieve a balance between economic stability achieved through monetary and fiscal conservatism and the loosening of these controls in order to cater to pressing social needs (e.g., unemployment benefits, industry subsidization, etc.) Therefore, reform will proceed in fits and starts. The government will constantly monitor social reaction and adjust its reforms accordingly. The pace of reform will be slower. The recovery period may last longer, but the acute pain associated with shock therapy will be avoided. Also, if these compromises are successful, a Russian-led reform program may also diminish the risk of a crisis in the political sector due to a social backlash against economic hardship. Furthermore, the West is still likely to support such efforts financially as long as it appears that reform is moving forward, even though at a slower pace.

### **Likely Political Outcome**

If Yeltsin is able to achieve reform while guaranteeing society's basic needs, he will likely remain in office. Yeltsin's political survival does not ensure the continuation of economic reform, however. Even those who oppose reform have chosen thus far to work through Yeltsin. If he is swayed by public opinion to accept the views of the opposition, he will put the brakes on reform. However, if reform appears to be progressing while basic social needs are still being met, it is likely that the public will not oppose the current effort. In this case, Yeltsin will continue with this program.

### **Effect on the Military**

Under a program of Russian-led reform, the military budget will be cut more, but special government programs will probably be implemented to protect servicemen.

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1. "IMF Supports Aid Advance for Russia," by Stuart Auerback and John M. Berry, *The Washington Post*, June 25, 1992.

2. The World Bank and IMF have, in the past, given in to the political pressures of some of its member states. For example, in 1988, the World Bank arranged a \$1 billion loan to Argentina despite the fact that Argentina had no IMF program and a shaky economic reform program. The World Bank was reluctant to provide these funds, but did so at the request of then-U.S. Secretary of Treasurer James Baker. The result was disastrous—Argentina failed to comply with the World Bank's conditions within such a short period of time that only a small portion of the loan had been disbursed. (*The Economist*, October 12, 1991, p. 22.)

Weapons procurement and funding for R&D will continue to decline, but not as much as under an austerity program. It is likely that the government will attempt to support the new military doctrine by providing more funds for defense than under shock therapy, if the military's demands meet with government policies (e.g., reasonable sufficiency and less public spending). In essence, the government will meet the demands of a military making modest requests on state resources. In the long run, however, this type of reform effort may delay the institution of a strong market economy. Thus, the military may have to wait longer before it can enjoy the benefits of a healthy economy, such as a solid infrastructure, higher quality equipment, an improved standard of living for servicemen, and greater purchasing power.

### **Effect on Defense Industry**

The make up of the defense industry will change under Russian-led reform. A state sector will remain, but will be eroded by a growing private sector. The government may also force the creation of new industries in the defense sector to support new military doctrinal requirements, letting obsolete industries wither. In fact, the state will likely adopt a selective subsidization program that will force most defense enterprises to privatize or disappear. It will also support the creation of new industries that can meet unfulfilled demand. The government will encourage foreign military sales, as long as industries comply with international agreements and national laws. In the end, the character of defense production will change, that is, enterprises will be sensitive to demand and quality of production (especially if they wish to compete on the international market). Russian-led reform, however, will occur more slowly than under a shock therapy program. The state sector will be preserved longer to avoid mass unemployment. Once a robust private sector is created, resources will slowly be shifted away from the defense/state sector to the civilian/private sector. Only the most competitive factories will remain.

### **Likelihood of Implementation**

Until recently, it appeared that Russian-led reform was the chosen direction of reform. The Yeltsin government and the Parliament were locked in a battle for control over the reform process, but appeared able to reach a compromise that would allow the Gaydar program to be implemented with some modifications for social welfare. Thus, Gaydar and his people still had the upper hand, but it looked as if they would be compelled to water down some aspects of their program in order to reach an agreement with the legislative branch. This "democratic" approach, however, may soon be replaced due to the emergence of a third power—Russia's industrialists.

The industrialists have emerged as a political power not only because they have organized a coalition within Parliament,<sup>1</sup> but because Yeltsin has acceded to some of their demands. He has appointed opposition members to his Cabinet (industrialists) and he has delayed some key aspects of Gaydar's reform program (further price liberalizations) that hurt industry. At the same time, he has also re-stated his support for Gaydar and announced the implementation of a privatization program, beginning October 1. Yeltsin's vacillations are undermining the Gaydar program and his own political legitimacy. It remains to be seen what will fill this political vacuum. At the moment, the industrialist movement claims it supports Yeltsin, not Gaydar. As long as Yeltsin remains necessary to both reformers and industrialists, a modified macro-economic stabilization program may continue in fits and starts. If Yeltsin becomes more unpopular and tries to bolster his authority through new alliances, a new direction for economic reform may emerge. Thus, the outcome of this struggle will depend largely on whether the industrialists, through Yeltsin, gain control of the government. The agenda of this new, powerful lobby is discussed below.

