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Levers of Law Reform: Public Goods and Russian Banking

Patricia A. McCoy*

Today, a half-decade after the demise of the Soviet Union, Russia wobbles precariously between economic transformation and civil strife. After five painful years of market reforms, inflation is down, unemployment is falling, and real incomes are rising. But for many, that progress is too little, too late. Citizen resentment is smoldering, catapulting the communists into the forefront of the summer 1996 presidential elections and fueling fears of a coup, dissolution of the parliament, martial law or civil war. To its vast credit, Russia avoided those catastrophes and successfully navigated the elections, but its political stability remains fragile.

This anxious state of affairs thus raises the question whether commercial law reforms designed to enforce market discipline in Russia were too late.¹ There has been general agreement, both among adherents of the "big bang" theory of reform and those who preferred to see economic

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¹ By law reforms designed to enforce market discipline, I mean statutes, rules and other laws that promote market efficiency by penalizing financial losses. In the banking context, such measures include legally-mandated loan underwriting standards, interest rate deregulation, restrictions on insider loans, collateral forfeiture laws and bankruptcy provisions. See, e.g., infra notes 38-41 and accompanying text. Although privatization laws may also promote market efficiency in a broader sense by providing a potential framework for rewarding gains, most such laws in post-communist countries either did not penalize financial losses at their inception or did so only weakly. Accordingly, I use the term “market discipline” herein only in the narrow, negative sense of penalizing losses. The focus of this Article will be on market discipline measures exerted through the banking sector.

change proceed at a slower pace, that market-oriented laws in Russia cannot be adopted off-the-rack from Western legal codes. There has not been a consensus, however, on the optimal speed and sequencing of market discipline laws.

Some Western advisers subscribe to the view that market discipline laws should have been implemented quickly, both to hasten the creation of new jobs and to avoid the market scandals that could discredit reforms. Others believe that economic liberalization had to precede market discipline laws, and that any attempt to rush through such laws would have been doomed from the start. Those proponents assume, in essence, that market discipline reforms could not take place until the political institutions and psychological attitudes conducive to reform had taken root.

Much hangs in the balance of this debate. At stake is the credibility of economic reforms, the welfare of individual citizens and the very survival of Russian democracy. Accordingly, now that reforms in Russia have been underway for five years and President Yeltsin's first term is at an end, it is well and meet to consider whether the transition could have been less painful had accelerated law reforms enforced market discipline.

There is no easy answer to this question. Central planning was an abject failure and left the Soviet economy in ruins, generating mass protests for radical economic liberalization. At the same time, Russia, of the newly-independent states, lived under communist rule the longest and had the least entrepreneurial heritage to fall back on from its pre-revolutionary, tsarist days. Russia has no tradition of democracy, and democratic institutions are still in their infancy. Civil society, which was brutally suppressed under communism, is only beginning to take on life. Unlike in post-war Germany or Japan, moreover, the old leadership was not put down through military conquest and resurfaced in new positions. Far from being written on a tabula rasa, then, market discipline reforms in Russia are heavily freighted with the past.

Nowhere has this been more true than in the reform of Russian banking. The Russian Federation enacted major bank privatization legislation in December 1990, a year before the Soviet Union even disbanded. The 1990 legislation, however, did little to impose market discipline on the banking system or on borrowers. In particular, the 1990 laws were notable for failing to prohibit self-dealing by bank directors and shareholders. No accident, that omission was symptomatic of the entire Soviet approach to finance, in which the banking system served to subsidize state priorities rather than allocate funds to their most productive use. Soon after enactment of these laws, the fruits of that omission became apparent as the old communist-era factory managers successfully maneuvered, in violation of basic precepts of sound banking, to gain control of private banks and to milk those banks for subsidies veiled as low-interest loans.

A scant half-decade later, however, the situation has changed significantly. New legislation has begun to address bank conflicts of
interest, the Central Bank of Russia has closed hundreds of banks that failed due to delinquent loans to shareholders, and central bank loan subsidies to former state-owned firms have largely stopped. By any account, these developments represent a sea change. Undeniably, those reforms have also proved highly divisive, triggering armed conflict, constitutional crisis and the ouster of three central bank chairmen. With democratic principles hanging in the balance, banking reforms have survived so far, but their durability remains in doubt.

The course of banking law reforms in Russia raises fundamental questions for students of law reform in formerly planned economies. What social, economic and political conditions caused the drafters of the initial 1990 legislation to be impervious to conflict-of-interest concerns? Given those conditions, what accounted for the significant subsequent turnabout in legal norms and the dislodging of entrenched interests that those reforms represented? Was conditional financing from the International Monetary Fund, or instead domestic pressure, primarily responsible for reform? Could the resulting reforms have been accelerated and, if not, why? Finally, what was the cost of delayed reforms and what are their future prospects?

In analyzing these problems, it is useful to consider the theory of public goods. Public goods are benefits to a group such that if one member enjoys the benefit, all other members of that group will necessarily enjoy it as well. In capitalist systems, the concept of private property results in a sharp demarcation between public goods that must be shared with others and private goods that may be consumed alone. In the Soviet Union, however, most goods except consumer durables were provided in the form of public goods, both due to the collectivist ethos and strict prohibitions on private ownership. In the household sphere the state provided workers with their housing and livelihoods as well as innumerable other benefits. In the commercial sphere the state was the generous and sole legitimate provider of financing to state-owned enterprises.

The transition from a command to a market economy thus raised unique problems of public goods for banking law and policy. In the Soviet command economy, firms regarded financing as a public good that government banks supplied. Soviet finance, however, hastened the decline of the Soviet economy by diverting financial resources from efficient enterprises to inefficient uses. Thus, a major challenge in the Russian transition to market-based banking was to develop a banking system that would redirect funds to their best use.

To do that, it was necessary to alter firms' and citizens' expectations that the government would continue to provide subsidized financing in the form of a public good. That expectation collided with a key tenet of market discipline, that firms should not receive credit unless they are creditworthy and have the financial wherewithal to repay their loans. The Soviet system of finance likewise collided with other market tenets, namely that the price
of credit should be calibrated for risk and that the market, not the
government, allocates capital most efficiently.

Market-oriented banking codes have attempted to deal with concerns
about efficient allocation of credit by adopting loan underwriting norms,
by limiting loans of last resort, and by regulating conflicts-of-interest so as
to forestall borrowers from operating banks as captive financing arms.
When bank privatization legislation was enacted in Russia in 1990,
however, such provisions were unimaginable. In 1990, prices were still
controlled and nearly all domestic constituencies (apart from a handful of
reform economists) felt they had nothing to gain and everything to lose
from a halt to subsidies. State-owned firms that were insolvent could not
qualify for market-based credit, and their solvent counterparts were less
skilled in competing for financing on the market than in lobbying the
government for funds. Thus, at the beginning of Russian reforms, there was
a social consensus in favor of subsidies and against market-based finance.

Given that seemingly unassailable consensus on the one hand and the
disastrous economic effects of Soviet finance on the other, the difficult
question was whether market discipline reforms could be instituted in
Russia in a manner consistent with democratic norms. This Article
examines that question through the prism of public goods, from the start
of the reform process through the end of President Yeltsin's first term in
August 1996. While a few legal scholars have employed public goods
analysis in the post-communist context, none has yet consciously used
that analysis to examine situations in which there was broad social
consensus against reform. Indeed, most discussions of public goods
assume that opposing viewpoints already exist and focus on the
prerequisites and consequences of mobilizing those latent opposing views.
The transition to market discipline in Russia, however, presented a very
different problem: how to generate dissent in the face of a social
consensus that was economically dysfunctional, and how to do so through
democratic means.

Public goods theory offers a theoretical explanation of how to institute
market discipline laws through democratic means in post-communist
countries that lack a pre-revolutionary capitalist tradition. The Russian
experience suggests that at the outset of reforms there will be political
support for laws protecting private property and improving consumer
choice (such as privatization laws). But there will be little initial support
for laws designed to enforce market discipline (such as bans on
government subsidies and bankruptcy laws) because no organized group
will perceive any advantage from such measures. As subsidies fuel

2. For early, useful works in this regard, see Robert D. Cooter, The Theory of Market
Modernization of Law, 16 INT'L REV. L. & Econ. 141 (1996); Jonathan R. Macey & Enrico
Colombatto, Public Choice Theory and the Transition Market Economy in Eastern Europe:
Currency Convertibility and Exchange Rates, 28 CORNELL INT'L J. 387 (1995); Paul B.
Stephan III, Barbarians Inside the Gate: Public Choice Theory and International Economic
3. See, e.g., James M. Buchanan & Gordon Tullock, The Calculus of Consent:
inflation, however, the public will demand relief. Likewise, the more entrepreneurial elements of the business community will come to realize that inflation will not slow unless subsidies are halted. As the business community's perception of subsidies as a public good in infinite supply begins to change, stronger firms and banks can be expected to oppose subsidies.

The effect of such reforms upon Russian democracy, however, remains uncertain and gives grounds for both optimism and pause. As recent experience has shown, the social toll of Russian monetary and banking reforms has been incalculable. Public confidence in the commercial banking system was never strong to begin with and has been shaken by the failure of hundreds of Russian banks burdened by delinquent shareholder loans. The stoppage of subsidies put millions of Russians out of work, at least in the short term, and caused their real incomes to drop. Since 1993, political in-fighting over the cessation of subsidies has been nearly constant, resulting in market crises and President Yeltsin's October 1993 armed assault on the parliament. Recently, nonetheless, Russia successfully completed two rounds of presidential elections and voted resoundingly, despite the pain of anti-subsidy policies, against a return to communism. Thus, Russian democracy is alive but terribly frayed.

I embark upon this analysis with several normative assumptions. For the sake of simplification, I assume that potential consumers of public goods tend to maximize their economic self-interest more often than not in economic policy matters. Particularly in matters such as joblessness and banking, such a motive cannot be overlooked. I further assume that the Soviet economy had collapsed by 1990-91, that communist central planning had failed and that the larger social good would be best served in Russia if, in the long run if not in the short run, capital was redirected toward more efficient uses. Finally, I proceed on the assumption that democracy is of crucial importance in Russia and that one task of legal scholarship should be to examine how commercial law reforms can be accomplished with the least individual pain, consistent with democratic values.

In undertaking this analysis I am also mindful that public goods theory has distinct limitations. Public goods theory cannot describe the complex Russian reality in its entirety, particularly given data constraints, the rapidly changing conditions in Russia, and the limited Western understanding of Russian conditions and mores. It can, however, provide a useful heuristic tool for understanding certain aspects of that reality.

Public goods theory has also been criticized for ignoring motivations such as altruism, collectivism and ideology. That is certainly a fundamental concern in post-communist economies such as Russia, which

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4. John Maynard Keynes remarked in a similar vein in 1925: [The economic system of Soviet Russia [in the early 1920s] has undergone and is undergoing such rapid changes that it is impossible to obtain a precise and accurate account of it. . . . Almost everything one can say about the country is false and true at the same time.]
followed in the wake of strongly ideological systems. There can be no doubt that lingering communist norms impeded the adoption of market discipline in Russia.\(^5\) At the same time, it is remarkable that the on-going transition from subsidies to market discipline was accomplished largely (although not entirely) through democratic means and in the face of communist ideology. It is important not to overstate this proposition, because democratic tenets were breached at several points during those reforms and communist ideals still live on in large segments of the Russian populace today. Nevertheless, voters resoundingly rejected a return to communism in the 1996 Russian presidential elections. From a theoretical perspective, then, public goods analysis can provide useful insights into the degree to which communist ideology lost sway during the progress of economic reforms.

Public goods theory has also been censured as morally impoverished by appearing to sanction narrow self-interest over the pursuit of the broader social good.\(^6\) In leveling that reproach, moral critics of public goods theory often mistake its descriptive claims for normative claims. Certainly, public goods theory, as a descriptive tool, will often identify outcomes in which narrow group interests prevail at the expense of the broader polity. But that will not always be the case. In other contexts, public goods theory will identify outcomes that are wealth-maximizing in the aggregate sense and that thus serve the larger public good. That is particularly the case in transition economies where severe macroeconomic shocks can serve as a catalyst for defeating rent-seeking by old communist elites in favor of broadly beneficial law reforms.

Section I of the Article provides an overview of the theory of public goods and explores its significance for the transition from communism to a market economy. Section II discusses the Soviet system of financing and the Soviet perception of financing as a public good. Section III employs public goods theory to examine how Soviet-era managers co-opted the drafters of the 1990 bank legislation to include provisions which enabled those managers to capture private banks and use those banks as a conduit for state subsidies. Section IV uses public goods analysis to examine how the former Party elite wrested control of the refinance facilities of the Central Bank of Russia to assure continued access to subsidies once bank privatization was underway. In Section V, the Article examines how the economic repercussions of subsidies after economic liberalization, including inflation and financial crises, altered perceptions about the nature of subsidies as a public good so as to generate domestic support for market discipline reforms. Section VI considers the future course of those

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\(^5\) I would like to particularly thank Tobias M.C. Asser for his insights into the role of ideology in economic reforms in Russia.

reforms and their implications for Russia's future stability. The Article concludes by discussing the larger theoretical ramifications of recent Russian events for the theory of public goods.

I. Public Goods Theory and Transition Economies

While no one theory can settle the question of the optimal timing and sequencing of commercial law reforms in post-communist economies such as Russia, public goods theory may offer hitherto unrecognized insights into those issues. Public goods analysis holds out intriguing possibilities in this regard because former communist regimes such as the Soviet Union were organized to provide the bulk of goods in public rather than private form. Public goods theory has particular relevance to banking law reforms in Russia, both because banking reforms necessarily involve economic decisions and because subsidies by the central planning authorities provided the bulk of financing in the Soviet Union. As such, Soviet financing was a quintessential public good that was provided by the state.

Public goods theory, in brief, examines the economic incentives that encourage or thwart the provision of public goods. Such goods are benefits that must be provided to all members of a group if they are to be provided to any member of that group at all. Roads and clean air are examples of public goods, as are cash subsidies, entry barriers, tax loopholes, restraints on product substitutes and price regulation. Private firms such as banks and manufacturers may prize public goods because those goods can provide unique sources of revenue that can only be secured through the exercise of coercion by the state. While such goods can be valuable whether a firm is profitable or in decline, public goods in the form of subsidies are an especially attractive source of revenue when a firm's market activities are losing money.

A principal task of public goods theory is to identify when individuals will organize in pursuit of a public good. As scholars have recognized, public goods present unique organizational problems because the individuals who pay for public goods cannot exclusively enjoy their benefit. Everyone in the group may want to enjoy that benefit, but ordinarily will not want to pay for their fellow members' shares. Conversely, each member knows that if someone else pays for the benefit, he or she will enjoy it cost-

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free, giving rise to the familiar free-rider problem.8

Given that problem, one of the principal aims of public goods theory is to identify the circumstances in which one or more members of a group will have incentives to pay for a benefit, such as low inflation, that fellow members will also automatically enjoy. According to the theory, groups are most likely to mobilize in favor of a public good when the personal gain to one or more group members exceeds the total cost of obtaining the benefit.9 The policy that will prevail will depend, in part, on how much opposing parties spend, whether the costs outweigh the benefits, and whether the individual costs are relatively small and easily masked.

In addition to these considerations, instituting market discipline laws in transition economies poses a more basic, antecedent public goods concern. Public goods theory, as it has been discussed with respect to mature capitalist economies, takes it as a given that social differences of opinion exist over which public goods the government should provide. The the-

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8. See, e.g., OLSON, supra note 7, at 20-21. Edward Rubin has criticized the free-rider analysis for “sanitizing” traditional interest-group theory of its normative criticisms of privilege and class. See Rubin, supra note 7, at 11.

9. Early works posited that this is most likely to occur in small groups, particularly groups marked by a fair degree of inequality and where one or more members stand to gain a disproportionate share. Those same works predicted that large groups are least likely to take action to obtain a public good because no one individual stands to benefit enough personally to shoulder the cost to the entire group. Mancur Olson has argued in this regard that large groups will successfully organize lobbying campaigns for public goods only when they are able to attract members either through coercion or through individual side benefits, such as cheap insurance or technical advice and education. Absent such side benefits, small groups would be expected to lobby more effectively for public goods than large groups. Large groups would be more likely to lapse into inaction, representing a failure of collective action. See OLSON, supra note 7, at 33-34, 44, 49-63, 132-33; MANCUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES 41 (1982) [hereinafter OLSON, THE RISE AND DECLINE OF NATIONS]. See also George J. Stigler, Free Riders and Collective Action: An Appendix to Theories of Economic Regulation, 5 Bell. J. Econ. & Mgmt. Sci. 359, 362 (1974).

This version of public goods theory has since been questioned for underestimating the ability of larger groups to mobilize in furtherance of their shared goals. See, e.g., RUSSELL HARDIN, COLLECTIVE ACTION 38-49 (1982); Geoffrey P. Miller, Public Choice at the Dawn of the Special Interest State: The Story of Butter and Margarine, 77 Calif. L. Rev. 83, 85 (1989); Rubin, supra note 7, at 12-13; Lars Udén, Twenty-Five Years with The Logic of Collective Action, 36 Acta Sociologica 239, 241 (1993). Critics have noted that large organizations engage in collective action far more often than the theory would predict. Some critics also maintain that voting under the theory should present collective action problems, because voting is the quintessential situation in which one individual’s act is unlikely to make a noticeable difference in outcome. Nonetheless, voters do turn out in impressive numbers and on occasion make their collective protests heard. See, e.g., DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 23-24, 28-29 (1991); Richard A. Posner, supra note 7, at 340-41; Eric A. Posner, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 U. Chi. L. Rev. 133, 139 n.12 (1996). In response, other commentators have pointed out that voting makes sense either because it requires relatively little expenditure of effort, because it satisfies a desire for civic participation or both. See OLSON, THE RISE AND DECLINE OF NATIONS, supra, at 28-29; Edward L. Rubin, Public Choice in Practice and Theory, 81 Cal. L. Rev. 1657, 1668 (1993) (reviewing FARBER & FRICKEY, supra). See also Dwight R. Lee, Politics, Ideology, and the Power of Public Choice, 74 Va. L. Rev. 191, 193-95 (1988).
ory's stated task is then to examine whether and when latent groups will organize to lobby for public goods that are in their respective self-interests. But what if there is broad social consensus in favor of a public good that has proven economically ruinous on a macroeconomic level? Does public goods theory suggest a way to cut the Gordian knot so as to mobilize self-interest in aid of the larger social good? And if so, does it do so in a way that does not undermine democratic mores, let alone the very fabric of society?

This is the problem that confronted Russian banking reforms in the early 1990s and that still confronts those reforms today. Given the abject failure of Soviet finance, an overriding goal of market-based law reforms in Russia was to transform the finance system from one that rewarded inefficiency through subsidies to one that rewarded efficiency through market discipline. The difficulty, however, was how to achieve that change in the face of near-universal opposition and countervailing ideological mores.

When Russia's bank privatization law was passed in December 1990, there were few private enterprises and most firms were owned by the state. Numerous state-owned firms were insolvent or teetering on the brink of financial ruin and adamantly opposed a stoppage of subsidies. Those firms had little experience competing in the market, had few wares or services that anyone wanted to buy and had little chance of securing market-based finance. With their market revenues dwarfed by their expenses, those firms (and their managers) were desperate for government subsidies to survive.

Individual citizens likewise opposed a subsidy cut-off because the overwhelming number of those individuals worked for those same state firms and were dependent on those firms for their livelihoods. In addition, the collectivist ethos of sacrifice for the common good still persisted (albeit in a weakened and oft-discredited form) and citizens harbored deep suspicions toward “speculation” and “profiteering.” Hence, at the outset of reforms in Russia the social consensus in favor of subsidies and against market discipline measures seemed well-nigh insuperable.

From a market point of view, however, Russian finance needed to transform itself from a system that did not allocate scarcity to one that did. A major task of market-based law reforms was thus to create an environment in which support for market discipline could emerge from the old pro-subsidy consensus. To accomplish such a change in a democratic manner called for nothing short of a radical overhaul of public attitudes.

To examine how such a transformation could occur, it is useful to make a foray into an obscure corner of public goods theory involving the distinction between what economist Mancur Olson has termed inclusive and exclusive public goods. Some public goods, such as air, are inclusive public goods in the sense that they are in superabundant supply and will not decline in any perceptible amount per person, regardless of the size of the group. Other public goods, known as exclusive public goods, are visibly scarce in the sense that people believe the per capita share of those goods will decline as the number of recipients increases. Per capita shares
can decline either because the individual share is smaller or because the marginal cost to the beneficiary that is associated with that share exceeds its marginal benefit.  

Consequently, a group that is considering an exclusive public good will face two choices: either to maximize the per capita shares of its members by capping the size of the group or to forego the exclusive public good altogether in favor of an inclusive good. If the group decides to cap its size, it can do so either by designating a sub-group of beneficiaries or by winning the adoption of entry barriers designed to bar new membership and to encourage existing members to leave. If, on the other hand, the group decides that seeking an exclusive public good is too costly, it can simply pursue an inclusive public good.

These dynamics mean that interest groups seeking exclusive public goods are more prone to internal fissures and are less stable than groups that seek inclusive public goods. A group that reserves exclusive benefits for some but not all of its members risks alienating those members who will not receive the benefits. By the same logic, groups that lobby for exclusive public goods can expect opposition from other groups that are denied those goods.

Thus, the internal cohesion of a group can depend on which type of public good the group is pursuing, or, to be more precise, on which type of public good the group believes it is pursuing. As the latter statement suggests, there is a strong psychological element to the distinction between inclusive and exclusive goods. Goods are exclusive when group members believe that expanding the group will reduce their own share of the good. Similarly, goods are inclusive when group members believe that the good is sufficiently abundant that their own share will not shrink even if the group expands. The few scholars who have written on this subject in the context of mature capitalist societies have tended to assume that the distinction between inclusive and exclusive public goods is relatively static. In other words, theorists have tended to assume that citizens will by and large agree on the degree to which a good is abundant or scarce.

In transition economies, however, any such assumption is misplaced. In comparison with their counterparts in mature capitalist societies, Soviet citizens and enterprises were more prone to regard certain public goods, including financing, as commodities in infinite supply. Put differently, before the breakup of the Soviet Union, financing was generally viewed as an inclusive public good. There was little public perception that money was a scarce resource or that subsidies to one firm adversely affected subsi-

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10. See Olson, supra note 7, at 36-38; Olson, The Rise and Decline of Nations, supra note 9, at 67; Hardin, supra note 9, at 17-20; Udéhn, supra note 9, at 241. Because all goods, strictly speaking, are scarce, the terms inclusive and exclusive goods refer less to a dichotomy and more to a range of possibilities arrayed along a continuum.

11. For discussions of these aspects of public goods, see Olson, supra note 7, at 36-38; Olson, The Rise and Decline of Nations, supra note 9, at 67; Posner, supra note 7, at 354-55; Stigler, supra note 7, at 4; Udéhn, supra note 9, at 241. Note that entry barriers can either be used to maximize the per capita value of an exclusive public good or as a substitute for an exclusive good.
dies to other similarly-situated firms. Similarly, there was little public appreciation that subsidies exacted an economic toll in the form of shortages and inefficiency.\textsuperscript{12}

Thus, at the fall of the Soviet Union in 1991, the commonly-held view that subsidies were an inclusive public good could be expected to result in specific organizational dynamics. Most state-owned firms could be expected to prefer subsidies to non-cash public goods because their other sources of revenue had dried up. Under the guise of privatizing the banking sector (thus appeasing popular sentiment in favor of economic liberalization), those firms could be expected to lobby for early banking legislation that would allow them to capture banks and to use those banks as a conduit for continued government subsidies. The cost-push effect of those subsidies, however, would aggravate inflation and erode the buying power of the subsidies that failing firms had just won. Those firms and the banks they controlled could then be expected to seek legal caps on the total number of subsidy claimants.

Such pro-subsidy sentiment would mobilize immediately because the old organs of power--ministries, state enterprises and those organizations sympathetic to the Communist Party that were not subsequently outlawed--emerged from communism bloodied but well-organized. That coalition had long since absorbed the startup costs of lobbying and thus could seek legislation for only a small marginal expenditure.\textsuperscript{13}

Thus, public goods theory would expect pro-subsidy forces to have a substantial lead in lobbying and early banking legislation to bear their mark. Conversely, the theory would suggest that anti-subsidy sentiment would not coalesce overnight and would face significant organizational barriers. In Russia, those impediments were particularly high because Russia emerged out of the ruins of the old Soviet Union almost bereft of civil society. The Soviet Union had forcibly repressed most voluntary group activities, save for groups that were organized and sanctioned by the state or the Party. Similarly, private businesses had historically been outlawed and legitimate private sector activity in Russia in 1990 was negligible despite some nominal liberalization in the late 1980s.\textsuperscript{14} As a consequence, in 1990, the entrepreneurial sector that might have served as an ally to the pro-subsidy forces was only beginning to materialize. In the interim, the pro-subsidy coalition seized the opportunity to mold the 1990 bank legislation to its objectives.

\textsuperscript{12} C\textup{f.} Anders Åslund, The Gradual Nature of Economic Change in Russia, in Changing the Economic System in Russia 19, 27 (Anders Åslund & Richard Layard eds., 1993); Thomas E. Owen, Russian Corporate Capitalism from Peter the Great to Perestroika 98 (1995).


\textsuperscript{14} The black market economy was an important exception, but that economy pursued profits through other means, particularly criminal conduct. See infra notes 25-26, 61 and accompanying text.
Simultaneously, however, the demise of the U.S.S.R. caused Russia to experience a rapid succession of economic shocks that would later prove to be a catalyst for attitudinal change. By late 1991, price controls had resulted in such severe food shortages that hunger was rampant and some citizens were near starvation. With the economy on the verge of a collapse, newly-elected President Yeltsin had little choice but to deregulate most prices, which he did on January 1, 1992. Food soon returned to the shelves, but prices rapidly surged to levels approaching hyperinflation.¹⁵

Due to those economic shocks, public goods theory would predict an attitudinal rift in the Russian business community, with ripple effects in the public at large. The worst-off firms could be expected to cling to subsidies because they had no other significant source of income, having nothing that customers wanted to buy. Conversely, as subsidies fueled inflation, the better-off firms would come to realize that their marginal harm from inflation outweighed their marginal gain from subsidies. What were once seen as limitless subsidies would suddenly be seen by those firms as scarce resources whose overuse carried severe negative external consequences. To couch the phenomenon in public goods terms, Russian entrepreneurs would begin to view subsidies as exclusive rather than inclusive once they realized that any gains from added subsidies would be more than wiped out by inflation. Public goods theory would therefore expect stronger firms eventually to support new, inclusive public goods in the form of reduced inflation and an across-the-board halt to subsidies.

Such opposition would take time to materialize, however. After the fall of the Soviet Union in December 1991, the entrepreneurial sector was free to organize politically, but high organizational costs continued to discourage the formation of an anti-subsidy coalition. New enterprises needed time and funds to launch their business operations; they could scarcely afford to divert their resources early on to finance and mount a political campaign.¹⁶ Likewise, political mobilization entailed high, fixed startup costs that the established pro-subsidy lobby had already absorbed.

In addition, the entrepreneurial sector faced high informational barriers to organizing against subsidies. Some time would have to pass before inflation's effects were felt and before market principles were sufficiently familiar so that the link between inflation and subsidies was understood. Even after the fall of communism, information often remained closely held and financial transparency was seriously wanting. In-bred lack of trust and fears of a communist comeback also discouraged organizing. For these reasons, public goods theory would expect opposition to subsidies to be slower to form.

Nonetheless, public goods theory would predict an anti-subsidy lobby to organize eventually. The catalyst would occur as viable firms realized that inflation was eroding their working capital and that inflation would

¹⁵. See infra notes 139-41 and accompanying text.
not drop until subsidies came to a halt. A subsidy halt would also bolster the position of those firms by eliminating their weaker competitors. Similarly, a backlash could be expected to develop among firms that were excluded from subsidies, as their competitors successfully lobbied for measures designed to hoard state subsidies for themselves. With the passage of time, the stronger segments of the Russian business community would accumulate capital to foot the bill for lobbying. Thus, entrepreneurs who were excluded from subsidies or who concluded they would be better off with low inflation would eventually lobby hard for measures to drive down inflation, most notably a halt to subsidies in favor of other, inclusive public goods.17

As for the general public, the deeply ambivalent loyalties of most voters would be up for grabs and subject to manipulation by both sides. Pro-subsidy firms could coerce voter support by withholding workers' wages and laying blame on the government.18 That tactic could generate a backlash, however, if workers learned that management corruption and graft, rather than nonpayment of subsidies, was responsible for their wage arrears. Conversely, anti-subsidy forces could capitalize on public outrage over inflation to lobby against inflationary subsidies. In the short term, such a campaign would garner widespread support because citizens' purchasing power had dropped and low, fixed prices under communism had been the norm.19 Once the effects of a subsidy halt were felt in the form of job loss, however, popular demands for subsidies would increase and would foment political unrest. Thus, public attitudes about inflation and subsidies would be deeply mixed and volatile.

In sum, public goods theory suggests that in post-communist countries, economic dislocation had to occur before any appreciable support could develop for market discipline laws. Those reforms could not have occurred at the outset, because the original 1990 Russian bank privatization legislation predated the surge of inflation by more than a year. Instead, public goods analysis indicates that market discipline laws could be accomplished through the democratic process, but not until the onslaught of market forces (in the Russian case, inflation) had effected attitudinal change.

17. Cf. Åslund et al., supra note 16, at 256 ("as new interest groups develop and a free press emerges, placing more checks on the leader's behavior . . . then the incentive to inflate will be reduced").
18. See Stephan, supra note 2, at 749.
19. Macey and Colombatto noted in this regard:

[A] nation's monetary policy, exchanged by the politician for support from a distributional coalition, may dramatically increase costs to individuals. In such a case, the costs to the individual of obtaining information about the policy and organizing to oppose it may be less, perhaps even significantly less, than the per capita cost of the legislation. Because of these increased costs, previously uninformed citizens and individual opponents to the legislation will coalesce into effective distributional coalitions to oppose the legislation.

Macey & Colombatto, supra note 2, at 402. See also id. at 406-09, 412.
II. Soviet Banking and Finance

The state-owned firms that emerged from Soviet communism had a crippling dependence on financing in the form of a government-sponsored, public good. That dependence, which was deeply rooted in Soviet finance practices, paralyzed Russian banking reforms from 1990 to 1993 and continues, in a lesser but still virulent form, to rear its head today. To understand the roots and tenacity of that dependence, it is necessary to examine the functions and operations of Soviet finance.

In the Soviet Union under Stalinism, the state expropriated nearly all means of production and byways of exchange. As a result, Soviet firms regarded supplies and sales as public goods to be ordained by central planners, rather than as market phenomena subject to supply and demand. Soviet firms were equally dependent on the government to provide financing. Under communism, the regime was the sole legitimate provider of financing. As a result, firms regarded financing as a public good and looked to the government to provide it. Furthermore, firms regarded financing as an inclusive public good, i.e., one in near-infinite supply, because Soviet banks normally extended financing without regard for profit, loss or repayment. When the U.S.S.R. disbanded, Soviet firms thus had little incentive to reject the old form of finance in favor of market-based approaches that allocate financing according to scarcity and creditworthiness.

A. Central Planning and the Control Functions of Money

In modern market-based economies, individual firms and consumers have broad autonomy to make their own economic decisions, subject to available information and funds. In contrast, under Soviet communism—the state dictated, to the maximum possible extent, what to make, what to sell and what to buy. The overriding achievement of Soviet central planning was to strip individual citizens of economic choice and consolidate virtually total economic power in the hands of the state. The state, in turn, was subservient to the Communist Party and the Party’s economic and political goals.\(^\text{20}\)

In public goods terms, Soviet central planning had two dramatic effects. First, it tilted the Soviet economy to an unprecedented degree away from private goods such as consumer durables in favor of public goods, most notably heavy industry and defense. In addition, many goods that ordinarily would be provided as private goods in market-based economies were provided as public goods in the U.S.S.R. Sometimes this was to prevent private wealth accumulation by consumers, as in the case of housing and other real property. In other circumstances, it served to prevent wealth accumulation by private suppliers.\(^\text{21}\)

\(^{20}\). See 1 International Monetary Fund et al., A Study of the Soviet Economy 8 (1991) [hereinafter IMF].

\(^{21}\). Cf. id. at 10 (describing restrictions on private capital accumulation).
To achieve this transformation, the Soviet economy required an unprecedented degree of authoritarian central control. That control was wielded in the first instance by the central planning agency Gosplan, which issued one-year and five-year plans dictating what goods firms were to produce. Gosplan measured success largely according to the volume of production, with little emphasis on earnings and cost recovery.\textsuperscript{22} Gosplan's directives were mandatory and unauthorized departures (in theory) were not to be brooked.\textsuperscript{23}

Although Gosplan measured success by physical output rather than by profitability, money was nevertheless essential to avoid the inconvenience of barter. Money provided Soviet citizens with purchasing power, as it does in the West. Money similarly furnished a unit of account that facilitated the exchange of products and services.\textsuperscript{24}

In other respects, however, money in the official Soviet economy differed sharply from money in market economies. The most significant difference was that money did not allocate scarce resources by directing them to the highest bidder. Instead, prices were bureaucratically fixed under central planning without regard for supply or demand. Thus, Soviet money was passive because it did not independently set prices so as to allocate scarcity.\textsuperscript{25}

The uniquely passive character of Soviet money had several important ramifications. Citizens regarded low, fixed prices as a public good that the government was expected to provide. As a result, the Soviet system masked inflation and Soviet citizens had little experience with inflationary dynamics. As is well-known, however, price controls meant that goods were in chronically short supply because prices were too low to induce suppliers to manufacture enough to meet demand. Shortages posed problems not only for consumers, but also for industries, whose managers could only redress supply bottlenecks by interceding with higher-ups or colluding in illicit


24. See George Garvy, Money, Financial Flows, and Credit in the Soviet Union 42-43 (1977); Kushchpeta, supra note 23, at 13, 220. Money had less purchasing power for Soviet firms, whose buying activities were strictly regulated by the state, than it did for consumers. See infra notes 49-52 and accompanying text.

25. See Garvy, supra note 24, at 36, 42-43, 48-51; Kushchjeta, supra note 23, at 160-61, 225, 229. There were unofficial free markets where supply and demand determined prices, most notably the black market and markets for produce grown by collective farms. See Garvy, supra note 24, at 39; Kushchpeta, supra note 23, at 239; Gregory Grossman, Sub-Rosa Privatization and Marketization in the USSR, Annals Am. Acad. Pol. & Soc. Sci. 44, 47 (1990). The Soviet government outlawed the black market and restricted the truck farm market as much as possible.
barter, rather than through price adjustments.26

A final difference between Soviet money and money in market economies was that the state did not allow firms to stockpile cash as a store of wealth. Rather, idle money was siphoned back into the coffers of the state.27 Just as scarce goods and property expropriation prevented individual wealth accumulation, confiscation of bank accounts prevented wealth accumulation by firms.

In order for this closed economy to work, the Soviet central plan had to be financed and financial controls had to be instituted to thwart deviations from the plan. The Soviet banking system was instrumental in both of those tasks.

B. The Soviet Monobank System

Lenin envisioned that a "single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus."28 By the late 1920s, in accordance with Lenin's vision, the Soviet government confiscated all private banks in Russia and consolidated them into a unitary bank that was state-owned and state-controlled.29

After the private banking sector was liquidated and consolidated, the Gosudarstvenny bank, or U.S.S.R. Gosbank (the State Central Bank), became the principal Soviet bank. Over time, the Soviet government established a handful of additional state banks to serve the needs of specific sectors. Of the sector banks, the most prominent were Prombank (later renamed Stroibank) for commerce and industry, Vneshtorgbank for foreign trade, and Sberbank for private household savings. All three operated as arms of Gosbank and were subordinate to it. Taken as a whole, Soviet banking was thus a monobank system in which central and commercial

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26. As Mancur Olson has pointed out, the supply bottlenecks came to be so severe that factory managers often were forced to collude in illegal supply swaps simply to satisfy quotas:

[In the Soviet-type countries sometimes a factory manager could not even get his work done—could not fulfill his quota—without engaging in quasi-legal or illegal deals to obtain inputs. The whole system of Soviet-style planning was so market-contrary that even the high officials—and perhaps especially high officials—had to violate the rules and the plan in order to comply with the orders and targets they were given.]

Mancur Olson, Jr., Therapies for Corruption, Fragmentation, and Economic Retardation 12 (1995) (unpublished manuscript, on file with author); accord Vadim Radaev, On Some Features of the Normative Behavior of the New Russian Entrepreneurs, 37 PROBS. ECON. TRANSITION 17, 20 (1994) (“although in these tough times no one dared to engage in a sit-down strike, it was clear that if even half of the [central planners’] instructions had been observed, all activity would have come to a standstill”).

27. See Kuschpeta, supra note 23, at 221; Macey & Colombatto, supra note 2, at 389; infra note 59 and accompanying text.


29. See Kuschpeta, supra note 23, at 24-38.
bank functions were combined and competition among banks was suppressed.³⁰

In its role as the Soviet central bank, Gosbank had some of the functions of a traditional Western central bank. Gosbank, for example, issued notes and coins, regulated currency circulation and served as the central clearinghouse for payments. It maintained foreign exchange reserves and discounted foreign payments. Gosbank also served as the central repository for the collection and disbursement of government revenues.³¹

In other respects, the central bank functions of Gosbank differed radically from those of central banks in Western countries. Gosbank regulated the money supply through confiscation rather than through monetary tools such as the discount rate or sales of government securities.³² Similarly, because the monobank system eliminated any need for the supervision of autonomous private banks, Gosbank had no supervisory apparatus in place.

Gosbank's other role was as Russia's leading commercial bank. Unlike Western commercial banks, however, Gosbank did not operate according to profit. Rather, Gosbank operated as an arm of the state in furtherance of the central plan, without regard to profit.³³ In carrying out that mission, Gosbank had two main tasks. Gosbank played an essential part in achieving the plan by supplying financing and by monitoring firms to assure that they reached production quotas. Additionally, Gosbank was responsible for suppressing private monetary exchanges that could divert resources from the plan.

C. Gosbank's Role in the Administration of the Central Plan

1. Provider of Financing

As the financial arm of the Soviet government, Gosbank was responsible for providing the necessary financial support and oversight to carry out the central plan. One of Gosbank's primary functions in that regard was to finance state-owned enterprises through the provision of credit.

Nominally, Gosbank extended financing in the form of loans conditioned on repayment. In deciding whether to extend credit, Gosbank principally asked whether a firm had met its production targets and whether the central plan authorized the expenditure in question. In theory, Gosbank also was supposed to consider the prospects for repayment according to the Soviet principle of "economic accountability" or khozraschet, which specified that firms could not spend more than they earned and were

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³¹ See Garvy, supra note 24, at 52-53.
³² Id. at 52-53, 59-60; Kuschpeta, supra note 23, at 54-55.
³³ See Kornai, supra note 28, at 131-32.
responsible for paying their debts. In reality, Gosbank approved low-interest loans for almost any proposed transaction if the firm was meeting its quotas and the transaction was authorized by the plan. Where that was the case, Gosbank normally issued loans without regard to the borrower's risk profile or ability to repay.