### **Indicators of Future Development**

A key indicator that this reform direction is being pursued is that Yeltsin will clearly be manipulating Russia's various political/governmental institutions toward market reform. In other words, Yeltsin will still dominate the political process and will be able to force (through his policies) or achieve compromises that will allow reform to move forward, although haltingly. Yeltsin will be able to maintain his political authority by balancing social welfare requirements with economic reform necessities. Some outward indicators of this balancing act will be gradual price rises, unemployment benefits, and wage and pension increases. These indicators will result in moderate inflation. On the other hand, Yeltsin will also decrease industry subsidization (although not as much as under Gaydar) and tighten credit, which will increase state industry bankruptcies, although they will not occur at the same rate as under Gaydar's Western-led reform program.

### **INDUSTRY-LED "REFORM"**

Another outcome of the Sixth Congress was the government's realization that the industrialist lobby was still powerful in Russia. Much of the opposition expressed at the Congress was backed by the leaders of state enterprises. These are the people who wrestle daily with economic decline and who will be the ultimate losers should the reform succeed. What the state industry leaders want most is to prevent many of the reforms that will erode their sector. They also champion efforts to preserve the state industries on the basis that, if there is widespread industrial collapse, unemployment would skyrocket and production

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1. This is why there is significant overlap between the positions of the Parliament and the industrialists—many industrialists serve as People's Deputies. One could argue, however, that the two groups have different emphases due to the parochial interests of the industrialists. For example, most Deputies (who are not industrialists) would say they favor an extremely egalitarian privatization program, which would place institutions in the hands of the workers and the "lower" classes. Most industrialists wish to see control of enterprises remain in the hands of management.

would almost halt. Thus, the industrialists support the social welfare program introduced by Parliament, and believe that preservation of the industrial sector is the way to guarantee social welfare. The energies of this group are directed at:

- Heavy subsidies for state enterprises
- A gradual (three-year) rise in fuel prices
- Limits on indebtedness to the West<sup>1</sup>
- Limits on foreign entry into the Russian market<sup>2</sup>
- Worker/manager dominated privatization<sup>3</sup>
- Access to Western markets (defense industrial emphasis on foreign military sales)
- Tax privileges for investment
- Lower tax rates on profit
- Attracting Western investment, but not accepting Western "interference" in the course of reform.

These reforms are designed primarily to further the cause of state industry.

Recently, Yeltsin appears in part to have acceded to the demands of this still powerful interest group. In June, he appointed three "industrialists" to his government to the positions of first deputy and deputy premiers. Probably the most influential of these appointments is Vladimir Shumeiko, who was formerly the deputy chairman of the Russian parliament. Shumeiko, previously a defense plant director, will serve in the post of first deputy premier (this gives him the same status as Gaydar). The appointee to the post of deputy prime minister is Georgy Khizha, an ex-director of a defense factory and recently a St. Petersburg deputy mayor. Yeltsin has stated that Khizha's primary responsibility will be to head the entire industrial sector.<sup>4</sup> Lastly, Viktor Chernomyrdin, a former union gas industry minister, was selected to run Russia's Oil and Gas Ministry. Chernomyrdin is a well-known opponent of freeing energy prices.<sup>5</sup>

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1. "Yeltsin Agonistes," *The Economist*, June 20, 1992, p. 63.

2. "The Revolt of the Industrialists," by Joseph Diskin, *Politics of Soviet Economic Reform*.

3. Conversation with Julian Cooper, Carnegie Endowment for International Peace, July 7, 1992.

4. "Boris Yeltsin: I am Not Hiding the Difficulties and I Want the People to Understand This," Interview with Russian President Boris Yeltsin by D. Muratov and Yu. Sorokin, *Komsomolskaya Pravda*, May 27, 1992, printed in *Central Eurasia: Daily Report*, FBIS-SOV-92103, May 28, 1992, p. 28.

5. "Yeltsin Agonistes," *The Economist*, June 20, 1992, p. 63.