As such, the concept of creditworthiness was foreign to Soviet banking. In a functioning market economy, credit decisions steer scarce supplies of credit away from money-losing ventures toward the most creditworthy users. For the most part in the Soviet Union, in contrast, Gosbank issued credit at trivially low interest rates regardless of the borrower's ability to repay.

Thus, Soviet banking was premised on what the Hungarian economist János Kornai terms "soft budget constraints." The terms soft and hard budget constraints describe the degree to which the external economic environment tolerates losses by firms instead of driving insolvent enterprises into bankruptcy. The less tolerance shown to losses, the harder the budget

34. See Harold J. Berman, Justice in the U.S.S.R.: An Interpretation of Soviet Law 110-11 (rev. ed. 4th prtg. 1976); Garvy, supra note 24, at 114; Kornai, supra note 28, at 145. In a similar vein, Soviet civil law contemplated secured loans. Collateral provisions had limited usefulness, however, because collateral consisted solely of the assets that were financed. Other income-generating assets, such as buildings and equipment, were exempt from use as security. See Garvy, supra note 24, at 114; Kuschpeta, supra note 23, at 235; Richard E. Ericson, The Classical Soviet-Type Economy: Nature of the System and Implications for Reform, J. Econ. Persp., Fall 1991, at 17; Simon Johnson et al., New Banks in the Former Soviet Union: How Do They Operate?, in Changing the Economic System in Russia, supra note 12, at 183, 186.

35. See Garvy, supra note 24, at 115-16; Kuschpeta, supra note 23, at 152, 183, 235; Ronald I. McKinnon, The Order of Economic Liberalization 125 (1991); Johnson et al., supra note 34, at 185-86. Cf. Gregory & Stuart, supra note 22, at 183; Peter Rutland, The Politics of Economic Stagnation in the Soviet Union 168 (1993) (khозрасчет (cost accounting) was undermined by "the party's deep-seated ideological fear of increased reliance on money and market-type forces").

36. See Garvy, supra note 24, at 115-16; Kuschpeta, supra note 23, at 235; Johnson et al., supra note 34, at 185-86; V. Sundararajan, Central Banking Reforms in Formerly Planned Economies, Fin. & Dev., March 1992, at 10, 11. Instead of penalizing nonpayments through denials of future credit, Gosbank sought to induce loan repayment through higher credit lines, better loan terms and bonuses to firm managers. See Berman, supra note 34, at 113-14; Garvy, supra note 24, at 117; Kuschpeta, supra note 23, at 152.

Kuschpeta ascribed the Soviet aversion to creditworthiness analysis in part to Stalin's ban on statistical analysis:

In Stalin's time general economic doctrine was almost exclusively concerned with explaining and analysing property relations. Price theory and other micro-economic problems were totally neglected. Stalin's dogmatism even impeded the development of planning theory and methods: remember Stalin's prohibition of mathematical methods and mathematical statistics in compiling data and plans. It is no wonder that no economic criteria were used in the planning and that a paradoxical situation under which inefficient enterprises were favoured and the efficient ones had to work under unfavourable conditions was the practical result.

Id. at 241 (footnotes omitted).

37. See Ronald I. McKinnon, Taxation, Money, and Credit in a Liberalizing Socialist Economy, in The Emergence of Market Economies in Eastern Europe 112 (Christopher Clague & Gordon C. Rausser eds., 1992) [hereinafter Emergence].
Where budget constraints are hard, firms are expected to earn more than they spend and to go out of business if they cannot pay their debts. Similarly, banks that enforce hard budget constraints lend only to firms that can repay out of future revenues. In a regime of hard budget constraints, banks impose credit limits, vary interest rates according to risk, report credit ratings, collect overdue loans and deny credit to firms that have defaulted on past loans. Thus, where firms operate under hard budget constraints, their growth potential depends upon their ability to attract investment (including credit) or to plow back savings into fueling future growth. The ability to attract credit depends, in turn, upon credit history and present and future profitability. Further, firms know they will face extinction through bankruptcy if their financial condition declines to the point where their liabilities exceed their assets. Thus, as Kornai noted, hard budget constraints are “a form of economic coercion: proceeds from sales and cost of input are a question of life and death for the firm.”

In contrast, where budget constraints are soft, as was true in the Soviet Union, earnings and cost controls are not “a question of life and death.” In economies where soft budget constraints predominate, firms expect to get bank loans regardless of future profitability or repayment ability. Similarly, banks do not allocate credit according to risk through credit limits or interest surcharges. Instead, as Kornai has noted, troubled firms “whine” for credit that actually includes a veiled grant. In such regimes, when firms default banks do not institute collection but rather often advance additional funds. Firms know too that they will not face bankruptcy if they become insolvent because the state will bail them out with cash subsidies or subsidized loans.

Soviet banking was specifically designed to generate the state subsidies that are characteristic of soft budget constraints. If a firm failed to repay its loans, Gosbank had the hypothetical authority to sanction the firm through cash penalties, credit caps and closer oversight of management. In reality, however, where sanctions “conflicted with the need to keep the particular enterprise operating,” they were “unlikely to be pushed very far.”

38. See Janos Kornai, Contradictions and Dilemmas: Studies on the Socialist Economy and Society 12-15, 48, 143-44 (1986). See also Macey & Colombatto, supra note 2, at 389, 391-92 & n.34.
39. See Kornai, supra note 38, at 12-13, 36-40.
40. Id. at 38.
41. See McKinnon, supra note 37, at 112.
42. Kornai, supra note 28, at 142.
43. See Kornai, supra note 38, at 13, 41-44; Kornai, supra note 28, at 140, 142; Ericson, supra note 34, at 19-22; Sundararajan, supra note 36, at 11. See generally Grossman, supra note 25.
44. See Garvy, supra note 24, at 117-18; Kuschpeta, supra note 23, at 182-84.
45. Garvy, supra note 24, at 117. See also Kuschpeta, supra note 23, at 183-84; Paolo Miurin & Andrea Sommariva, The Financial Reforms in Central and Eastern European Countries and in China, 17 J. Banking & Fin. 883, 895 (1993). Gosbank had its own perverse incentives to excuse nonpayment because delinquent payments triggered
Instead, directors of ailing firms routinely secured extra financing by appealing to higher-ups to intercede with Gosbank for additional funds. Such rent-seeking, as Kornai noted, required "a lot of legwork, searching for connections and supporters," and consumed time that otherwise could have been spent on improving production and sales.\textsuperscript{46} Rent-seeking was so lucrative, however, that pleas for state aid were the normal \textit{modus operandi}.\textsuperscript{47}

Thus, bank loans in the Soviet Union almost always operated as subsidies rather than as constraints on firm conduct. Credits flowed freely to implement physical production targets in the central plan, regardless of efficiency or risk.\textsuperscript{48} This free flow of subsidies had several important consequences.

One obvious effect was that firms viewed finance in the U.S.S.R. solely as a public good. As a result, Soviet managers emerged from communism with no experience in securing private finance. To the contrary, they were conditioned to seek finance solely from the government. Finance was thus politicized, something to be accomplished through bureaucratic intercession.

Further, because soft budget constraints predominated, managers viewed financing as an inclusive public good. That was because nothing in the Soviet experience gave managers reason to believe the subsidies to other firms in equal need would reduce subsidies to their own firms. Consequently, Soviet managers saw no harm and every advantage in working collectively to obtain subsidies. For the same reason, Soviet managers had no reason to consider subsidies less desirable than other forms of public goods.

Finally, because Gosbank fixated on physical production targets rather than on repayment prospects, Gosbank defined the monitoring aspects of its work as tracking physical production rather than overseeing loan repayment. Those surveillance activities required strict central control of payments and cash reserves.

2. Monitoring Performance Under the Central Plan

Gosbank, in coordination with Gosplan, monitored production quotas by tracking financial activity in each firm's bank accounts. Gosbank accomplished higher interest charges and penalty payments that Gosbank booked as paper income under its accounting rules. See Woody, \textit{supra} note 30, at 54.

\begin{itemize}
  \item See Kornai, \textit{supra} note 28, at 142 n.19.
  \item See Garvy, \textit{supra} note 24, at 47, 116-17; Kornai, \textit{supra} note 28, at 142 & n.19; Woody, \textit{supra} note 30, at 27; Olson, \textit{supra} note 26, at 20 n.18. Cf. Sergei A. Vasiliev, \textit{Economic Reform in Russia: Social, Political, and Institutional Aspects}, in \textit{CHANGING THE ECONOMIC SYSTEM IN RUSSIA}, \textit{supra} note 12, at 72, 73 ("Lodging a complaint with the powers-that-be, that is, the boss, the chief, or the superior administrator, was the most natural way of upholding one's rights in Russia."); V.V. Vitrianskii, \textit{Contract as a Means for Regulating Market Relations: The Draft Civil Code (First Part) of the Russian Federation}, 20 Rev. Cent. & E. Eur. L. 649, 649 (1994) (noting that Soviet managers who were aggrieved by breaches of contract habitually appealed to the government for help in lieu of suing their contract partners).
  \item See Garvy, \textit{supra} note 24, at 36; Kornai, \textit{supra} note 38, at 44.
\end{itemize}
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plished this surveillance through a compulsory system of bank accounts and transfer payments designed to insure that firm payments did not evade Gosbank's scrutiny.

Under that system, all state enterprises had to maintain accounts with Gosbank or one of the sector banks into which their revenues had to be deposited.\(^4\) Each account was divided into sub-accounts that were earmarked for specific expenses. Enterprises could only use funds in a particular sub-account to pay for designated expenses and could not shift these funds to another sub-account. Funds reserved for raw materials, for example, could not be spent on equipment.\(^5\)

Gosbank was able to track money flows because it served as the exclusive clearing agent for the transfer payment system. Gosbank maximized its surveillance capabilities by requiring firms to make payments through inter-account transfers and by prohibiting firms from paying in cash.\(^5\) In the process of clearing payments, Gosbank could tell how much a firm earned and how much the firm spent and on what. Because finished products were to be sold under the plan at a fixed percentage above cost, Gosbank's analysis of firm revenues and expenditures furnished a rough-and-ready indicator of whether production targets were being fulfilled.\(^5\)

In sum, Gosbank used its position as the exclusive clearing agent for payments to keep tabs on who was paying how much for what. These supervisory powers served not only to track the fulfillment of quotas, but also to root out deviant economic conduct at variance with the plan.

D. Gosbank Techniques for Suppressing Deviations from the Plan

For central planning to work, not only was it important for targets to be met, it was crucial to stamp out private market transactions that could divert financial resources from the central plan. The state, and in particular Gosbank, employed a variety of techniques to funnel money out of private hands and back into the coffers of the state.

The consumer market, for example, represented a threat to central planning because consumer choice, through the black market and other-

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\(^4\) See Garvy, supra note 24, at 56; Kuschpêta, supra note 23, at 75.


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wise, represented a diversion of resources from state priorities and state
control. Consequently, the state sought to suppress consumer choice as
much as possible by maintaining low wages and bare shelves. Although
Soviet citizens were low-paid by Western standards, they nevertheless had
large cash surpluses because consumer goods were artificially underpriced
and in notoriously short supply. As a result of suppressed consumer
demand, consumer purchases were negligible and Soviet households had
high rates of forced savings.

Although Soviet citizens were flush with rubles, they had extremely
limited options as to what to do with their cash. Essentially, citizens were
limited to keeping surplus rubles under their mattresses or depositing
them with the state-owned savings bank, Sberbank, the only available vehi-
cle for investment. The state exhorted citizens to deposit their surplus
funds with Sberbank and enticed them to do so with deposit guarantees.
Over the years, household deposits at Sberbank became an increasingly
important source of short-term loans to the state. Thus, low wages, empty
stores and high savings combined to pump idle consumer funds out of the
private economy and back into the hands of central planning.

Similarly, the banking system was designed to suppress independent
economic decisions by firms and their managers that could result in deviations
from the plan. Firms could only obtain credit from the state-owned
banks and were forbidden from securing credit from suppliers or private
financiers. Similarly, firms could not spend funds in their state bank
accounts as they wished. By law, their access to those accounts was
blocked; Gosbank limited how much enterprises could withdraw from
their bank accounts and what those funds could buy. Likewise, the rule
requiring firms to pay through inter-account transfers instead of in cash
was designed to prevent unauthorized purchases that could not be traced.

These restrictions had the sum effect of extracting the maximum pos-
sible revenues from individual firms for the financing of the overall plan.
As revenues mounted in a particular firm's account, Gosbank raked off the
surplus and transferred those funds to unprofitable firms that needed extra
funds to fulfill their targets. Essentially, the system of blocked bank

53. See Kuschpeta, supra note 23, at 1, 93, 161, 177, 179, 219-21, 225; Olson, supra note 26, at 14.
54. See Carlo Cottarelli & Mario I. Blejer, Forced Savings and Repressed Infla-
tion in the Soviet Union: Some Empirical Results (IMF Working Paper No. WP/91/
55, 1991); 1 IMF, supra note 20, at 39; Kuschpeta, supra note 23, at 239; Marek Dabrow-
ski, The First Half Year of Russian Transformation, in Changing the Economic System in
Russia, supra note 12, at 1, 3; Hill & Slavinski, supra note 51, at 38 ("Russian house-
holds saved 32 percent of their disposable income in 1992 mainly because there just
was not much to purchase . . . .").
55. See Garvy, supra note 24, at 64-66; Kuschpeta, supra note 23, at 73, 87, 89-91,
219-20.
56. See Kuschpeta, supra note 23, at 73, 177; Ericson, supra note 34, at 16-17.
57. See Kornai, supra note 28, at 546; Kuschpeta, supra note 23, at 47, 54.
58. See Kornai, supra note 28, at 132-33; McKinnon, supra note 37, at 111-12; Jeffrey
D. Sachs & David Lipton, Remaining Steps to a Market-Based Monetary System in Russia,
in Changing the Economic System in Russia, supra note 12, at 127, 136.
accounts enabled the Soviet government to levy taxes through confiscation and freely reallocate those revenues to money-losing firms.\textsuperscript{59}

Gosbank's confiscation of deposits fostered economic ruin by creating perverse incentives for successful firms. Firms that did well saw their revenues raked off and transferred to less efficient firms. Thus, subsidies penalized the best firms and rewarded the worst. But far from convincing successful managers that subsidies were scarce, this incentive structure simply convinced them that their subsidies would increase if their firms lost money too. From a financial standpoint, then, \textit{inefficiency} was the only rational objective.

Gosbank's confiscatory practices similarly fueled official corruption by instilling incentives to engage in illicit, non-cash barter. To evade the restrictions on cash withdrawals that facilitated state confiscation, managers hoarded inventory, rather than selling it, for use in elaborate barter schemes. Sometimes this was necessary to achieve production quotas; more often it was done as a means of private gain.\textsuperscript{60}

While barter deals were one of the few ways in which managers gained entrepreneurial experience, such deals also fostered disregard for the law because they entailed pilferage. As barter schemes multiplied and became harder to hide, managers developed elaborate webs of payoffs, both to superiors and to officials of Gosbank, as protection against prosecution and punishment. Over time, managers and higher-ups became so enmeshed in illicit conduct that the whole fabric of Soviet law was undermined.\textsuperscript{61}

As inefficiency and corruption mushroomed, the Soviet economy rotted to its core, hastening the U.S.S.R.'s demise. That did not mean, however, that a functioning market economy would necessarily rise out of the ashes of communism. To the contrary, lingering Soviet practices and attitudes created severe barriers to banking sector reform and reform of the economy at large.

\textsuperscript{59} See \textit{Garvy}, supra note 24, at 116; \textit{KuschprirA}, supra note 23, at 79-80, 109-10, 131, 138-39, 230; McKinnon, supra note 37, at 110-12; Sundararajan, supra note 36, at 11. As noted by one commentator:

\begin{quote}
[T]here is nothing puzzling in the fact that Soviet-type regimes normally required state enterprises to make all payments through the state banking system and whenever possible tried to keep enterprises from using or holding currency—which facilitated extraction by the center and made retention of profits by the enterprise more difficult.
\end{quote}

Olson, supra note 26, at 14, 25-26.

\textsuperscript{60} See supra notes 25-26 and accompanying text, infra note 61 and accompanying text.

\textsuperscript{61} See Olson, supra note 26, at 10-12, 22-25; Merton J. Peck, \textit{in What Is To Be Done? Proposals for the Soviet Transition to the Market} 1, 3 (Merton J. Peck & Thomas J. Richardson eds., 1991); Paul B. Stephan III, \textit{Toward a Positive Theory of Privatization—Lessons from Soviet-Type Economics}, 16 Int'l Rev. L. & Econ. 173, 178-81 (1996); Sundararajan, supra note 36, at 11. While Gosbank had authority to limit future credits and report a firm to central authorities if it suspected that firm of hoarding, see \textit{Kornal}, supra note 28, at 133, that authority eroded over time due to the profusion of protection payments. See Olson, supra note 26, at 10-12, 22-25.
E. The Public Goods Legacy of Soviet Central Planning

From the standpoint of the transition to a market economy, the subjective
expectations that communism fostered proved to be one of the most vexing
impediments to reform. Those expectations were a direct legacy of Stalin's
nationalization of virtually the entire Soviet economy. As a result, Soviet
firms had to look to the government for goods that market economies
would normally provide privately. By negating private ownership while
ignoring scarcity, Soviet communism achieved an unprecedented expan-
sion of the concept of public goods.

The expectation that the government would be the principal provider
of financing (and of a generally unprecedented range of public goods) cre-
ated a knot of obstacles to banking system reform. First and foremost, it
politicized industrial finance. The only way managers knew how to get
finance was through the lobbying of higher-ups. Thus, managers had
neither the inclination nor the skills to compete for private finance in the
marketplace.

Compounding matters, the prevalence of soft budget constraints
meant that finance in reality took the form of subsidies, not loans, and was
available regardless of a firm's financial shape. Indeed, the worse off the
firm, the more likely the subsidy. Thus, financing turned on a host of
political factors inimical to economic efficiency. As ever-increasing num-
bers of firms concluded that subsidies were more lucrative than positive
balance sheets and cost controls, a vicious cycle arose. Perversely, under
communism, efficiency came to be seen as a hindrance to financing, rather
than a prerequisite, because surpluses were removed from successful firms.
As the general condition of firms declined, subsidy demands became
increasingly desperate and widespread.

Soviet enterprises thus emerged from communism in the worst possi-
ble shape: with dire financing needs and badly impaired competitiveness.
Not being accustomed to market discipline, moreover, managers did not
regard subsidies as in scarce supply. Rather, in the view of individual man-
gers, there was no reason why subsidies to one firm should reduce subsi-
dies to any other firm in need. Consequently, Soviet-style subsidies were
regarded as the quintessential inclusive public good.

It was therefore predictable that immediately after the fall of commu-
nism subsidy demands would be loud and encounter virtually no opposi-
tion, either internally among firms or from the citizenry at large. Soviet
citizens could be expected to favor subsidies as essential to keeping their
jobs. Because of the Soviet system's success in repressing inflation, more-
over, the public did not link subsidies with shortages and other trade-offs.
Among firms, subsidies had a powerful allied voice because the political
relationships that were needed to secure government finance at the minis-
tries and with Gosbank were already well-cemented. Consequently, bar-
r ing the power structure's overthrow, the subsidy lobby, with its inbred
relationships and entrenched ways of dealing, could be expected to survive
communism intact and to impede the transition to a banking system pre-
mised on rewards for efficiency and penalties for losses.
III. Reform and Liberalization

The general deterioration of the Soviet economy in the 1980s did not spare Soviet banking. By 1987, the Soviet banking system was on the verge of a massive breakdown. Gosbank's continual advance of funds to loss-generating firms had caused those firms to proliferate and money-making firms to run operating deficits, or "go into the red." As enterprise revenues dried up, so did funds for subsidies, and Gosbank began to experience losses. In desperation, the Soviet government took its first tentative steps toward banking system reforms in 1987.

Given the widespread social affinity for subsidies and the antipathy to hard budget constraints in Russia, the key question was whether the early legislation would promote or resist market discipline through banking norms. Under the theory of public goods, resistance could be expected for two reasons: first, because the pro-subsidy lobby was already organized; second, because it had no effective opposition.

In the Soviet Union, a pro-subsidy lobby was already mobilized in the form of the nomenklatura. The nomenklatura were well-connected and well-organized to lobby for financial assistance from the state. Further, they were marked by hierarchical distinctions of status, wealth and power that gave the nomenklatura's highest members a disproportionate stake in reforms. In contrast with post-war Germany and Japan, moreover, the members of the old communist elite were not barred from new positions of power, either due to military occupation, prosecution or political suppression. Accordingly, the nomenklatura could be expected to assert a powerful voice in favor of a banking system designed to serve as a continued conduit for state subsidies.

The nomenklatura were able to exploit the absence of effective opposition to subsidies during the first phase of reforms. While reform economists in Russia and abroad sought to dismantle subsidies, their campaign was an uphill fight. There was a broad social consensus in favor of continued financial lifelines. Compounding matters, members of the nomenklatura who ran factories had the distinct ability to exploit this sentiment at the polls by withholding workers' paychecks and blaming it on lack of subsidies. In the meantime, the old Soviet system of repression had stunted private association and expression and thus had suppressed any nascent opposition to the managers. As Mancur Olson has noted, entrepreneurial firms were too new, too few and too disorganized during the final years of the Soviet regime to provide an effective political counter-

64. See infra notes 176-77 and accompanying text.
65. See Anders Aslund, How Russia Became A Market Economy 7, 308 (1995). Cf. Anders Aslund, Post-Communist Economic Revolutions: How Big A Bang? 63 (1992) ("[I]n Russia, the power of the state enterprise directors appeared to be increasing in the summer of 1992, one year after democratization; the reason was that civil society was so poorly developed, providing few organized counterweights to the old industrial lobby.").
weight to subsidy demands by the *nomenklatura*.\(^6\)

Thus, public goods theory suggests that the *nomenklatura* would exert influence disproportionate to their size in the earliest stages of economic and political liberalization, when competing private groups had not yet formed. That prediction was borne out by early bank reform legislation between 1987 and 1990.

A. Banking Law Reforms During Perestroika

The Soviet Union paved the way for later, more radical reforms by spinning off Gosbank's commercial bank functions in 1987 to a new group of commercial banks.\(^6\)\(^7\) In the new two-tier bank system that resulted, Gosbank continued to act as the Soviet central bank, supervising the money supply as well as the newly-authorized commercial banks. The second tier was formed by assigning Gosbank's commercial bank functions to five new state-owned banks that were the successors to the old sector banks. The new banks were the Bank for Industrial Construction (Promstroibank), successor to the old Stroibank; Sberbank; the Bank of Foreign Economic Activity (Vneshekonombank), successor to the old Vneshtorgbank; the Agro-Industrial Bank (Agroprombank); and the Bank for Housing, Municipal Services and Social Development (Zhilsotsbank). Their customer bases continued to be divided along sectoral lines. Promstroibank served heavy industry, Sberbank served households, Vneshekonombank handled foreign trade, debt and currency dealings, Agroprombank served farms and farm industries, and Zhilsotsbank served light industry and the service sector.\(^6\)\(^8\)

6. See Olson, supra note 26, at 29.


Vneshekonombank collapsed upon the fall of the Soviet Union in December 1991. Those assets that did not disappear were frozen and much of Vneshekonombank's operations were then transferred to Vneshtorgbank of Russia. See Jonas Bernstein, *Nickel For Your Thoughts?*, RUSSIA REV., Feb. 26, 1996, at 22, 23 (stating that some assets went to Vneshtorgbank); Peter J. Pettibone & Juliette M. Passer-Muslin, *Russian Banking and Currency Regulations: Overview of the Russian Banking System*, 1 PARKER SCH. J.E. EUR. L. 709, 716 n.1 (1995) (stating that all assets went to Vneshtorgbank); Yeltsin Issues Decree on Bank of Foreign Economic Activity, BBC SUMMARY OF WORLD BROADCASTS, Jan. 28, 1994, quoting Ivan Zhagel, President Has Decided to Resurrect USSR Vneshekonombank, IZVESTIA, Jan. 18, 1994, at 2; Ivan Zhagel, $8 Billion Frozen by Soviet Government Is Beginning to Be Returned to Russian Enterprises, IZVESTIA, May 17, 1994, at 1, reprinted in CURRENT DIG. POST-SOVET PRESS, June 15, 1994, at 18. Vneshekonombank had been scheduled to be phased out in any case after it completed debt service on the old debts of...
The 1987 reforms had two ostensible goals: to tighten credit discipline and to facilitate the financing of the government budget. In a stab at hard budget constraints, the specialized banks received new powers, including the authority to oversee management decisions, to grant better terms to creditworthy borrowers and to deny new advances to delinquent borrowers. By the late 1980s, overall credit to firms had dropped, advances to delinquent borrowers had been cut and overdue loans reportedly had shrunk.69

Still, the 1987 reforms were considerably more cosmetic than real because they denied crucial credit discipline techniques to commercial banks. Commercial banks could not calibrate interest rates according to risk, because the government still set interest rates centrally. Similarly, while commercial banks had the power on paper to conduct creditworthiness analyses, they could not interfere with production. In reality, then, the 1987 reforms posed little serious threat to the continuation of soft budget constraints.

The 1987 bifurcation of the monobank system similarly fostered a false impression of competition. The formation of the specialized banks did little to promote competition because each institution had monopoly rights over a specific segment of the banking market.70 Nonetheless, the Soviet Union's half measures in 1987 at least gave lip service to the possibility of competitive reforms. One year later, in 1988, the first such reforms arrived, when the Soviet government passed the 1988 Law on Cooperatives, authorizing the formation of private cooperatives, either in the form of subcontractors to state enterprises or spin-offs from state firms.71

As a condition of the 1988 legislation, the nomenklatura who planned on running the new private cooperatives demanded separate banking services of their own. Fearful that the five specialized banks would refuse to serve the new cooperatives, factory heads and Party officials demanded authority to form their own banks. In response to those demands, the Law


on Cooperatives authorized the first private commercial banks in Russia since Lenin's time.72

Under the Law on Cooperatives, cooperatives were permitted to form new private banks to serve both their own banking needs and those of their customers and members. The cooperative banks had authority to serve borrowers not served by the specialized banks and had marginally greater independence in choosing borrowers and interest rates. Soon, cooperative banks expanded into a wide variety of activities besides deposit-taking and lending, including the underwriting of cooperative securities, leasing, factoring, barter brokerage and the formation of financial syndicates.73 By mid-1990, approximately 280 new cooperative banks had been formed in Russia.74

Despite those developments, by late 1990 competition in the Russian banking industry remained moribund. Private banks accounted for only five percent of total credit. True to the cooperatives' fears, the specialized banks hoarded credit for the state-owned sector, impeding the ability of new private enterprises to obtain financing.75 Tight credit was further exacerbated by the government's insistence on interest rate controls, both for deposits and for loans. As the infant private sector clamored for credit, pressures for greater bank liberalization continued to mount. Envious of the newly-formed cooperatives, state-owned enterprises and ministries demanded the right to found their own private banks.76 Matters came to a head when, in 1990, Russia and the other Soviet republics accelerated their quest for independence from the U.S.S.R.

B. The 1990 Legislation

In the turbulent last days of 1990, the new Russian parliament enacted major new legislation, launching the Russian banking industry down the path of privatization. The Law on the Central Bank, enacted on December 2, 1990, authorized a new central bank for the Russian Federation, in direct defiance of Gosbank.77 The Law on Banks and Banking, enacted that same date, decreed the privatization of most Russian commercial

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72. See Law on Cooperatives in the USSR, supra note 71, art. 23, pt. 5; Rumer, supra note 63, at 20. See generally Rutland, supra note 35, at 215-16 (describing how the nomenklatura captured cooperatives to protect their privileges); Stephan, supra note 61, at 179-80 (same).


75. See 2 IMF, supra note 20, at 110-11.


banks and authorized them to freely compete for customers.\textsuperscript{78} For the first time in memory, citizens and firms were free to patronize any bank they liked\textsuperscript{79} (in contrast with the past assignment of banks) and to maintain bank accounts at more than one bank.\textsuperscript{80} Together, the two laws formalized and liberalized the two-tier banking system first instituted in 1987.

The 1990 banking laws resulted from a unique confluence of events on three separate fronts. The first front was the economy, which was in dire straits. As the failure of central planning and the inadequacy of piecemeal Soviet reforms became more and more apparent, public pressure mounted for full-scale privatization. Under intense pressure, in mid-1990 President Gorbachev finally acceded to public demands for a full-fledged transition to a market economy. Soon, four groups of academics were jockeying to persuade the U.S.S.R. Supreme Soviet to advocate their individual plans for reform. When the warring reform groups were unable to reach a compromise, President Gorbachev issued his own reform guidelines, which the U.S.S.R. Supreme Soviet approved on October 19, 1990. The Gorbachev guidelines called for an immediate overhaul of the banking system as the first step in a multi-stage plan for reform.\textsuperscript{81}

The second front consisted of the old \textit{nomenklatura}, who were shrewd enough to see that the social forces propelling economic privatization and the dismantling of central planning could not be stopped. Although industry privatization did not get underway until late 1992, the \textit{nomenklatura} knew it was inevitable and decided to control it and to profit from it by owning and running state industrial firms that were slated to be privatized.\textsuperscript{82} While the power of the \textit{nomenklatura} was diminished, they were organized and presumed to be in control of the army, and thus represented a threat of civil war. As such, the \textit{nomenklatura} were in a strong position to control newly-privatized state firms. The same was true for their ability to
shape the new banking industry so as to assure continued state financing, either directly from the government or through private banks as intermediaries.

The third front consisted of mounting tensions between the central U.S.S.R. government and reform-minded republics such as the Russian Federation. These tensions fostered rivalries conducive to banking reforms. In 1990, that friction resulted in the first free parliamentary elections in the Russian Republic since 1918. That same year, the Russian Republic succeeded in wresting key economic powers from the central Soviet government. As the Russian Republic struggled for economic autonomy, Gosbank's allegiance to the Soviet government became a major battleground for control.93

Almost immediately, the new Russian Parliament engaged its rival, the U.S.S.R. Supreme Soviet, in a race to privatize the banking industry. The Russian Parliament won that race on December 2, 1990, with its enactment of the Law on the Central Bank and the Law on Banks and Banking.94 Nine days later, on December 11, 1990, the U.S.S.R. Supreme Soviet enacted its own competing version of those two laws.95 The Russian versions survived the breakup of the Soviet Union and remain in effect, as amended, in Russia today.96

1. The Law on the Central Bank

In the Law on the Central Bank, the Russian Parliament designated the new Central Bank of Russia (the "Bank") as the central bank for the Russian Federation, with responsibility for currency stability, international reserves, national monetary policy, bank supervision and payments.97 The Bank officially opened for business in late 1990.98

Certain aspects of the Law on the Central Bank were patterned after Western banking laws and incorporated significant elements of market reform. For example, the Russian Supreme Soviet expanded the monetary powers of the Central Bank of Russia to include central bank functions that

94. See supra notes 77-78.
96. See Andrei I. Kazmin, The Contours of a New Banking System in the Dissolving Soviet Union, Bankarchiv, Feb. 1992, at 113, 114 & n.1. The Union versions were superseded upon the demise of the Soviet Union.
97. See Law on the Central Bank, supra note 77, ch. I, arts. 1, 5; Constitution of the Russian Federation § I, ch. III, art. 75(1), in Official Codification With Commentary, supra note 77 ("The monetary emission shall be the exclusive responsibility of the Central Bank of the Russian Federation."); id. art. 75(2) ("The protection and stability of the ruble is the main function of the Central Bank of the Russian Federation . . . .").
98. See Fedorov, supra note 73, at 60.
Gosbank previously had not performed. The act gave the Bank explicit authority to use direct and indirect tools of monetary control, including discount rate policies, refinance quotas, open market sales of government securities and mandatory reserves (funds that banks must keep on reserve with the central bank in non-interest bearing accounts).\textsuperscript{89} Similarly, the law gave the Bank expanded supervisory powers over commercial banks, including the power to license commercial banks and to prescribe financial norms.\textsuperscript{90} The law further empowered the Bank to formulate standard rules of accounting, to require banks to submit periodic financial reports, to examine banks and to enforce bank legislation through sanctions.\textsuperscript{91}

Nevertheless, other aspects of the Law on the Central Bank perpetuated soft budget constraints and bore the distinct mark of the nomenklatura. For example, while the law contained provisions relieving the Central Bank of Russia of liability for Russian Federation obligations, it did so only for those obligations that the Bank chose not to assume.\textsuperscript{92} Similarly, the 1990 law only prohibited the Bank from printing money to finance the state deficit "directly."\textsuperscript{93} Indeed, a sister provision specifically authorized the Bank to make loans on ordinary market terms to the Minis-


\textsuperscript{90} Such norms include minimum capital standards; capital/asset ratios; mandatory reserves; limits on loans to one borrower; limits on major credit risks; standards on capital adequacy and liquidity, currency, interest and other risks; minimum loss reserves; and limits on equity holdings. See Law on the Central Bank, supra note 77, ch. VI, arts. 22-28. See also Amendments and Addenda to the RSFSR Central Bank (Bank of Russia) Act, RF Federal Act No. 65-FZ, ch. X, arts. 61-71, 73 (Apr. 12, 1995) (Russ.), available in Westlaw, Ruslegisline Database, 1995 WL 320349; European Bank for Reconstruction and Development, Transition Report 1995, at 156 (1995) [hereinafter Transition Report 1995]; Kazmin, supra note 86, at 116-17. By law, banks must be licensed by the Central Bank of Russia before they accept deposits. See Law on Banks and Banking, supra note 78, ch. II, art. 11; Civil Code of the Russian Federation, pt. 2, art. 835 ¶ 1 (1996).

\textsuperscript{91} See Law on the Central Bank, supra note 77, ch. VII, arts. 30-33; Law on Banks and Banking, supra note 78, ch. VII. Sanctions included monetary fines, increased central bank reserves, recapitalization directives, replacement of management, operating restrictions, appointment of an interim administrator, bank reorganization, bank liquidation and license revocation. See Law on the Central Bank, supra note 77, ch. VII, art. 33. See also Natalia G. Markalova, Contemporary Banking Legislation in the Russian Federation, 122 Corp. Counsel's In'tl Ad viser 122-02, 122-04 (1995). License revocation was authorized for banking law violations, insololvency, falsehoods in the license application, start-up delays of more than one year after licensing, unauthorized bank activities and breaches of the antimonopoly laws. See Law on Banks and Banking, supra note 78, ch. II, art. 18. Under the 1990 laws, license revocation was tantamount to liquidation and was only to be used if breaches were not cured. See id.; Law on the Central Bank, supra note 77, ch. VII, art. 33.

\textsuperscript{92} See Law on the Central Bank, supra note 77, ch. I, art. 2.

\textsuperscript{93} See id., ch. II, art. 11.
try of Finance to finance budget shortfalls, in amounts not exceeding limits set by parliament.  

Coupled with provisions making the Bank "accountable" to parliament, the 1990 law thus left the Bank politically vulnerable to parliamentary demands to fund the government deficit.

Other provisions authorized the Central Bank of Russia to serve as a lender of last resort in a fashion that left the Bank susceptible to subsidy demands by private industries and banks. As lender of last resort, the Bank received authority under the 1990 law "to refinance banks by offering them short-term credits at the Bank of Russia interest rate," as long as those credits were secured by collateral. But in contrast with Western banking practices, the Bank was authorized to extend such credits not only to insure liquidity, but also to supplement the deficient deposit bases of private banks. In practice, thus, the lender of last resort provisions paved the way for thinly veiled central bank subsidies masquerading as loans.

As these provisions suggest, in order to gain support for the legislation, the drafters had to walk a precarious line between divesting the state of control over banking and allowing the apparatchiks of the dying Soviet regime to control access to bank funds, both to finance their companies and to enrich themselves through rake-offs and graft. That same tension marked the Law on Banks and Banking.

2. The Law on Banks and Banking

In tandem with the Law on the Central Bank, the Law on Banks and Banking set forth the statutory framework for privatization and regulation of the fledgling commercial banking industry in Russia. The same political compromises that appeared in the Law on the Central Bank were evident in the Law on Banks and Banking.

One obvious example can be seen in the law's equivocal provisions on commercial bank control. On the one hand, the 1990 law paid lip service to privatization by outlawing certain types of state involvement in commercial banks, including the financing of charter capital and day-to-day management. On the other hand (save for the latter provisions and

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94. See id., ch. IV, art. 17. See also Kazmin, supra note 86, at 115; Vysman, supra note 67, at 267.
95. See Law on the Central Bank, supra note 77, ch. I, art. 1; infra notes 165-66, 203 and accompanying text.
96. See Law on the Central Bank, supra note 77, ch. III, art. 14; id., ch. IV, art. 16(a).
98. For comprehensive summaries of this law, see Juhani Laurila, Russian Banking Legislation and Supervision, in RUSSIA'S FINANCIAL MARKETS AND THE BANKING SECTOR IN TRANSITION 83 (Jouko Rautava ed., 1996); Pettibone & Passer-Muslin, supra note 68, passim; Vysman, supra note 67, at 268-74.
99. On the topic of financing, the law provided that legislators, their executive bodies, political parties and specialized public funds could not contribute funds to the charter capital of a bank. See Law on Banks and Banking, supra note 78, ch. I, art. 10. On the topic of management, the law made commercial banks independent of the executive and administrative branches in day-to-day operating decisions and officials of those branches were specifically banned "from taking part . . . in the governing bodies of
provisions restricting foreign ownership of banks), the law did not restrict the identity of founders or shareholders. Nothing prevented the Central Bank of Russia from later acquiring holdings in private banks. Similarly, nothing prevented industrial enterprises, former Party apparatchiks or factory managers from obtaining control stakes in banks.

In view of these provisions, it comes as no surprise that the 1990 law was devoid of any provisions regulating conflicts of interest and self-dealing. Nothing in the 1990 law limited bank loans to bank shareholders, officers or directors. Nor could the Central Bank of Russia deny or revoke a bank license due to concerns over insider loans.

Hence, the 1990 law was specifically designed to elicit the support of the nomenklatura in return for the right to capture banks for use as private financing arms. The 1990 laws paved the way for privatization of the Russian banking industry by assuring the nomenklatura that the bank funds they had come to regard as an entitlement would not be cut off. Armed with the legal wherewithal to capture banks, the nomenklatura proved more than equal to steering the course of privatization.