While Gaydar and his team are trying to create an atmosphere for new private sector growth, the industrialists are advocating the use of already existing state industries as the basis for a new market-based industrial sector. The industrialists like Minister Khizha claim that: "The military-industrial complex represents the best of our national industry rather than narrow military interests. The state's duty (my duty) is to act in such a way that these powerful enterprises develop."<sup>1</sup> These new leaders are advocates for state industry, yet they also say they support the move toward a market economy. They only wish to see a safety net preserved until the market is in place.<sup>2</sup> They claim that local governments have no means to support these people and, as of now, the private sector is too small to support large numbers of unemployed. Other more conservative industrialists would like to see the state sector continue to be preserved, even within a market economy. This group feels that the state industries are the home to the best resources and brightest personnel, and, therefore, these capabilities must be preserved intact.

In May, Yeltsin met several times with representatives of the defense industries and appeared sympathetic to their agenda. The industrial lobbyists have made it clear to Yeltsin that his reform program would collapse under the burden of massive unemployment. It appears that Yeltsin (but not necessarily all members of the government economic team) appreciates these arguments and has acceded to some of the enterprise leaders' demands. For example, Yeltsin has promised an extra R200 billion of cheap credit for industry, plus R120 billion for the oil business. He has also postponed the freeing of energy prices. (The R320 billion of additional subsidization will double the government's anticipated second quarter deficit.<sup>3</sup>) In addition, Yeltsin told defense industrialists at a meeting on May 13, 1992, that he supports arms sales as a means of sustaining the defense industries until their conversion is possible.<sup>4</sup>

Therefore, Russia's President appears not only to have acknowledged the problems facing state industries, but is seeking ways to ease their predicament. His recent governmental appointments will provide the industrial lobby not only with support, but real power within the government. On the other hand, the industrialists Yeltsin selected are self-proclaimed advocates of market reform and many officials believe they will work well with the Gaydar government.<sup>5</sup> Also, in June, Yeltsin announced his selection of Gaydar as premier (although he called this a temporary appointment) and has repeatedly expressed his support of Gaydar and his team, even after his other appointments. This suggests that, in the short-term, the government will continue with its reform efforts, but certain key aspects (those most harmful to industry) will be delayed.

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1. "Georgiy Khizha: I represent Major Industrial Interests," Interview with Russian Vice Premier Georgiy Khizha by Correspondent Sergey Krayukhin, *Izvestiya*, May 25, 1992, p. 1.

2. Conversation with Julian Cooper, July 7, 1992.

3. "Yeltsin Agonistes," p. 64.

4. "Yeltsin Meets with Military-Industrial Leaders," *Interfax*, May 13, 1992, printed in *Central Eurasia: Daily Report*, FBIS-SOV-92-094, MAY 14, 1992, p. 29.

5. Conversation with Julian Cooper, July 7, 1992.

It should be noted, however, that the industrialists' reform program is, in the long-term, inherently contradictory. A successful shift to the market can only erode the state sector as more resources are shifted to the private sector. Therefore, economic success may threaten the existence of the state enterprises and the importance of their managers, causing them to reject reform. Also, when the state sector begins to decline, it is likely that many industrialists will attempt to stop the reform effort. Thus, as reform progresses, those industrialists who have not made the transition to the private sector will likely oppose further reform. Likewise, the current brakes that the industrialists are applying to reform (lax fiscal and credit policies designed only to sustain industry) can only create further instability in the economy. This too will eventually affect the state sector. At some point, the industrialists will have to be more explicit as to which economic direction they support.

### **Likely Economic Outcome**

The primary objective of this program is to protect state industry from the worst effects of the Gaydar austerity program. Therefore, the industrialists will attempt to increase state subsidies to industry, lower corporate taxes, and loosen credit. If they are successful, this program will effectively undermine Gaydar's efforts to achieve stability and avoid hyper-inflation. Hyper-inflation makes conducting business nearly impossible—future planning becomes extremely difficult. Furthermore, hyper-inflation is a real disincentive for investment. Profits are quickly eaten by the fast pace of inflation. Russia desperately needs both foreign and domestic investment to build its economy. Hyper-inflation will force investors to look elsewhere.

An economy in the midst of hyper-inflation will also have an enormous impact on those people with fixed incomes, such as pensioners. They will quickly become impoverished as the rise in prices exceeds their monthly incomes.

### **Likely Political Outcome**

If hyper-inflation occurs under an industry-led reform program, Russians will quickly lose faith in the industrialists and Moscow's ability to provide economic guidance. Political disintegration would occur at a more rapid pace, that is, republics may adopt their own measures for combating economic hardship. If certain regions in Russia do gain more political and economic autonomy, this will make it even more difficult for industries/enterprises to conduct inter-regional trade. There will no longer exist a common framework for conducting business relations. Autonomy will also lead to political instability in other areas. For example, class conflict will emerge between those who are benefiting from an industrial program and those affected by hyper-inflation, and economic conflict will arise between the industrial and entrepreneurial sectors.

At this point, those in power in Moscow will have to re-assert order over the economy. To do this, they must have a comprehensive plan that will establish a common basis for economic relations; they can no longer focus only on the needs of industry, while sacrificing overall economic good. Common ground rules and business practices must be used that are universally recognized and understood by all sectors of the economy.

Therefore, the industrialist must ultimately choose re-centralization or movement towards a market economy. Otherwise, continuing chaos will undermine the political system.

### **Effect on the Military**

The dominance of industrialists in deciding economic policy will have some short-term benefits for the military, but will be detrimental in the long run. The more conservative defense industrialists will encourage defense spending in order to preserve their power base. This increase will have short-term advantages for the military in terms of procurement and R&D, but may do less to solve the more critical social problems. Furthermore, defense industry domination of the procurement and development process is not necessarily in the military's best interest, as has been demonstrated in the past.

### **Effect on Defense Industry**

The effect of industry-led reform on the defense industries depends on how one defines "defense industry." An industrialist-led economic program will certainly benefit the defense industries that exist today, especially if large portions of the economy's resources are rededicated to defense. It is not likely, however, that these policies will improve the defense industry in the generic sense. The old regime demonstrated that the defense sector could not shield itself from the failing civilian economy. Even if defense industrialists attempt to isolate themselves from the private sector or go so far as to establish greater central control, they will still be affected by the general economic decline that these systems cause.

### **Likelihood of Implementation**

There is now a chance that the industry lobby will be able to dominate the reform effort completely. A strong industrialist lobby (the All-Russian Renewal Union) has joined with the Democratic Party of Russia (led by Nikolai Travkin) and the People's Party of Free Russia (led by Vice President Aleksandr Rutskoi) to form a political opposition group called Civic Union. This new political organization's members can be found in industry and government, and they also form a large group in Parliament. Yet, while industry-led reform may indeed be implemented, it will not likely be successful. As stated above, the industrialists will reach a point in their reform effort where they will have to sacrifice their power base (the state sector) if market reform is to continue. Some will advocate further reform; others will still attempt to preserve the state sector by emphasizing the need for a strong government role in the economy. If these "conservative" industrialists begin to dominate the political process, the fourth direction of economic reform—a return to a state-run economy—could occur.

### **Indicators of Future Implementation**

The first political indicator that the economy may conform to this "reform" direction is that members of the industrialist lobby will attain prominent positions in the Yeltsin government, and, through these offices, influence the course of reform. First, however, these industrialists will have to co-opt Yeltsin in order to have enough political power to

move forward with the key aspects of their program. These "reforms" can be identified as pro-state industry. Indicators that these reforms are being implemented are:

- Price controls in sectors supporting industry
- Low interest rates on loans to industry
- More and more defaults on government loans to industry without penalties being assessed
- High rates of currency printing.

The result of these policies will be hyper-inflation, and little or no Western aid and investment.

## **RETURNING TO A STATE-RUN ECONOMY**

There is no doubt that proponents of this scenario still exist and will likely become more vocal as the economy continues to deteriorate. Nevertheless, even committed Communists under Gorbachev acknowledged the need to reform the system and allow some de-centralization. The real debates during the pre-coup period concerned the pace of reform, not whether to reform. Thus, advocates of a stronger state system would attempt to re-centralize, but not completely. They would encourage some private activity and certainly more autonomous decision-making at the lower (enterprise) levels. In addition, most (but not all) of these conservatives appreciate the need for economic interaction with the West. They do not, however, support what they perceive as dependence on the West in the form of economic/humanitarian aid and IMF/World Bank lending. In short, supporters of this ideal advocate:

- Re-institution of state control mechanisms
- Limited private sector
- Limited interaction with the West
- No Western economic support.