IV. The Appearance of Marketization

With the passage of the 1990 laws, the commercial banking sector in Russia underwent privatization at breakneck speed. On January 2, 1991, the Russian Federation registered 1,085 private banks that were spin-offs from the old Soviet banks. Today, when former state-owned banks, collective
banks and new institutions are included, there are roughly 2,000 licensed commercial banks in Russia.\textsuperscript{104} By divesting its state-owned banks, Russia deliberately opted for a liberal proliferation of new private banks at the risk of weak capitalization and subsequent bank failures. Through its aggressive course, Russia privatized its banking system much more quickly than some of the Soviet Union's former satellites in central and eastern Europe, which simply split their former state-owned banks into a central bank and several smaller, state-owned commercial units.\textsuperscript{105}

By first appearances, the Russian banking industry transformed itself into a decentralized market-based system. The proliferation of Russian commercial banks alone suggests the dimension of this change. Depositors now have freedom to select their banks and borrowers have the legal freedom to shop for lenders. Most medium- and large-sized banks offer wire transfers, correspondent account services, letters of credit, hard currency accounts and even credit cards.\textsuperscript{106}

On closer examination, however, the transition to a market model of banking was less successful than it might seem at first blush. On the liability side, competition failed to attract significant private deposits to commercial banks. On the asset side, banks endangered their solvency by making loans with scant regard for creditworthiness or profits.

These problems dashed the hopes of economists who had looked to Russian commercial banks as the engine for financing the new private sector in Russia. In mature capitalist economies, banks normally share that task with the securities markets. In Russia, however, the difficulties of relying on the capital markets for financing are many and well-known. The

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\textsuperscript{105} See POL & CIAassens, \textit{supra} note 83, at 2-3; TRANSITION REPORT 1995, \textit{supra} note 90, at 161-62.

\textsuperscript{106} As Kornai aptly noted:

The banking system of a reform economy looks similar at first sight. The central influence of the state—the vertical link—is undeniably strong, but the impression, nonetheless, is that the managers and officials here are dealing with money; bank deposits come into being, loans are made, current accounts are run, checks and transfers are written, interest is calculated, bonds and shares are handled, and so on. All these indicate commercial transactions, horizontal relations, and "business," in other words, the presence of market coordination.

This impression is reinforced by the structural changes undergone by the banking system during the process of reform. Tendencies toward decentralization appear. Some of them are connected with the growth of regional autonomy; separate banks are set up for each region. The rest are directed at replacing the earlier monobank with a \textit{two-level banking system}, with the Central Bank operating as the upper tier and mutually independent commercial banks as the lower. So the impression is given that the decentralization has been accompanied by the appearance of competition among the commercial banks.

Russian stock market is in its infancy and rife with deterrents to investment, including clouds on stock ownership, rigged prices, weak or absent secondary trading markets, and rampant fraud. 107 The Russian corporate bond market barely exists. 108 Consequently, many commentators looked to the Russian banking industry to supply the bulk of Russia's corporate financing needs. 109

To date, however, the Russian banking industry's track record has been disappointing. Russian banks are wary of lending to start-up businesses. When they do, the loans usually bear prohibitively high rates of interest. 110 As a result, new businesses in Russia normally finance their


operations from retained profits, rather than from external financing.\textsuperscript{111}

There are numerous reasons for this state of affairs, not the least of which are Russian banks' understandable difficulties in assessing creditworthiness and obtaining assurances of repayment. Credit reporting services are practically non-existent and there are few if any sources of publicly available information about prospective corporate borrowers. Businesses lack track records of success under the new economic regime and banks lack experience in evaluating creditworthiness.\textsuperscript{112} To compound matters, bank collateral laws are in their infancy,\textsuperscript{113} collateral registries barely exist, collateral ownership is highly uncertain\textsuperscript{114} and judicial enforcement of collateral and bankruptcy rights is haphazard at best.\textsuperscript{115}

\textsuperscript{111} See Caprio & Levine, supra note 109, at 13; Colin Jones, Banking and Financial Sectors in East and Central Europe 12 (Financial Times Management Report 1993); Transition Report 1995, supra note 90, at 87, 91-92; Leonid Khotin, Old and New Entrepreneurs in Today's Russia, 43 PROBS. POST-COMMUNISM 49, 55 (1996); Morgenstern, supra note 107, at 90; Mark E. Schaffer et al., Bank-Enterprise Relations and Credit Allocation in Russia 12 (June 1995) (unpublished manuscript, on file with author). Ronald McKinnon presaged this development. See McKinnon, supra note 37, at 121-23. For proposed solutions to this financing impasse, compare id. at 121-24 (would initially halt bank loans and require businesses to expand through retained earnings) with Hugh Breidenkamp, Conducting Monetary and Credit Policy in Countries of the Former Soviet Union: Some Issues and Options 17-20, 22 (IMF Working Paper No. WP/93/23, 1993) (would limit bank loans to enterprises that had current audited financial statements and a model business plan).

\textsuperscript{112} Cf. Calvo & Kumar, supra note 109, at 27, 29; Stanley Fischer & Alan Gelb, Issues in Socialist Economy Reform 9 (World Bank Policy, Research, and External Affairs WPS 565, 1990); Kenneth Kletzer & Jorge Roldos, The Role of Credit Markets in a Transition Economy with Incomplete Public Information iii (IMF Working Paper No. WP/96/18, 1996); Andy Mullineux, Progress with Financial Sector Reform in Six Transforming Economies 24 (U. Birmingham Dep't of Econ. & Int'l Fin. Group Working Paper IFGPW-95-04, 1995); Edmund S. Phelps et al., Needed Mechanisms of Corporate Governance and Finance in Eastern Europe 25 (European Bank for Reconstruction and Development Working Paper No. 1, 1993); Johnson et al., supra note 34, at 185, 194-95; Jacek Rostowski, Dilemmas of Monetary and Financial Policy in Post-Stabilization Russia, in Economic Transformation in Russia, supra note 109, at 72; David Rudnick, First Sort Out the Banks, Euromoney, Mar. 1994, at 157, 158; Vysman, supra note 67, at 278. As a result, Russian banks have "tended to favor those borrowers who had large fixed assets that could serve as collateral," i.e., large formerly state-owned enterprises. See Roman Frydman & Andrei Rapaczynski, Privatization in Eastern Europe: Is the State Withering Away? 130 (1994).

\textsuperscript{113} See Johnson et al., supra note 34, at 187, 194-95.

\textsuperscript{114} The newly enacted Russian Civil Code attempts to redress this problem. See generally Civil Code of the Russian Federation, pt. 1, arts. 25, 65 (1993).

\textsuperscript{115} See Åslund, How Russia Became a Market Economy, supra note 65, at 169, 211; Bernard S. Black et al., Corporate Law From Scratch, in 2 Corporate Governance in Central Europe and Russia, supra note 82, at 245, 292; Transition Report 1995, supra note 90, at 114-15; Vysman, supra note 67, at 278. See generally Peter Rutland, Bankruptcy Data, OMRI Daily Dig. (Mar. 28, 1996) <http://www.omri.cz/Publications/Digests/DigestIndex.html> (noting that although Russian courts declared 459 enterprises bankrupt in 1995 and another 1,103 firms voluntarily declared bankruptcy that
Because formal enforcement is more important for longer-term contracts, enforcement problems discourage longer-term capital investment loans.\textsuperscript{116}

In addition, many of the old state-owned banks that underwent privatization were saddled with operating losses inherited from Soviet times. Rather than write off those losses, the Russian government simply apportioned them among the state-owned banks when it came time to privatize.\textsuperscript{117} High inflation and negative real interest rates eventually wiped out those losses.\textsuperscript{118} In the short term, however, the effect was to sap operating funds, reducing the funds available for lending and encouraging burdened

year, no large-sized enterprise had been declared bankrupt). In theory, the Law on Banks and Banking gave banks the right to secure loans with collateral and to force insolvent borrowers into bankruptcy. See Law on Banks and Banking, \textit{supra} note 78, ch. IV, arts. 32-34. For a description of procedures for the enforcement of bankruptcy rights, see generally Russian Federation Insolvency (Bankruptcy) of Enterprises Act, Russian Federation Act No. 3929-1, Russian Federation Supreme Soviet Decree No. 3930-1, arts. 1, 10(1) (1992), \textit{available} in Westlaw, Ruslegisline Database. But a 1994 survey found that while virtually all bank loans in Russia were collateralized, collateral provisions were of questionable value because banks rarely took legal action to seize secured assets. See Schaffer et al., \textit{supra} note 111, at 2, 7.

Instead, many banks rely upon private security forces to collect collateral, spawning violence and vigilantism. See, \textit{e.g.}, Black et al., \textit{supra}, at 63. Baidina and Baidin describe the enforcement problems in detail:

For example, these kinds of situations are not unusual: A borrower gets credits in several banks using the same property as collateral, a building for example. In case of default, several banks start claiming the same building; what results is a fight among the banks rather than between the bank and the borrower. The situation becomes even more complicated when the property is a plot of land, because it is very difficult to determine the rightful owner under current law. Legal recourses for foreclosing on a mortgage are quite cumbersome, and it is even more difficult to force a firm to declare bankruptcy to settle debts to creditors. These actions can only be brought in a court of arbitration, and the flood of such cases has brought relatively long delays in having cases heard (at least three months). In a fluid situation such as Russia’s, this is long enough for property to become unsaleable or for the debtor to disappear.


116. See Rubin, \textit{supra} note 115, at 1, 14.

117. See \textit{MICHAEL S. BORISH ET AL., RESTRUCTURING BANKS AND ENTREPRISES: RECENT LESSONS FROM TRANSITION COUNTRIES} 16 (World Bank Discussion Paper No. 279, 1995). \textit{Cf.} Blinov et al., \textit{supra} note 62, at 87-88; Yavlinsky \textit{et al.}, \textit{supra} note 81, at 34 (proposing in the 500-day plan that “the balance sheets of state banks shall be divided; all transactions shall be passed through correspondent accounts”).

118. See Blommestein & Lange, \textit{supra} note 109, at 17-18.
banks to flout sound banking practices in exchange for higher rates of return.\textsuperscript{119}

But beyond these problems lay more fundamental difficulties. The apparent market tilt of Russian commercial banking veiled the fact that major segments of the Russian banking industry continued to serve as conduits for Soviet-style soft budget constraints. The large majority of Russian banks practiced Soviet banking as usual, but in a new guise. That was the direct legacy of the ownership structure of most Russian commercial banks.

A. Market Failure and the Resurgence of the Nomenklatura

Approximately two-thirds of private Russian banks today are organized as partnerships, while the remaining banks are organized as joint-stock companies.\textsuperscript{120} In either case, organizers of new Russian banks are required to contribute specified amounts of capital by law. By surface appearances, then, stakeholders in Russian banks put their own funds at risk and the pursuit of profit should be their overriding motive.

In all too many instances, however, new Russian banks subordinated profit-seeking to other goals, such as providing subsidies to failing private industries or economic demands by the state. Why those banks resisted market principles is apparent when the ownership origins of Russian commercial banks are examined.

Private banks in Russia are of three distinct types. The first consists of banks previously owned by the state.\textsuperscript{121} During privatization, the banks' traditional customers—state-owned enterprises themselves slated for privatization—acquired controlling stakes in those banks.\textsuperscript{122} The second type consists of other banks formed by government ministries and state-owned firms. Generally, these banks were created either from the financial administrations of one-time government ministries or local branches of state-

\textsuperscript{119} See Borish et al., supra note 117, at 16; Transition Report 1995, supra note 90, at 20, 153; Kazmin, supra note 86, at 117. Cf. Calvo & Kumar, supra note 109, at 27; Caprio & Levine, supra note 109, at 18; Fischer & Gelb, supra note 112, at 27-28; Mathieson & Haas, supra note 89, at 8-9; McKinnon, supra note 37, at 121; Anthony Saunders & Andrea Sommariva, Banking Sector and Restructuring in Eastern Europe, 17 J. Banking & Fin. 931 (1993); Joseph E. Stiglitz, The Design of Financial Systems for the Newly Emerging Democracies of Eastern Europe, in Emergence, supra note 37, at 161, 170-74.

\textsuperscript{120} Markalova, supra note 91, at 122-03.

\textsuperscript{121} In 1990 Agroprombank and Zhilsotsbank were converted into joint-stock companies. Promstroibank followed suit in 1991. See Johnson et al., supra note 34, at 186. See also Craig Mellow, Upstarts and Mother Wolf, The Banker 14, 14-15 (May 1993); Osakwe, supra note 68, at 322; Russia's Leading Commercial Banks 81-82 (Martin McCauley ed., 1994); Russian Banks; Overgrown and Under Financed, Economist, July 18, 1992, at 84. Stolichny Savings Bank acquired Agroprombank in late 1996. See Poul F. Larsen, Stolichny Opens Russia's First Private Savings Bank, Russia Rev., Dec. 16, 1996, at 23. In the meantime, Zhilsotsbank went out of business and its branches were spun off into new commercial banks. See Brown, Of Brokers, supra note 107, at 202.

\textsuperscript{122} See Khotin, supra note 111, at 50, 53-54; Mellow, supra note 121, at 14-15; Rudyck, supra note 112, at 158, 160; Vysman, supra note 67, at 279.
owned banks that split off on their own.\textsuperscript{123} The last type consists of banks created from scratch (often, however, with capital supplied by the state). These most resemble independent commercial banks.\textsuperscript{124}

In January 1991, when bank privatization began, state-owned enterprises and government ministries moved aggressively to seize control of state-owned banks. The sorry financial shape of these state-owned firms made captive financing essential. When the command economy unraveled, Russian industry went into a free-fall as trade partners reneged on their debts, demand for outmoded products plummeted and the Soviet trade alliance fell apart.\textsuperscript{125} Hemorrhaging losses, state-owned firms took full advantage of the provisions in the 1990 laws that made captive banks available for the taking.

The minimum capital provisions of those laws made the taking easy. Until July 1, 1993, only five million rubles were required to start a commercial bank in Russia (approximately equal to $5,000 in late May of 1993), and even that amount was soft because intangibles such as the banking experience of managers counted toward capital. As inflation soared, starting a bank became less costly than starting a kiosk, and sometimes the state even supplied the capital.\textsuperscript{126} Over 2,000 banks sprang into existence.

\begin{itemize}
\item \textsuperscript{123} Examples include Mosbusinessbank, formerly a branch of Zhilsotsbank; ICB in St. Petersburg and the Commercial Bank of Western Siberia, once branches of Promstroy; Avtovaz Bank, formed by the company that manufactures Lada cars; and Uneximbank. See Pohl \& Claessens, supra note 83, at 7; Bernstein, supra note 68, at 23; Olga Kryshantanovskaya, The Financial Oligarchy in Russia, Izvestia, Jan. 10, 1996, at 5, reprinted in Current Dig. Post-Soviet Press, Feb. 21, 1996, at 1, 2; Rumer, supra note 63, at 19, 21-22; Russian Banks; Overgrown and Under Financed, supra note 121, at 84; Vysman, supra note 67, at 279. Estimates of the number of such banks vary but in any event are substantial. Former Central Bank of Russia chairman Viktor Gerashchenko estimated in 1993 that "more than one-third of the small banks were created from divisions of former state specialized banks." Viktor V. Gerashchenko, Tekushchie zadachi Denezhnno-Kreditnoi Politiki i Tendentsii Razvitia Bankovskoi Sistemy RF, 7 Den'gi i Kredit 14 (1993), reprinted as Current Problems of Monetary and Credit Policy and Developmental Tendencies in the Banking System of the Russian Federation, 30 Russian \& E. Eur. Fin. \& Trade 7, 11 (1994); see also The Emerging Russian Commercial Bank Sector, Business Bulletin (Int'l Trade Adm., U.S. Dep't of Commerce, Washington, D.C.), Dec. 1993-Jan. 1994, at 1, 3 (estimating that 700 banks are spinoffs of the old sector banks); Russian Banks; Overgrown and Under Financed, supra note 121, at 84 (estimating that four-fifths of Russian commercial banks are owned by state-run enterprises). Many banks flouted the legislative ban on using funds from political and governmental organizations for purposes of bank capital, while others complied with the ban by recapitalizing and reorganizing their boards. See Kazmin, supra note 86, at 116; Vysman, supra note 67, at 279.
\item \textsuperscript{124} Pohl \& Claessens, supra note 83, at 6-8; Celeste E. Greene, A Regulatory Framework for Commercial Banking in Russia, 12 Int'l Tax \& Bus. Law. 63, 66-68 (1994); Johnson et al., supra note 34, at 186, 188; Hill \& Slavinski, supra note 51, at 38, 41; Kryshantanovskaya, supra note 123, at 3; Mellow, supra note 121, at 14-15; Rostowski, supra note 73, at 446; Rudnick, supra note 112, at 157, 158. Credobank, Inkombank, Bank Stolichny, Menatep and Kommercbank are examples of commercial banks started from scratch. See Pohl \& Claessens, supra note 83, at 7; Kryshantanovskaya, supra note 123, at 3; Mellow, supra note 121, at 15.
\item \textsuperscript{125} See Jones, supra note 111, at 11; Blommestein \& Lange, supra note 109, at 17.
\item \textsuperscript{126} See Hill \& Slavinski, supra note 51, at 41; Central Bank of the Russian Federation, Russia's Central Bank Report, May 28, 1993, available in LEXIS, News Library, Arcnews File (reporting that the official exchange rate for the ruble on May 28, 1993 was
during that period, at least eighty percent of which were severely undercapitalized by Western standards. Thus, during the first two years of

reform, even ailing manufacturing firms could afford to found a bank. As a result, large segments of the Russian banking industry are client banks, owned and run by former state-owned enterprises and ministries that have now been privatized.128 Most of the newly privatized firms, in turn, are owned and run by members of the old-line Party elite who are imbued with Soviet norms.129 As Anders Åslund described the mentality of the party-elite-turned-managers:

[They] seem to have all the characteristics that one would like to avoid: they have little knowledge of economics; they are firmly moulded by the old Soviet command economy; they know nothing of the outside world; their purpose for coming into power is to gain wealth for themselves and their narrow constituency.130

Thus, in many instances the legal form of banks and firms changed, but their economic behavior did not. Because very little capital was at risk, insider loans, rather than return on equity, were the primary motivating factor behind the formation of a majority of Russian banks.131 Moreover, with bankruptcy laws rarely enforced, borrower-shareholders knew that they were unlikely to be shut down if they could not repay their loans.132 Client banks thus faced intense pressures from their shareholders and boards to compromise profits in order to perpetuate the old Soviet system of soft budget constraints.

To be sure, not all commercial banks in Russia were controlled by borrower-clients. A small minority of Russian banks were created without ties to the old albatross businesses. But even of those, fewer than twenty, according to the World Bank, have made significant strides in clamping
down on shareholder loans.\textsuperscript{133}

Thus, the resurgence of the \textit{nomenklatura} assured that most commercial banks in Russia would be run on the basis of political and economic clout, rather than market principles. The resulting clamor for massive subsidies by banks and their owners created intense demands for the government to respond in kind.

B. The Weak Deposit Base of Russian Commercial Banks

Compounding these problems was the Russian banking industry's dependence on government funding, due to the industry's weak deposit base. In Russia today, most commercial banks have difficulty attracting private deposits, particularly household deposits.\textsuperscript{134} These difficulties hamper the Russian banking industry's ability to channel private savings into the private investment sector and thus serve as a genuine financial intermediary. The reasons for these difficulties are numerous and complex, complicating the task of building a traditional deposit base.