Essentially, the conservatives not only want to preserve the state sector, but to use it as the basis of economic relations. This approach differs from the industrialists now in the government, who believe that the state sector (home to the best technology and most skilled workers) can lead the reform effort.

## **Likely Political Outcome**

As suggested above, efforts to halt the reform will cause further political and economic disintegration. Relations will be severed between regions that have adopted the "path towards a market" and those areas pushing for re-centralization. A serious break-down in

ties between regions will result in a "feudal" system where communities have few ties with their neighbors.

### **Likely Economic Outcome**

If the economy continues to decline, the citizenry will become disillusioned with "the market" and turn toward the familiar—a centrally planned economy. Nevertheless, retrenchment will be an extremely disruptive and difficult process that will eventually lead to the same economic situation that caused the "Russian" revolution in the first place. This extreme anarchy combined with autocratic attempts to re-centralize may be the impetus for civil war.

### **Effect on the Military**

If Russia begins economic re-centralization, the political struggles that ensue will have an enormous impact on the military. The breakup of the Soviet Union has divided the Red Army into 15 republican militaries; the dissolution of Russia will only further this process. If re-centralization is successful and Russia survives intact, the military-industrial sector will regain prominence. (This is especially true if the regime is worried about domestic upheaval in addition to traditional external enemies.) Defense spending will increase, but the same problems that plagued the military in the past will recur under a similar system. The military will again be working within a supply-dominated economy; it will have difficulty procuring needed and quality equipment. In addition, a centrally planned economic system does not encourage innovation and advances in technology. Russia's weapons systems will fall more and more behind the technology curve. In the social sphere, the military will have less difficulty providing for its forces under this type of system. A decaying infrastructure will cause training and supply problems, however.

### **Effect on the Defense Industries**

In a return to a state-run economy, the defense industries will regain their former position in the nation's economic structure; that is, these industries will have access to the best resources and personnel and will receive priority funding. The backwardness of the civilian sector, however, will continue to constrain progress in the defense sector. Moreover, if the defense industries continue to consume a large portion of the nation's resources, the civilian sector will continue to dwindle, thus exacerbating the defense sector's problems. The inability of the defense industries to develop new generations of weapons systems will continue under this system. The Soviet Union's defense industries were capable of incremental changes in technology, but had difficulty developing radically new technologies and incorporating them into weapons systems. These manifestations of the systemic problems of central planning will continue to plague defense.

### **Likelihood of Implementation**

Attempts to re-centralize Russia will not only jeopardize the reform efforts, but will launch a political struggle between political and economic factions. As this is an issue of national identity and the basic political and economic character of Russia, there is no doubt

that the general population will choose sides. The nation will likely split along geographic lines as well. For example, while certain regions of the country will excel under a market economy, others can only be hurt. A useful analogy is the situation in Czechoslovakia today. Slovakia was the more backward of the two regions; its economy was mostly based on agriculture. The Communist regime attempted to correct this disparity by situating most of the heavy industry in this region. On the other hand, the Czech republic inherited most of the "high-tech" industry established in its pre-Communist period. Therefore, the economic reform movement has affected each of the republics differently. The Czech republic is in a better position going into the transition and is, therefore, more pro-market. Slovakia has suffered most from the current economic austerity program and, in the recent referendum, has voted not only to discontinue the reforms, but to secede.

Many of these same parallels can be seen in Russia today. Areas like St. Petersburg and the Far East are far better suited for the transition to a market economy than heavy industrial regions such as Udmurtia and Gorky. The more progressive regions will fight any attempt to re-centralize, especially if it means jeopardizing already achieved growth and development.

### **Indicators of Future Development**

Probably the best indicator of a return to a state-run economy will be extreme chaos in the spheres of economics and politics. As the Old Guard re-emerges and attempts to re-centralize political and economic institutions, conflict will break out between those regions and organizations that support a market economy and those that support a planned economy. The central government's policies will result in the re-emergence of central planning institutions, centrally controlled prices, and an increase in the number of state-run industries. These are the indicators that retrenchment is occurring.

## CONCLUSION

When assessing the future direction of reform in Russia, it is important to distinguish between what is most likely to be implemented versus what is most likely to succeed. As stated earlier, a successful reform effort will be measured by its ability to (1) improve the general economic situation and (2) provide a common framework for conducting economic relations. It may be that the reform direction Russia embarks on in the short-term will not achieve long-term success. In this case, a new direction will have to be determined.

This paper concludes that Russia will adopt either the Russian-led or Industry-led direction of reform. It also concludes that only one direction—Russian-led reform—is likely to provide economic growth and a basis for national economic relations. However, this reform program will cause severe economic hardship in the short-term. Its attempts to limit inflation and decrease the debt will affect the common citizen the most. At the same time, when public opinion demands that Yeltsin relax some of these austere programs, the result will be economic instability. These fluctuations in the economy will severely test the strength of the government and the endurance of the people. In the long run, however, this program will have the best chance of accomplishing financial and monetary stability, as well as social protection. If the Yeltsin government is successful in achieving this balanced program, it will also strengthen democratic traditions in Russia. The longer a democratic government is in power in Moscow, the more likely it is that democracy will become a Russian institution. Thus, the future of this reform direction depends on the political will of Russia and the ability of its citizens to endure severe economic hardship and recognize that this will achieve long-term gains.

On the other hand, the Industry-led program may provide short-term stability by preserving elements of the old structure. Government subsidization will ensure relative stability (low unemployment, continued productivity) in those sectors that receive support. This stability may encourage the citizenry to support the industrialists further. Unfortunately, however, an economic program with the sole focus of propping-up state industry will fail in the long-run. Hyper-inflation will ensue under such a program, causing investment capital and foreign aid to disappear. People on fixed incomes will suffer most. In addition, hyper-inflation will make the political leadership in power extremely vulnerable. Regional governments will attempt to shield themselves from Moscow's policies by seeking further economic/political autonomy. Disputes will emerge between classes (those affected by hyper-inflation and those benefiting from government support) and between economic sectors (entrepreneurs versus industrialists).

At this point, it will be necessary to alter the direction of reform to start moving toward a market, or to recentralize economic relations. The first option, as discussed above, will eventually lead to a stronger economy through a more rational distribution of resources, and will strengthen the democratic process by encouraging more individual participation in the economy in both the supply (small business) and demand (consumption) sides. The latter option—recentralizing economic relations—will likely be an extremely disruptive and difficult process because most of the old command linkages have been broken and, in some cases, new market ties already formed. It will be more difficult, therefore, for this reform

effort to establish a common basis for internal trade. In addition, the re-institution of a state-run economy will only revisit the same systemic problems that existed for 70 years under Communism. That is, it will be more and more difficult to achieve economic and technological growth under a centrally organized economic system. In the end, an Industry-led reform program can only delay economic recovery.

The military and the defense industry can only benefit from economic growth and a nationally integrated economy. Therefore, they will most likely prosper in the long-term under market reform and flounder under the effort to re-centralize. Nevertheless, these sectors will suffer short-term economic hardships before these benefits are evident. Unfortunately, enduring five to seven years of severe economic strain will test the political will of any country. It is not likely that any reform direction will have this long to implement its policies. Russia will probably implement and reject a number of programs. It is only hoped that, in the end, the one program that can ensure economic revival and political promise for the entire country—Russian-led reform—will endure, and that, in the process, civil conflict does not occur.