The first major impediment to attracting deposits consists of customers' long-standing allegiance to their Soviet-era banks.\textsuperscript{135} This problem is particularly pressing for household deposits, because Russian citizens historically depended upon Sberbank for all of their banking needs. Before the reforms, Sberbank was the only bank that served individual citizens and Sberbank continues to hold a high percentage of individual deposits today.\textsuperscript{136} In addition to familiarity and habit, Sberbank offers consumers distinct advantages that other banks do not. It is convenient, with over

\begin{itemize}
\item \textsuperscript{133} See Greene, supra note 124, at 68. Cf. Rudnick, supra note 112, at 158. Oleg Kharkhordin and Theodore Gerber commented in this regard in their study of St. Petersburg managers: "Instead of dealing with new private commercial banks, directors tended to rely on the former ministerial banks, which had by then also been transformed into independent banks." Oleg Kharkhordin & Theodore P. Gerber, \textit{Russian Directors' Business Ethic: A Study of Industrial Enterprises in St. Petersburg, 1993}, 46 EUR.-ASIA STUDIES 1075, 1076 (1994).
\item \textsuperscript{135} See Sundararajan, supra note 36, at 12 (the ability of commercial banks "to compete for deposits" is "limited, owing to the dominance of specialized banks that existed prior to the reform").
\end{itemize}
40,000 branches in a country where branch offices are otherwise rare.\footnote{137} More importantly, Sberbank deposits are fully backed by an implicit government guarantee, unlike deposits at other commercial banks.\footnote{138} Given


\footnote{138} See Law on Banks and Banking, supra note 78, ch. VI, art. 41; Civil Code of the Russian Federation, pt. 2, art. 840, § 1 (1996); Fein, supra note 97; Pettibone & Passer-Muslin, supra note 68, at 717 n.3; Vysman, supra note 67, at 280. See generally Guillermo A. Calvo & Manmohan S. Kumar, Part I Financial Markets and Intermediation, in FINANCIAL SECTOR REFORMS AND EXCHANGE ARRANGEMENTS IN EASTERN EUROPE 26-27 (IMF Occasional Paper 102, 1993) (discussing the advisability of deposit insurance in former socialist countries); Giorgio Szegö, Introduction, 17 J. BANKING & FIN. 773, 776-81 (1993) (same). The Central Bank of Russia has attempted to safeguard individual deposits at other banks by capping total household deposits at the amount of the bank’s capital, through high mandatory reserves and through supervision and enforcement. See Bank of Russia, Instruction No. 169: On Measures to Ensure the Fulfillment by Commercial Banks of Obligations to Depositors (May 24, 1995) (available on Kodecks; translation on file with author); Andrei Grigoryev, Central Bank Steps Up Oversight of How Depositors’ Money Is Handled, SVODNYA, June 3, 1995, at 3, reprinted in CURRENT Dig. Post-Soviet Press, June 28, 1995, at 19. To that end, the Bank also issued new licensing rules effective April 19, 1996 that require new banks to be in sound financial condition and to have at least two years of experience in handling the deposits of legal entities before they can accept deposits from individuals. Russia Raises Minimum Capital Rules, Sets New Licensing Regulations for Banks, supra note 126, at 757.

Although the 1990 legislation instructed the Central Bank of Russia to institute universal deposit insurance, the Bank has not done so to date. See Law on the Central Bank, supra note 77, ch. I, art. 6; id. ch. VI, art. 29; Law on Banks and Banking, supra note 78, ch. VI, art. 39. See also Amendments and Addenda to the RSFSR Central Bank (Bank of Russia) Act, RF Federal Act No. 65-FZ, ch. X, art. 71 (Apr. 12, 1995) [hereinafter 1995 Amendments to the Law on the Central Bank], available in Westlaw, Ruslegisline Database, 1995 WL 320349; Amendments and Addenda to the Banks and Banking Business in the RSFSR Act, RF Federal Act No. 17-FZ, ch. VI, art. 38 (July 21, 1995) (Russ.) [hereinafter 1995 Amendments to the Law on Banks and Banking], available in Westlaw, Ruslegisline Database, 1996 WL 135282; Civil Code of the Russian Federation, pt. 2, art. 840 (1996); Fein, supra note 97; Markalova, supra note 91, at 122-05. In November 1995, the Duma approved a bill for mandatory deposit insurance which President Yeltsin refused to sign into law. The Bank and the government opposed the bill because it authorized the deposit insurance fund to borrow from the government if the fund experienced shortfalls. The Bank’s opposition was also fueled by the fact that under the bill the fund would have independent powers to examine and monitor insured banks. See Yelena Medvedeva, Federation Council Supports President, Central Bank and Finance Ministry, KOMMERSANT-DAILY, Dec. 13, 1995, at 2, reprinted in CURRENT Dig. Post-Soviet Press, Jan. 10, 1996, at 19; Peter Rutland, Protection for Depositors and Investors, OMRI DAILY Dig. (Mar. 22, 1996) <http://www.omri.cz/Publications/Digests/DigestIndex.html>.

Another reason why the government has opposed universal deposit insurance is due to its potential fiscal consequences. The Law on Banks and Banking authorizes the Bank, Sberbank’s majority owner, to finance budget shortfalls from Sberbank’s deposit base. See Law on Banks and Banking, supra note 78, ch. VI, art. 41. The amount of household deposits that are available for financing the government budget is maximized so long as Sberbank has a monopoly on deposit insurance. Sberbank’s special status in this regard has reduced “competition for household deposits, so as to maintain the pre-emption of household savings for financing of the budget.” 1 IMF, supra note 20, at 371. Cf. McKinnon, supra note 37, at 114 (“liberalizing socialist governments typically cover their revenue shortfalls by borrowing from the (state) banking system which funds itself by issuing modest-yield saving deposits and liquid cash balances to households”).
widespread (and justified) public fears about bank failures, the ability to offer deposit guarantees gives Sberbank an obvious competitive edge.

Nonetheless, all Russian banks, including Sberbank, suffered from a massive outflow of deposits after prices were deregulated in 1992. Until price liberalization, Russians had high levels of bank savings because there was little to buy. But when the Yeltsin administration deregulated prices in early 1992 and goods suddenly appeared on the shelves, Russian consumers withdrew their deposits en masse in order to make purchases. The resulting surge in pent-up demand was worse than in almost any recent peacetime economy bar Brazil.

When consumers flooded the retail market with rubles in 1992 and 1993, inflation erupted. By the end of 1992, consumer spending had helped propel inflation to over 2,000% per annum and the deposit outflow had worsened. In theory, under the 1990 legislation, commercial banks were free to combat withdrawals by offering competitive interest rates on deposits. In practice, to profit on the spread between loans and deposits, most banks did not pay competitive interest on deposits until the latter half of 1992 and Sberbank declined to do so until the latter half of 1993. The victims were depositors, who watched their deposits dwindle.


143. Notwithstanding the 1990 laws, the government had capped interest rates well below inflation as an anti-inflationary device until January 1992. See David Fairlamb, Moscow’s Financial Crisis, Institutional Investor, Jan. 1992, at 81, 83; Hill & Slavinski, supra note 51, at 38; Mellow, supra note 121, at 17. In late 1991, the Central Bank of Russia also limited the spread between deposits and loans to three percent. Banks responded by charging higher fees to offset government caps on interest charged on loans. A few banks, such as Menatep and Avtovazbank, also evaded interest caps on
in value as inflation raged out of control. In response, consumers withdrew their savings in droves and converted them into household goods or hard foreign currency, which were superior stores of value.144

In its effort to curb inflation, the Russian government then worsened public mistrust of banks through its repeated, ill-fated attempts to freeze deposits and confiscate bank notes.145 Although these attempts were in


After commercial banks finally raised their rates in late 1992, Sberbank suffered an exodus of household depositors. Upon urging by reformers, and in an effort to stem deposit outflows, Sberbank finally began paying positive real interest rates on savings in late 1993. Mellow, supra note 121, at 17; Yevgenyev, supra note 136 (by the end of 1993, Sberbank was offering 120% per annum on time deposits).

144. See Rostowski, supra note 112, at 60-66; Summers, supra note 139, at 182 ("In periods of high inflation, the value the public attaches to money diminishes, to the point where money loses its usefulness as a store of value and medium of exchange. Under these circumstances, public preferences would shift to a more primitive system, based on barter, or a system based on use of foreign currencies."); Uno, supra note 139, at 171. Between February 1992 and March 1993, the real value of bank accounts dropped 17% based on the consumer price index and 44% based on the wholesale price index. See Rostowski, supra note 112, at 60 (citing Russian Economic Trends, May 1993). However, reduced the value of household savings from 37% of gross national product in 1990 to less than 2% of GNP by year-end 1992. See Pohl & Claessens, supra note 83, at 6.


145. In late 1990, the government floated but rejected a plan to impose a partial freeze on enterprise accounts. 1 IMF, supra note 20, at 65. Instead, in January 1991, the Bank froze household bank accounts and declared 50-ruble and 100-ruble bank notes void, triggering hysteria as people rushed to exchange their bills. Depositors were only allowed access to their accounts for limited monthly withdrawals. Public outcry forced the Bank to lift the freeze the following month. Åslund, How Russia Became A Market Economy, supra note 65, at 130; Gros & Steinherr, supra note 50, at 161; 1 IMF, supra note 20, at 65; John Williamson, The Economic Opening of Eastern Europe 83 (1991); Petr O. Aven, Appendix A: Economic Policy and the Reforms of Mikhail Gorbachev—A Short History, in What Is To Be Done? Proposals for the Soviet Transition to the Market, supra note 61, at 205. Later that year, public confidence took another blow when the failing Vneshekonombank froze hard currency accounts on instructions from the government. See Hill & Slavinski, supra note 51, at 42; Geoff Winestock, Trade Grows In Vnesh Bonds, MOSCOW TIMES, Mar. 3, 1994.
part motivated by a legitimate desire to curb inflation and prop up shrinking tax revenues,\textsuperscript{146} the public perceived confiscatory measures as a disturbing throwback to Soviet times, when the government routinely blocked enterprises' access to their bank accounts. The recent confiscations were neither long-lived nor successful,\textsuperscript{147} but caused incalculable damage to the public trust in the banking system.

Russian citizens have additional reasons to avoid depositing their funds in bank accounts. Fears continue to abound that the government conducts surveillance by monitoring individuals' bank accounts. Some also fear that their deposits will be reported to tax collectors, or to the mafia for protection money demands.\textsuperscript{148}

Two years later, in July 1993, panic struck when the Central Bank of Russia announced on a Saturday morning that bank notes predating 1993 would no longer be good the following Monday. Although President Yeltsin immediately issued a decree permitting citizens to exchange the old bills, public confidence in the banking system was badly shaken. Viktor Gerashchenko, then-chairman of the Bank, engineered the ruble-note confiscation. Cf. Aslund, How Russia Became A Market Economy, supra note 65, at 56, 129-30; Jonathan Steele, Eternal Russia 359-62 (1994). See generally Uno, supra note 139, at 172; Barry R. Weingast, The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development, 11 J. L., Econ. & Organization 1, 1 (1995) ("[t]hiving markets require not only the appropriate system of property rights and a law of contracts, but a secure political foundation that limits the ability of the state to confiscate wealth"). Since then, rumors of deposit freezes have periodically cropped up and precipitated bank runs. See, e.g., Freeze Scare Prompts Frantic Run on Banks, Moscow Times, Jan. 15, 1995, at 57; Peck, supra note 61, at 3, 14.

146. Cf. Aslund, How Russia Became A Market Economy, supra note 65, at 129-31; McKinnon, supra note 37, at 115-16.

147. See Aven, supra note 145, at 179, 205. The Russian Civil Code now states that for demand deposits, "the bank shall be obliged to pay out the deposited amount or a part of it on the depositor's demand," subject to liability for damages. Civil Code of the Russian Federation, pt. 2, arts. 837 ¶ 2, 840 ¶ 1, 4 (1996).

148. Russian statutes forbid banks from disclosing information about natural persons' accounts to tax collectors, government officials or private individuals. See Law on Banks and Banking, supra note 78, ch. III, art. 25; see also Civil Code of the Russian Federation, pt. 2, art. 857 (1996). Mafia figures, however, have used those privacy provisions offensively to shield their infiltration of banks. Banks are key to mafia operations, both for money-laundering and as the target of financial frauds. Russian mafia have infiltrated an uncertain percentage of banks (estimates range anywhere from ten to eighty percent) by infiltrating bank management and by extorting protection payments. Bankers who refuse to cooperate are "tamed" through threats, kidnapping or murder. In 1995 alone, over fifty Russian bankers and businessmen were slain in contract killings, including the heads of Tekhno-Bank, Mosbiznesbank and the St. Petersburg offices of Inkombank and Agroprombank. Upon infiltrating banks, mafia figures steal billions of rubles, either by obtaining funds through fake letters of credit or by diverting loan proceeds from their intended purpose and transferring the funds abroad. Bank personnel and officials of the Central Bank of Russia have been found to receive kickbacks of up to 30% in exchange for their cooperation and silence. See, e.g., Another Moscow Banker Murdered, Monitor (Nov. 10, 1995) \(<\text{http://www.jamestown.org}\); Mikhail Berger, Want a Loan? You Need to Pay the 'Gangster Tax,' Moscow Times, Apr. 9, 1995, at 35; Glinkina, supra note 127, at 390-91; Charles Hecker, Raids Are Common, Say Russian Bankers, Moscow Times, Dec. 7, 1994; Here's an Offer You Can't Refuse, Russia Rev., Feb. 12, 1996, at 17; Rensselaer W. Lee, III, The Organized Crime Morass in the Soviet Union, II Demokratizatsiya 392, 393-94 (1994); Shelley, supra note 127, at 828, 831-32; Arkady Vaksberg, The 'Mafiya' and its Threat to Civil Society in Russia, CIS Law Notes, Apr. 1994, at 13, 14-15; Aleksandr Zhilin, The Financial Crime of the Century, Prism, pt. 1,
These problems have left the Russian banking industry starved for household deposits. As a result, many private Russian banks are heavily dependent on short-term loans from the Central Bank of Russia for their regular source of funds. In that capacity, the Bank not only acts as a lender of last resort in emergencies requiring back-up liquidity, but also as a lender of "first resort" by providing (along with the inter-bank loan market) a major, routine source of bank finance.

This dependence on central bank financing has a number of undesirable effects. It exerts inflationary pressures by placing demands on the Central Bank of Russia to issue more money. It means that the banking


149. See Fein, supra note 97; see also Hill & Slavinski, supra note 51, at 40-41; Kazmin, supra note 86, at 119; Rostowski, supra note 112, at 66; Vysman, supra note 67, at 278; infra notes 226-27 and accompanying text.
system is chronically underfunded and fails to serve its intended function as a financial intermediary. Furthermore, central bank dependence politicizes what should be a market process. It makes Russian private banks susceptible to political demands from the Bank. It also means that the task of attracting bank funds is accomplished through lobbying and political bargaining, instead of through competition in the marketplace. The perverse interaction of these dynamics helped fuel subsidy demands in 1992.

C. Collective Action and Government Failure

"What we have now is not reform—we have liberated the Soviet system instead of liberating society from the Soviet system."

— Grigory Yavlinsky

The incessant pressure for subsidies need not have become a self-fulfilling prophecy had the government been able to resist those demands. In other words, the market failure that the resurgence of the nomenklatura presaged might have been nipped in the bud if not for concurrent government failure. In the first two-and-one-half years of Russian reforms, however, that was not the case. That government failure and the government's later, partial success in reversing it sheds light on the economic factors conducive to market-based bank reforms.

The Russian government's initial failure to reject subsidy demands was thoroughly predictable from the vantage point of public goods theory. Public goods theory predicts that the Russian government would be especially vulnerable to subsidy demands in the first stages of reform, because communist-era managers had highly effective lobbies and faced little, if any, organized opposition. Indeed, managers were in a unique position to enlist other groups to aid in their cause. Managers and their companies controlled banks that could be pressured to advocate subsidies. Banks had their own reasons to clamor for subsidies, given their shaky deposit bases. Similarly, managers were in a unique position to foment labor support by exploiting fears of job loss through their power to hire, fire and withhold pay. Fearful of a workers' revolt and hoping to maximize their own chances for reelection, legislators and the government could be expected to

151. See Greene, supra note 124, at 80-81; Uno, supra note 139, at 170-71; Vysman, supra note 67, at 281.


153. See Christopher Clague, The Journey to a Market Economy, in EMERGENCE, supra note 37, at 4 ("government failure as well as market failure must be taken into consideration in designing institutions"). See also PHILPS ET AL., supra note 112, at 36 ("It is a matter of crucial importance, however, for any clear thinking about the future of eastern European reforms to realise at the very outset that . . . the state of the governments in the region is no better than that of the industry or the service sector, and that the job of reforming the former is no easier than the restructuring of the latter. Indeed, to a large extent, it is one and the same.") (emphasis in original).
fall in line and exert their influence to procure subsidies.154

A public goods analysis would also expect managers, at least initially, to prefer subsidies over other types of public goods. Subsidies provided the cash infusion that companies needed. When the reforms began, moreover, nothing in managers' experience prepared them to regard subsidies as finite in supply or as anything other than inclusive public goods. Loan subsidies also had obvious economic advantages over true loans because they did not bear market rates of interest and had no adverse consequences if they were not repaid.155 As such, loan subsidies represented assurances of continued soft budget constraints. Consequently, managers could be expected to prefer loan subsidies and to lobby vigorously for them.

Public goods theory also explains why factory managers might seek subsidies through intermediaries in the form of commercial banks rather than directly from the government. At the breakup of the Soviet Union, the Russian government had a severe budget deficit that made massive new appropriations fiscally onerous.156 The resulting pressure on new appropriations, in fact, was one of the first hard budget constraints that factory managers ever encountered. Accordingly, factory managers could be expected to seek alternative conduits for government aid. The most important such alternative was the refinance facility of the Central Bank of Russia, because the Bank was beholden to the Supreme Soviet, a majority of whose members belonged to the nomenklatura. The best way for factory managers to assure access to Central Bank of Russia refinancing, in turn, was to control a private commercial bank that qualified for such refinancing.157

Experience bore out each of these predictions. In the politically tense period surrounding the breakup of the Soviet Union on December 25, 1991, the government faced overwhelming subsidy demands from practically all quarters of society. The Gorbachev government was on its last legs when the Russian Supreme Soviet enacted the 1990 banking laws. The regime succumbed in December 1991 after the failed military coup in August of that year. The democratic government that ensued, led by President Boris Yeltsin, rested on the support of workers dependent upon public-sector jobs. When Yeltsin came to power in the fall of 1991, industrial privatization had not begun, private-sector jobs were few and citizens largely worked for state-owned firms that were bleeding losses. From the outset, then, the Yeltsin government faced overwhelming pressure to avoid mass layoffs at all costs.158

154. See infra note 162 and accompanying text.
155. See infra notes 169-70, 173-74 and accompanying text.
156. See infra note 164 and accompanying text.
157. Cf. supra notes 96-97, 150 and accompanying text.
158. See KORNAI, THE ROAD TO A FREE ECONOMY 111 (1990) (the state "is practically incapable of deciding to liquidate jobs en masse"); MULLINEUX, supra note 109, at 9-10; Mikhail Leontyev, Conflict: Parliament United Against the Central Bank, Nezavisimaya Gazeta, May 19, 1992, at 1, 4, reprinted in CURRENT DIG. POST-SOVIE T PRESS, June 17, 1992, at 9. See generally KORNAI, supra note 28, at 545; Macey & Colombatto, supra note 2, at 414. In 1991, over half of the able-bodied population in Russia worked for one of
During that early, crucial period, there was discussion of alternative ways to soften the blow of plant closings without fueling political unrest. Some analysts argued that a generous unemployment benefits plan would be cheaper than keeping failing plants open, with their added maintenance and materials costs.\(^{159}\) Other analysts called for massive investments in brand-new entrepreneurial ventures, predicting that rapid new job creation would absorb factory layoffs.\(^{160}\) Reformers similarly emphasized the negative trade-offs of keeping obsolete plants afloat through subsidies, including inefficient investment, continued economic decline and potential hyperinflation. In particular, these sentiments were voiced by a small band of highly-placed, young reform economists in the Yeltsin administration who were imbued with market principles and who vigorously militated for economic reform. Among them were Yegor Gaidar, the first minister of economy and finance under President Yeltsin; Boris Fedorov, the minister of finance and deputy prime minister in 1993; and Anatoly Chubais, first deputy prime minister for economic affairs from 1992 to 1996.\(^{161}\)

Nonetheless, during the Yeltsin administration's first years, these arguments fell on deaf ears, largely due to the successful machinations of factory directors who had belonged to the old *nomenklatura*. Managers painted grim scenes of massive layoffs that would ensue if subsidies were not paid, inciting massive protests by workers. Local politicians, fearing the public's wrath for failure to protect local industries, weighed in with lobbying support as well.\(^{162}\) Managers got further support from the Association of Russian Bankers, one of the most influential lobbying groups in Russia and one of the most vociferous advocates of cheap loans.\(^{163}\)

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\(^{160}\) In their 1995 report, Andrea Richter and Mark Schaffer supplied data in support of this hypothesis, noting that "newly-established private manufacturing [firms in Russia] are creating jobs at a much more rapid rate than state-owned or privatized firms; job destruction rates, by contrast, are similar in the two ownership groups." Richter & Schaffer, *supra* note 110, at i-ii, 11-12.


\(^{162}\) See Davis, *supra* note 132, at 62; McKinnon, *supra* note 37, at 114. Article 14 of the 1992 Law on Bankruptcy gave local governments added rent-seeking incentives by providing that a local government could rescue an insolvent firm from bankruptcy where the firm had received government subsidies and the local government had guaranteed repayment. See RF Insolvency (Bankruptcy) of Enterprises Act, RF Act No. 3929-1, art. 14 (Nov. 19, 1992) (Russ.), available in Westlaw, Ruslegisline Database, 1992 WL 472617; Davis, *supra* note 132, at 61.

\(^{163}\) See generally Åslund, *How Russia Became A Market Economy*, supra note 65, at 308. Cf. Johnson et al., *supra* note 34, at 195, 200 (describing Ukrainian bank lobbying "to keep rates down" and summarizing an interview with a Ukrainian bank director who said he could "use ministerial contacts to lobby for subsidy payments to enterprises which would otherwise default on their loans").
In the face of those pressures, central bank loan subsidies were the path of least resistance. Politicians feared tough bankruptcy laws and plant shutdowns because they did not have confidence that the private sector would expand sufficiently quickly to avoid massive lay-offs. Increased unemployment benefits required a massive outlay of funds that the government did not have. For the same reason, the government lacked funds to appropriate subsidies to failing enterprises outright. Under the circumstances, using Central Bank of Russia loan subsidies to prop up inefficient enterprises had the obvious appeal of staving off immediate shutdowns and unemployment without raising the government deficit.\footnote{As Robert King and Ross Levine put it: "Although every effort should be made to isolate government subsidies to loss-making enterprises from market-based credit decisions, political economy pressures suggest that governments will attempt to hide these losses in bank credit decisions." Robert G. King & Ross Levine, \textit{Financial Intermediation and Economic Development}, in \textit{Capital Markets and Financial Intermediation} 188 n.11 (Colin Mayer & Xavier Vives eds., 1993). See also Marie Montaner, Government Finance Statistics in the Countries of the Former Soviet Union: Compilation and Methodological Issues 17 & n.1, 40-41 (IMF Working Paper No. 95/2, Jan. 1995); Steele, \textit{supra} note 145, at 300; Hansson, \textit{supra} note 140, at 70, 73-75. King and Levine's observation finds support in empirical data. Between 1992 and 1994, directed credits from the Central Bank of Russia far outstripped subsidy payments out of the budget and were the largest source of government transfer payments to enterprises in Russia. See Gilles Alfandari et al., Government Financial Transfers to Industrial Enterprises and Restructuring 5-6 (June 1995) (unpublished manuscript, on file with author).}

Similarly, the Central Bank of Russia had neither the political autonomy nor the will to fend off subsidy demands from the legislature. The central bank that emerged from the 1990 banking reforms was headed by Georgy Matyukhin, a middle-aged Soviet-era economics professor, and was politically subordinate to the Russian Supreme Soviet, the branch of the government most sensitive to subsidy demands.\footnote{See Boris Fedorov, \textit{Monetary, Financial and Foreign Exchange Policy: A Key to Stabilization and Economic Reform in the USSR}, in \textit{The Post-Soviet Economy}, supra note 81, at 105-06; Hill & Slavinski, \textit{supra} note 51, at 38; Pettibone & Passer-Muslin, \textit{supra} note 68, at 710; Jeffrey D. Sachs, Prospects for Monetary Stabilization in Russia, in Economic Transformation in Russia, \textit{supra} note 109, at 48; \textit{supra} note 95 and accompanying text. See also Åslund, How Russia Became A Market Economy, \textit{supra} note 65, at 323; Bredenkamp, \textit{supra} note 111, at 9-10 (recommending a high degree of central bank independence for former Soviet countries); Kornai, \textit{supra} note 28, at 547; Mullineux, \textit{supra} note 109, at 12-13 (discussing aspects of central bank independence); Sachs & Lipton, \textit{supra} note 58, at 142-43 (recommending changes to increase central bank autonomy).}

Although the Bank was more "independent" than Gosbank insofar as the Law on the Central Bank made it "independent of the executive and the administrative authorities of the state," the Bank nevertheless remained "accountable to" the parliament under that law.\footnote{Law on the Central Bank, \textit{supra} note 77, ch. I, art. 1; 1995 Amendments to the Central Bank, \textit{supra} note 138, ch. I, art. 5. But see Constitution of the Russian Federation § I, ch. II, art. 75(2), in \textit{Official Codification With Commentary}, \textit{supra} note 77 (in defending the stability of the ruble, the Central Bank of Russia shall operate "independently from other bodies of state power"). See also Fedorov, \textit{supra} note 73, at 60; Kazmin, \textit{supra} note 86, at 114; Markalova, \textit{supra} note 91, at 122-04 to 122-05, 122-09 n.10; Vyssman, \textit{supra} note 67, at 266. As Boris Fedorov has noted, the Bank's continued obeisance to the parliament impaired its independence.}

The resulting political subordination made the Bank...
peculiarly susceptible to legislative subsidy demands.

Ideology, inertia and graft further conditioned the Bank to favor aid. Chairman Matyukhin had moderate reform leanings, favoring gradual price liberalization and interest rate reforms. At the same time, he had been nominated by Ruslan Khasbulatov, the pro-subsidy chairman of the Russian Supreme Soviet, and was ideologically sympathetic to aid in some form to ailing, state-owned industries. Many of the Bank’s employees, moreover, were holdovers from Gosbank and accustomed to issuing subsidies and extracting kickbacks in return.

Against this political backdrop, subsidy demands came to a head in the spring of 1992, after price liberalization unleashed consumer demand and, with it, rising prices. Hit by rapid inflation, factory managers found factory reserves rapidly shrinking. Rather than cut costs, managers hectored the parliament and the government for subsidies. With the Sixth Congress of People’s Deputies due to meet in April 1992, the government and the Central Bank of Russia quickly succumbed. On April 4, 1992, the government issued a decree authorizing massive subsidies to agriculture and industry. Almost immediately, the Bank flooded the market with subsidies in the form of cheap credits. Consistent with the old Soviet preoc-

The idea of Central Bank independence became widely popular without people understanding its meaning. The first mistake was to exchange the bank’s dependence on the government for a dependence on Parliament. The idea was to lessen the inflationary influence of the government, but in reality it was substituted, with Parliament attempting day-to-day management of the Central Bank. In what country does the speaker of Parliament ever have a direct telephone line to the governor of the Central Bank? Since our Parliament is even more dominated by lobbies than is the government itself, it is like giving the Central Bank to vultures. The pro-inflationary pressures only increased.

Fedorov, supra note 73, at 65.


cupation with production quotas over profits, the stated purpose of the subsidies was to jump-start production at state-owned plants.

The handouts from the Bank were called "directed" or "targeted" credits and ranged from outright grants to subsidized loans that were issued without underwriting or unambiguous expectations of repayment. The principal recipients of those credits were banks controlled by state-owned enterprises. At the direction of the Bank, the recipient banks then funneled those funds to designated, ailing state enterprises, including bank shareholders, through payments styled as loans. Banks were also subject to pressure from shareholders to lend money regardless of creditworthiness.

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See Fischer, supra note 109, at 10, tbl. 1.2, 14 & fig. 1.2, 15; Sachs, supra note 165, at 34, 39 & tbl. 3.1.


As had Gosbank in Soviet times, the Bank sent commercial banks mixed messages as to the collectibility of their subsidized loans. According to the Bank, "When centralized credit resources were allocated, specific deadlines for their repayment were usually set." When borrowers had difficulties making repayments, however, the Bank routinely postponed repayment dates. From the Annual Report of the Central Bank, supra note 169, at 28.

171. See Fein, supra note 97; From the Annual Report of the Central Bank, supra note 169, at 30 (conceding that "bank stockholders (shareholders) are usually given priority in receiving credits"); noting that some banks loaned up to eighty to ninety percent of their total loan funds to a single shareholder); Glinkina, supra note 127, at 386-87; Rudnick, supra note 112, at 158. See also Yuri N. Afanasyev, Russian Reform Is Dead: Back to Central Planning, 73 Foreign Affairs 21, 25 (1994) ("[p]seudo-commercial banks that merely redistribute state finances and do not depend on deposits from people or enterprises now prevail!).

172. See Fischer, supra note 109, at 15; From the Annual Report of the Central Bank, supra note 169, at 22, 27 ("Out of the sum total of centralized credit extended to commercial banks, about 1.9 trillion rubles were allocated (as targeted credits and credits to various branches to meet pressing needs) in accordance with the decisions of the Supreme Soviet and the government"); Greene, supra note 124, at 76 & n.137; Rudnick, supra note 112, at 158; Sachs, supra note 165, at 42, 58 n.3; Shake Up at Vostokinvestbank, Russian Far East Update, June 1995, at 3-4 (reporting that "several Vladivostok banks have been 'asked' by the Administration to make" unprofitable loans to specified borrowers). Matyukhin's 1992 successor as chair of the Central Bank of Russia, Viktor Gerashchenko, described the magnitude of this policy:

Considering the extremely grave situation that ha[d] developed in the national economy, the government and the Bank of Russia decided to supply credit resources to commercial banks, so that they [might] in turn grant credit to enterprises and organizations in priority branches in order to sustain the normal activity of enterprises and branches of the economy.

As of 1 May 1993, commercial banks had been allotted a total 4,841.2 billion rubles for these purposes, including 2,335.6 billion rubles in the current year.
In the subsidy campaign, another chief goal of management was to maintain highly favorable negative real interest rates on directed credits from the Central Bank of Russia. In the fall of 1991 and the first half of 1992, Chairman Matyukhin took extremely modest steps toward hard budget constraints by raising the Bank's refinance rate closer to the real price of credit. But Matyukhin's moderation proved his undoing. Inflation was so out of control, with March 1992 prices 1,300% higher than prices one year before, that refinance rates would have had to be raised dramatically to approach a positive real rate. Fearful that such a high rate hike would make managers explode, Matyukhin merely toyed with interest, raising it from single digits to eighty percent per annum without coming close to positive real rates. Having stopped with half-measures (and having refused to reform the payments system), Matyukhin infuriated managers, bankers and reformers alike. Soon, all camps were demanding a replacement for Matyukhin. The nomenklatura won out, with the appointment of former Gosbank chairman Viktor Gerashchenko on November 4, 1992.173

As Anders Åslund describes it, Gerashchenko was an old-line central planner who "was popular among the old elite because he gave everyone the cheap credits they asked for and kept the refinance rate very low."174 Matyukhin's ouster showed the fierce resistance of the old elite to any attempts, even feeble ones, to institute hard budget constraints, whether in the form of market-rate interest or otherwise. To them, the concept that unprofitable plants should pay higher interest for higher risk (let alone be barred from credit at all) was utterly foreign. Instead of adjusting to the new economic environment, the manager class successfully closed ranks to insure that subsidies were plentiful and factories did not close.

A recent set of World Bank studies confirms that management lobbying was the moving force behind the Central Bank of Russia's program of

Gerashchenko, supra note 123, at 8-9.


174. Åslund, How Russia Became a Market Economy, supra note 65, at 98; see also id. at 210. Referring to Gerashchenko, Marshall Goldman has noted: "In Russia, paradoxically, it was the prime minister (or at least Gaidar as long as he was the acting prime minister) who fought for monetary restraint, while the Central Bank director was determined to print hoards of money." Marshall I. Goldman, Lost Opportunity 107 (1994).
directed loans. In a survey of 439 Russian industrial enterprises conducted in the summer of 1994, World Bank researchers concluded that: “[O]verall, whether and how much transfers [were] given [was] related consistently to the size of employment and membership in industrial associations of the enterprises. In other words, the main allocation criterion of government financial transfers [was] the bargaining power of the enterprises.”\textsuperscript{175} According to the survey, the key to management's success in obtaining subsidies was manipulating workers' fears of job loss: “[W]orkers, more than the firm itself, [were] of real concern to the authorities, in their decision to provide transfers.”\textsuperscript{176} Managers exploited workers' fears by setting “wages higher . . . than the cash they had available to pay them, necessarily leading to wage arrears, turning workers' protests on to government authorities.” This tactic was so pervasive that one-third to one-half of wages in Russia were in arrears at the time of the study.\textsuperscript{177}

The survey also confirmed that managers preferred subsidized payments to other types of public goods. According to the researchers, “the most commonly requested form of government assistance (after tax breaks) was credit on preferential terms.”\textsuperscript{178} Thus, both the private and public sides of the Russian banking system acted as if money was infinitely plentiful rather than scarce. That attitude was so entrenched that when the


\textsuperscript{176} Alfandari et al., supra note 164, at 24 (from the viewpoint of the government, “employment appeared to be one of the main variables determining the amount of transfers as well as the probability of being a recipient”).


In 1996, in a move to clamp down on wage and tax arrears that was a throwback to Soviet practices, the government issued decrees requiring Russian firms to have a single bank account, barring those firms from withdrawing funds from their accounts except for wages and business travel expenses, and taxing all bank transactions. Business interests objected that the decrees were unconstitutional and contrary to election promises. \textit{See Decree Taxing Bank Transactions, Other Measures Signed by Yeltsin, supra note 148, at 568; Peter Rutland, Proposal to Tighten Control of Bank Accounts, OMRI DAILY Dig. (Apr. 5, 1996) <http://www.omri.cz/Publications/Digests/DigestIndex.html>; Yeltsin to Restrict Companies' Access to Cash, Monitor (Mar. 22, 1996) <http://www.jamestown.org>. \textit{See} Law on Banks and Banking, supra note 78, ch. IV, art. 29; \textit{id}. ch. VI, art. 38; Civil Code of the Russian Federation, pt. 2, arts. 845, 847 ¶ 2, 854, 855 ¶ 1, 856, 858 (1996) (giving bank depositors autonomy in controlling disposition of their funds); \textit{id}. art. 861 ¶ 2 (permitting businesses to pay with cash).

\textsuperscript{178} \textit{See} Schaffer et al., supra note 111, at 12.
chairman of the Central Bank of Russia increased the refinancing rate, an important market mechanism for allocating scarcity, he was ousted and replaced by an old-style Soviet central banker.

Thus, what public goods theory would predict in fact came to pass. Factory managers continued to treat financing as a public good to be secured through lobbying rather than a private good to be supplied by the market. Their lobbying campaign was highly successful, not only because managers met with little opposition, but because they were able to use their powers of coercion to enlist banks and workers to support their cause. Moreover, managers preferred subsidies to any other form of public good because they did not perceive subsidies to be in short supply. As inflation exploded and the problem with subsidies became more transparent, however, that perception began to erode, creating the possibility for market-based bank system reforms.

D. The Problem with Subsidies

In 1992, subsidy demands emanated from nearly every segment of Russian society and were virtually unopposed domestically, save by a small band of economic reformers. By mid-1992, however, the harmful effects of subsidies began to be felt. The Central Bank of Russia’s directed loans qua subsidies spawned a number of severe problems, most visibly inflation.

The initial cause of inflation in 1992 was not subsidies but rather pent-up consumer spending. But once inflation ate into firms’ bottom lines and subsidy demands were granted, the money supply ballooned, pushing inflation even higher. By year-end 1992, the inflationary spiral was so severe that the annual rate of inflation had reached 2,318%.179

The runaway inflation of 1992-1993 introduced severe distortions into the credit market. One major distortion was a marked bias toward short-term trading loans. To hedge for inflation, Russian banks limited loan terms to one to three months, both to reduce interest rate risk and to boost prospects of repayment. Banks that did not lend exclusively to shareholders restricted their other loans to businesses with high turnover. Generally those borrowers were traders who imported quickly-sold goods such as electronics, groceries, cigarettes and stockings, goods which could serve as collateral. As a result Russia suffered from a dearth of medium- to long-term manufacturing and capital investment loans.180

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180. Even today, a six-month loan is extremely rare, with only slightly over one percent of loans being made for more than three months. See Davis, supra note 132, at 74 n.51. See also Åslund, How Russia Became A Market Economy, supra note 65, at 208; FRYDMAN ET AL., supra note 83, at 13 (by September 1, 1992, “short-term credits constituted 95 per cent of the stock of outstanding credits”); Dimitry V. Nepiedov, Status Komercheskaya Banki 5 (1994) (original and translation on file with author); Blinov et al., supra note 62, at 89 (“since the inflation-induced cutback in domestic production aggravated the scarcity of goods and made it possible to jack up prices of imported goods sharply, importers received considerable profits from the sale of foreign
The only banks that made industrial loans were banks that received cheap directed credits, mostly captive banks that were heavily exposed to their shareholder-borrowers. The Central Bank of Russia had justified directed credits in 1992 as necessary to boost capital investment and hence production. But as subsidies ignited inflation and buying power dropped, loans slated for capital investment went instead to replenish working capital. Subsidies thus did little or nothing to rejuvenate production, contrary to the assertions of the Bank.181

181. The Bank admitted as much in its 1992 annual report, stating: "Credits to commercial banks... did not perform their task in full measure, because [of] the high level of inflation." From the Annual Report of the Central Bank, supra note 169, at 22. See also Åslund, How Russia Became A Market Economy, supra note 65, at 192; Calvo & Kumar, supra note 109, at 11, 13; Mikhail Delyagin, The Most Dangerous Thing Now Would Be a Drastic Change in the Government's Course, POLITICHESKAYA SREDA, Dec. 14, 1995, at 3, reprinted in CURRENT DIG. POST-SOVIET PRESS, Jan. 17, 1996, at 18, 27 ("The money put into the economy was more and more inflationary, and the effect on production was less and less real"); Andrei Grigoryev, The Central Bank Chairman Toughens His Position on Credits, SEVODNYA, Apr. 26, 1994, at 12, reprinted in CURRENT DIG. POST-SOVIET PRESS, May 25, 1994, at 12; Sachs, supra note 165, at 42; Schaffer et al., supra note 111, at 2 (half of all loans were used for working capital, while about 15% were used for productive fixed investment). In the World Bank survey of Russian industrial firms taken in the summer of 1994, Alfandari, Fan and Freinkman found that the average size of subsidies was too small to finance real restructuring and that subsidies were mostly used to cover operating expenses as supplier payments and wages. The authors further found that subsidy recipients had lower average labor efficiency and profits than non-recipients because they used subsidies to avoid shedding workers. See Alfandari et al., supra note 164, at 6, 12-13, 27-28. Svetlana Glinkina also attributes the lack of increased productivity to takeoffs of loan proceeds by bankers and industry managers. See Glinkina, supra note 127, at 387. Contrary to assertions that the Russian government should institute development banks, see, e.g. Alice H. Amsden et al., THE MARKET MEETS ITS MATCH: RESTRUCTURING THE ECONOMIES OF EASTERN EUROPE 4-5, 120-123 (1994), the Russian experience thus suggests that directed credits by the Central Bank of Russia were too imbued with the old mentality of soft budget constraints to reliably result in productive investment.
Even longer-term working capital and capital investment loans were nominally issued on a short-term basis. Inflation helped some borrowers retire those debts because they could repay in inflated rubles.182 Other borrowers were so cash-strapped that they could not meet payments at all. In those instances, most banks responded by tacking the overdue interest onto the principal and then rescheduling the principal payments. With each loan rollover, the borrower got deeper and deeper in debt, masking increasingly serious bad loan problems on the bank's books.183 Exacerbating matters, some banks tried to offset losses by charging higher interest to their better borrowers, further discouraging quality borrowers from seeking bank loans.184

As this irrational interest charge structure suggests, the directed loan program further distorted the credit market by siphoning off credit from truly entrepreneurial ventures to inefficient state-owned firms and their

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183. Mark E. Schaffer, Qimiao Fan and Une J. Lee noted: “Our survey indicates that in Russia that [sic] the practice of rolling over overdue bank credit is very common indeed.” Schaffer et al., supra note 111, at 7 (emphasis omitted). See also Borish et al., supra note 117, at 25-26; Fischer & Gelb, supra note 112, at 13-14 (“firms may simply refinance growing interest charges, in a giant Ponzi scheme that initially delays reform and then renders it extremely costly”); Phelps et al., supra note 112, at 26; Slay, supra note 180, at 3 (“state enterprises of questionable creditworthiness continued to receive loans (or to have existing loans rolled over), while small startups in the private sector frequently had no access to bank credit”); Salvatore Zecchini, The Role of International Financial Institutions in the Transition Process, 20 J. COMP. ECON. 116, 131 (1995) (“monetary policy tightening did not prevent banks from having to support heavily indebted public enterprises toward which they were heavily exposed”). Cf. Greene, supra note 124, at 71 (“although banks appear prosperous in terms of reported earnings, the integrity of their financial reporting systems does not conform to Western standards”) (footnotes omitted).