**APPENDIX**

**REVIEW OF FOUR REFORM PATHS**

	<b>Economic Policies</b>	<b>Economic Effects</b>	<b>Political Effects</b>	<b>Effects on Military</b>	<b>Effects on Defense Industries</b>	<b>Indicators</b>
<b>IMF-led reform</b>	<ul style="list-style-type: none"> <li>• Tight fiscal policy</li> <li>• Tight credit policy</li> <li>• New tax-collection system</li> <li>• Rapid freeing of prices</li> <li>• Stringent bankruptcy law</li> <li>• Cooperation with IMF/World Bank</li> <li>• Citizen-involved privatization</li> <li>• Rapid privatization</li> </ul>	<ul style="list-style-type: none"> <li>• Increase in class disparity</li> <li>• Unemployment</li> <li>• Control over inflation</li> <li>• Provision of Western aid</li> </ul>	<ul style="list-style-type: none"> <li>• Criticism of Western involvement in decisionmaking</li> <li>• Backlash against class disparity</li> <li>• Undermines Yeltsin government</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Large budget cuts</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Budget increases</li> <li>• Advantages of healthy infrastructure</li> <li>• Ability to purchase high-tech</li> <li>• Increased quantity/quality of supplies</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Increased bankruptcies</li> <li>• Dismantlement of sector</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Rebirth of new sector</li> <li>• Access to higher quality components</li> </ul>	<ul style="list-style-type: none"> <li>• Gaydar remains in power</li> <li>• Reform pace is rapid</li> <li>• High unemployment</li> <li>• Low inflation</li> <li>• Increased Western aid/investment</li> <li>• Increased bankruptcies</li> </ul>
<b>Russian-led reform</b>	<ul style="list-style-type: none"> <li>• Looser fiscal policy</li> <li>• Looser credit policy</li> <li>• Phased freeing of prices</li> <li>• Expenditure on social welfare</li> <li>• Privatization of light/service/consumer industry rather than heavy industry</li> </ul>	<ul style="list-style-type: none"> <li>• Increased social welfare</li> <li>• Slower pace of reform</li> <li>• Less acute economic dislocation</li> <li>• Western aid</li> </ul>	<ul style="list-style-type: none"> <li>• Continuing support of Yeltsin</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Fewer budget cuts</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Eventual budget increases</li> <li>• Advantages of healthy infrastructure</li> <li>• Ability to purchase high-tech</li> <li>• Increased quantity/quality of supplies</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Erosion of state sector</li> <li>• Creation of new industries to support defense</li> <li>• Foreign military sales encouraged</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• New defense sector with remnants of old</li> </ul>	<ul style="list-style-type: none"> <li>• Yeltsin manipulates reform</li> <li>• Wage/pension increases</li> <li>• Gradual price rises by sector</li> <li>• Socially protected unemployment</li> <li>• Tentative Western aid/investment</li> <li>• Moderate/high inflation</li> <li>• Some bankruptcies</li> </ul>

## REVIEW OF FOUR REFORM PATHS (Continued)

	<b>Economic Policies</b>	<b>Economic Effects</b>	<b>Political Effects</b>	<b>Effects on Military</b>	<b>Effects on Defense Industries</b>	<b>Indicators</b>
<b>Industry-led reform</b>	<ul style="list-style-type: none"> <li>• Worker/manager privatization</li> <li>• Maintenance of state sector</li> <li>• Loose credit for industry</li> <li>• Loose fiscal policy</li> <li>• State subsidization of industry</li> <li>• Limited freeing of prices</li> </ul>	<ul style="list-style-type: none"> <li>• Hyper-inflation</li> <li>• Decreased investment</li> <li>• No Western aid</li> </ul>	<ul style="list-style-type: none"> <li>• Industrialists dominate political process</li> <li>• Increasing regional autonomy</li> <li>• Eventual crisis in political system</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Some benefits in procurement/R&amp;D</li> <li>• Less support for troops</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Less ability to procure high-tech</li> <li>• Poor living for soldiers</li> <li>• Less infrastructure support</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Preservation of defense industry</li> <li>• Hyperinflation</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Industry affected by general economic decline</li> </ul>	<ul style="list-style-type: none"> <li>• Industrialists dominate government</li> <li>• Hyperinflation</li> <li>• Few bankruptcies</li> <li>• Prices controlled in industry-supporting sectors</li> <li>• Low interest rates on loans to industry</li> <li>• Defaults on loan payments</li> <li>• Printing currency at high rate</li> <li>• No Western aid/investment</li> </ul>
<b>Retrenchment</b>	<ul style="list-style-type: none"> <li>• Establishment of central planning institutions</li> <li>• Centrally controlled prices</li> <li>• Growth of state sector industries</li> <li>• Heavy subsidization of industry</li> </ul>	<ul style="list-style-type: none"> <li>• Economic chaos</li> <li>• Barriers to domestic regional trade</li> </ul>	<ul style="list-style-type: none"> <li>• Inter-regional instability</li> <li>• Conflict</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Increase in defense spending</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Increase in defense spending</li> <li>• Inability to procure high-tech</li> <li>• Less infrastructure support</li> <li>• Poor living for soldiers</li> </ul>	<p><b>SHORT-TERM</b></p> <ul style="list-style-type: none"> <li>• Preservation of defense sector</li> <li>• Defense industries are budget priority</li> </ul> <p><b>LONG-TERM</b></p> <ul style="list-style-type: none"> <li>• Industry affected by general economic decline</li> </ul>	<ul style="list-style-type: none"> <li>• "Old Guard" controls government</li> <li>• Emergence of central planning institutions</li> <li>• Controlled prices</li> <li>• Increased number of state industries</li> <li>• Increased conflict in political and economic spheres</li> </ul>

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