The potential dangers posed by directed credits were highlighted by the fact that under Gerashchenko, the Bank waived safety and soundness regulations at some 500 banks in order to permit them to funnel directed loans to their shareholders without fear of license revocation. See Bloomstein & Lange, supra note 109, at 18. Cf. Gerashchenko, supra note 123, at 14. During his tenure, the Bank's regulating scheme did not mandate strict loan loss reserves or loan classification standards. See Blommestein & Lange, supra note 109, at 18. Cf. Kokorev & Remizov, supra note 182, at 56-58 (discussing changes in policies on loan loss reserves and write-offs for bad loans); Rudnick, supra note 112, at 157. In fact, Russian tax laws discouraged the creation of loan loss reserves by making such reserves subject to profit tax. See Borish et al., supra note 127, at 10; From the Annual Report of the Central Bank, supra note 169, at 29, 49; Gerashchenko, supra note 123, at 14; Kazmin, supra note 86, at 118-19. Compounding matters, in 1992 the Bank took the view that it could not regulate the use of loan loss reserves due to their taxability, whereupon some banks spent their reserves on items such as bonuses, office equipment and buildings. See From the Annual Report of the Central Bank, supra note 169, at 49.

managers. The Central Bank of Russia blatantly favored the state-owned sector in the granting and terms of targeted loans. Market-oriented banks complained that the Bank gave preferential interest rates to former state-owned banks;\textsuperscript{185} new businesses complained that directed credits went only to their state-sector competitors.\textsuperscript{186} The directed loan program was also lambasted for providing old-line managers with a ready source of funds from which they lined their pockets.

Directed credits also had the undesirable effect of reinforcing the hopes of factory managers and outside investors for continued soft budget constraints. Banks that charged below-market rates of interest failed to penalize state-owned borrowers for their inefficient practices.\textsuperscript{187} Factory managers who received directed credits were thus conditioned to expect more credits from the state. Directed credits also made private investors prefer the state sector over the private because the credits lent the appearance that the old manufacturing companies were operating with implicit government guarantees.\textsuperscript{188} The result was to prop up obsolete Soviet-era factories at the cost of denying financing to new private ventures.

Privatization combined with subsidies thus proved to be the worst of both worlds. Under communism, subsidized enterprises at least were accountable to some degree to the government through the device of central planning. With privatization, however, accountability to the government vanished. Further, the continuation of subsidies, together with the absence of a working system of involuntary bankruptcy, meant that state-owned firms were not accountable to the market.\textsuperscript{189} If anything, inefficient firm practices became worse during the early phases of liberalization than they had been under communism.

Paradoxically, however, subsidies had the unintended effect of opening the door to market-based bank reforms. As inflation shot up to unprecedented heights, public outcry led to divisions in the pro-subsidy forces. Public calls for reduced inflation lent political credence to the campaign to curb subsidies.

\textsuperscript{185} The point spread between loans to the old ministerial banks and loans to brand-new banks was as much as 60% per annum. See Hill & Slavinski, supra note 51, at 41. See generally Kornai, supra note 28, at 453 (in reform economies, the “authorities allocating resources discriminate against the private sector in favor of the public sector”); Greene, supra note 124, at 64, 73; Mellow, supra note 121, at 15; Rudnick, supra note 112, at 158. Cf. Mathieson & Haas, supra note 89, at 19-20.

\textsuperscript{186} See Caprio & Levine, supra note 109, at 15; Frydman & Rapaczynski, supra note 112, at 84-85, 183-84; Schaffer et al., supra note 111, at 19. See also Sachs, supra note 112, at 42.


\textsuperscript{188} See Pistor & Turkewitz, supra note 82, at 216-17; Zecchini, supra note 183, at 131 (“steep rises in the cost of credit . . . tended to crowd out the credit demand of fledgling private enterprises in favor of public enterprises . . . because of government guarantees”).

\textsuperscript{189} See Fischer & Gelb, supra note 112, at 10-11; Clague, supra note 153, at 4, 12 (noting this situation “may lead to worse results than central planning”). Cf. McKinnon, supra note 37, at 112.
V. Struggle for Reform

Notwithstanding this discouraging state of affairs—indeed, because of it—countervailing forces came to bear in 1993 that enabled the Russian government to better withstand subsidy pressures. The frightening takeoff of inflation in 1992 and 1993 and the market crises that ensued were the turning point for truly market-based banking reforms. As inflation careened out of control, the general public demanded relief. A rift developed within the business community as its more enterprising members came to realize that crippling inflation was the price of subsidies. While enterprises in the worst straits campaigned desperately to hold on to their subsidy lifelines, stronger enterprises, some of which qualified for subsidies and many of which did not, fought subsidies in order to reduce inflation.

In public goods terms, the business community thus underwent a radical change in its conception of subsidies. No longer did firms invariably view subsidies as inclusive public goods in limitless supply. Rather, firms began to view subsidies as exclusive public goods in limited supply, whose net per capita value declined as the flow of subsidies increased. As a consequence, firms in the least need of subsidies could be expected to demand lower inflation and to oppose subsidies in favor of other public goods. Conversely, firms that were dependent upon subsidies could be expected to continue to press for them, while seeking to cap the number of recipients in order to maximize their per capita share. In the process, public goods theory would predict that the old consensus in favor of subsidies would be replaced by a pitched battle over their use. The only governmental good that supporters and opponents of subsidies might both support would be public goods other than subsidies, such as entry controls, that would cap industry membership.

Events since 1993 in Russia unfolded as public goods theory would predict. Inflation came to dominate the Russian economic agenda. Inflation's toll gave reform forces the political impetus they needed to take up the fight against subsidies. Before that juncture, the struggle over subsidies had been virtually non-existent; ever since, the struggle over subsidies has been fierce, constant and turbulent.

A. Inflation's Wedge

By the spring of 1993, Russians had been reeling from ruinous inflation for almost a year and were demanding relief. Three events that spring gave Russian reformers the power and momentum to institute the battle against inflation and for monetary reforms.

The first event was President Yeltsin's April 25, 1993 referendum on the program of economic reforms. In a bold and risky bid for a popular mandate, President Yeltsin asked voters to approve his economic overhaul program. His gamble paid off in victory, with voters approving the govern-
ment's program for economic reforms.  

Second, the government finally succeeded in launching a market for government bonds, which helped to relieve the pressure on the Central Bank of Russia to finance the deficit. The Soviet government's prior attempt to float government bonds in 1990 had been a failure, with Gosbank having to buy back over eighty percent of the offering. But by March 1993, market conditions had sufficiently improved that the Russian government was able to successfully float a modest offering of three-month bonds. As demand for the bonds grew, the government gradually increased the size of the offerings and twelve-month bonds were introduced in 1995.

Finally, the International Monetary Fund (IMF) admitted Russia to full membership in April 1993, enabling Russia to qualify for IMF assistance. The first such assistance was in the form of a $3 billion Systemic Transformation Facility. In return for that facility, Russia agreed to massive price liberalization, cutbacks in unemployment compensation, deficit reductions, increased taxes, higher interest rates, caps on directed credits, lower inflation and foreign trade liberalization. Henceforth, conditional IMF financing would be a pivotal (if erratic) inducement toward economic reform.

As an integral part of the IMF's conditions, the Central Bank of Russia and the Russian Ministry of Finance signed a joint economy policy commitment on May 22, 1993 agreeing to reforms. In a historic provision, the Bank agreed to cap the growth of credits to firms at 2% of gross domestic product by year-end 1993, a reduction of 90%. The Bank further agreed to raise the official interest rate to no less than 7% below the prevailing market rate and to abandon subsidized credits in favor of commercial bank loans pegged at market rates. Under this commitment, any future requests

190. See Celestine Bohlen, Yeltsin, Fresh From His Victory, Is Attacked by Political Enemies, N.Y. Times, Apr. 27, 1993, at A1; Serge Schmemann, Russians Appear to Hand Yeltsin a Victory in Vote, N.Y. Times, Apr. 26, 1993, at A1. The referendum asked voters to cast votes on four questions. With respect to the first question, confidence in President Yeltsin, 59.2% of voters answered yes. The second question asked voters whether they supported the president's economic reforms, with 53.6% voting to approve. On the third, whether there should be early elections for the president, a scant 49% agreed. In contrast, responding to the fourth question, 67.5% of voters called for early elections for the conservative Supreme Soviet. See Bohlen, supra, at A1.

191. See 1 IMF, supra note 20, at 42.
192. See Greene, supra note 124, at 86.
by firms for government credits additionally had to be approved by the Government Commission on Credit Policy (the Credit Commission), which was staffed by reform economists, rather than solely by the Bank.195

The Credit Commission's presence exerted a moderating effect, both by achieving macroeconomic targets and by applying a partial brake to cheap credits. Between March and October 1993, for the first time in memory, the official annual interest rate approached positive real levels, rising from 80% to 210%. In 1993, the Credit Commission worked to wean enterprises and the government off of central bank loans, reducing the total outstanding sum of such loans from 35% to 12.8% of gross domestic product. Also due to the Credit Commission's intervention, quarterly credit limits were achieved for every quarter in 1993 except the third. As a result, the annual rate of inflation dropped nearly two-thirds, from 2,318% in 1992 to 841% in 1993.196

Nonetheless, the targets set forth in the May 1993 commitment aroused fierce political opposition and proved painful to satisfy. Describing the period of early- to mid-1993, a frustrated deputy prime minister Boris Fedorov summed up the continuing impediments to reform:

The president and prime minister gave insufficient and inconsistent support, and the majority of the government did not really support the financial stabilization plan or the reforms. Throughout the year most reform policy measures were opposed by the Central Bank and Parliament, which constantly tried to undermine reforms at any cost.197

One of the most intractable roadblocks proved to be one of the May 1993 commitment's own signatories, the Bank, and its chairman Viktor Gerashchenko. Within months after signing the commitment, the Bank demonstrated through its actions that its agreement to the commitment had been little more than a ruse. At Gerashchenko's direction, the Bank broke its promise to halt credits to specific industries, regions and firms, violating the credit cap targets for the third quarter of 1993. The Bank further violated the commitment by issuing direct subsidies to enterprises on its own without first obtaining the approval of the Credit Commission.198

195. See Åslund, How Russia Became A Market Economy, supra note 65, at 4, 194; Fedorov, supra note 73, at 62; Boris G. Fedorov & Andrei I. Kazmin, 1993: The First Experiences of the Russian Financial and Monetary Stabilization Policy, in Economic Transformation in Russia, supra note 109, at 27; Sachs, supra note 165, at 49-50, 54. Four months later, on September 25, 1993, the Council of Ministers issued a directive prohibiting subsidized credits altogether. This directive set a significant precedent, even though in the short-term it was honored mostly in the breach. See Åslund, How Russia Became A Market Economy, supra note 65, at 4.

196. See Transition Report 1995, supra note 90, at 186; Fedorov, supra note 73, at 62 (citing inflation figures of 900-1,000% in 1993). See generally The World Bank, Fiscal Management in Russia 2, 4 (1997) [hereinafter Fiscal Management in Russia]; Kokorev & Remizov, supra note 182, at 60-61 (discussing transition to positive real refinancing rates).

197. Fedorov, supra note 73, at 60-61.

198. The Central Bank of Russia made direct loans to ailing enterprises when commercial banks refused to serve as loan conduits or where enterprises did not want the
Notwithstanding its intransigence, the Bank nevertheless took one major step toward banking system reform in 1993. That July, it increased the minimum capital required to start a new bank from five million rubles to one hundred million rubles. In February 1994, it raised minimum capital requirements again to two billion rubles. While any reform during this period might appear puzzling given the Bank's generally reactionary stance under Gerashchenko, entry controls were in fact consistent with the theory of public goods. Unlike the struggle over subsidies, entry controls favored both the captive banks and the independent banks. Strong banks wanted entry controls to keep new competitors out; weak banks wanted entry controls to maximize their loans from the Bank. Consequently, the successful campaign to raise minimum capital levels sent a signal that banks and bank shareholders were beginning to realize that subsidies were in short supply.

The consensus over entry controls was mirrored by a breakdown in consensus over subsidized loans. It was only with the onset of inflation, when the toll of subsidies was directly felt, that the first real movement against subsidies got underway in the form of an anti-inflation campaign. In its earliest phase, the campaign achieved temporary interruptions in subsidies and a short-term drop in inflation. Its most enduring contributions to reform were the establishment of macroeconomic targets, movement toward positive real interest rates and the activation of the Credit Commission.

In sum, inflation had precisely the effect that public goods theory would predict. For the first time, under the banner of reduced inflation, opposition coalesced against subsidies in favor of other, non-monetary types of public goods. Strong banks succeeded in winning entry barriers, which the pro-subsidy forces supported for their own reasons. Similarly, there were calls for a rollback in directed credits in order to reduce inflation. In the short run, however, neither business support nor IMF funding was enough to sustain the anti-inflation campaign on anything more than an episodic basis. For as long as the key instrumentality of monetary reform—the Bank—remained in revanchist hands, a consistent reform policy would remain beyond reach.

B. From Constitutional Showdown to Market Collapse

By mid-1993, the anti-inflation forces were sufficiently well-entrenched that, even though they were unable to consistently prevail, they posed a genuine threat to the pro-subsidy lobby. With their appearance, the battle over subsidies had begun. The subsidy battle would prove so divisive that it would trigger armed conflict and ultimately the collapse of the ruble.

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inconvenience of having to deal with a commercial bank. See Aslund, How Russia Became a Market Economy, supra note 65, at 56, 131, 182; Fedorov & Kazmin, supra note 195, at 27, tbl. 2.1, 28-29; Schaffer et al., supra note 111, at 2 (survey of Russian firms taken in the summer of 1994 indicated that 13% of enterprise loans came directly from the Bank). Cf. Hill & Slavinski, supra note 51, at 40.

199. See supra note 126 and accompanying text.
In the summer of 1993, the Central Bank of Russia’s loose spending drove up inflation, causing it to hit twenty-six percent a month in August 1993, an all-year high. With anxieties over inflation already high, the Russian Supreme Soviet exacerbated matters by approving an inflationary budget with a projected deficit of one-quarter of the gross domestic product. In short order, the showdown over the budget precipitated a constitutional crisis.

Twice President Yeltsin vetoed the proposed budget and twice the Supreme Soviet overrode that veto. His veto powers depleted under the constitution, Yeltsin faced an unavoidable emergency: permit the budget to become law, with certain hyperinflation, or dissolve the parliament and subvert the constitution. Yeltsin chose the latter course. He dissolved the Russian Supreme Soviet by presidential decree on September 21, 1993. In response, members of parliament barricaded themselves inside the parliament building, the now-infamous White House. Resorting to force, Yeltsin’s forces stormed the building on October 4, 1993, forcibly removed the legislators and put them in prison. In a gesture laden with symbolism, Yeltsin also encircled the Bank with tanks.

That fall, between the Supreme Soviet’s dissolution and the December 1993 elections, reformers had a brief interlude in which to keep subsidies in check. Their most enduring success was the adoption of market rates of interest. In a fight for political survival, Gerashchenko finally agreed to raise the refinance rate to 17.5% per month as a condition of keeping his job. By year-end 1993, real interest rates reached positive levels for the first time in memory and have remained positive ever since, but for the three-month period between November 1994 and January 1995.

The reform team similarly made inroads on directed credits. Four days after Yeltsin ordered the parliament dissolved, reformers Boris Fedorov and Yegor Gaidar issued a renewed order banning subsidized loans, which the Bank observed from October 1993 to the spring of 1994. Monthly inflation dropped to between six and nine percent for the second quarter of 1994, down from fifteen to twenty percent for the previous six months. The resulting drop sent firms the important messages that inflation could be controlled and that loan subsidies from the Bank were not

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200. See Serge Schmemann, Revolt in Moscow: How Yeltsin Turned the Tide, Hour by Hour, N.Y. Times, Oct. 11, 1993, at 6; Serge Schmemann, Yeltsin Sends Troops to Oust Armed Foes from Parliament; Fierce Battle Rages in Capital, N.Y. Times, Oct. 4, 1993, at A1. See generally Alexey Alyushin, Russia: The Constitutional Sources of Disarray, 4 E. EUR. CONST. REV. 61, 66 (1995) (Yeltsin “rested his right to dissolve the legislature on . . . his duty to protect natural security and socioeconomic reforms”); Claudia Rosett, Obstacle to Reform: Rooted in Soviet Past, Russia’s Central Bank Lacks Grasp of Basics, WALL ST. J., Sept. 23, 1993, at A1 (“At heart, Russia’s dramatic clash between President Boris Yeltsin and Parliament is a battle to decide who sets economic policy in the struggle to recover from 74 years of Soviet misrule”). The Russian Supreme Soviet’s predisposition toward subsidies was predictable, given the fact that it was elected in March 1990, almost two years before the fall of the Soviet Union. Fully 87% of the Supreme Soviet’s members had been Communist Party members at the time of their election. See BLANCHARD ET AL., supra note 169, at 33.

assured.202

Complete success, however, was not had. Demands for cash handouts, while diminished, never ceased, and the government was prone to accede to them whenever opposition forces gained ascendency. Those forces came to a head in the December 1993 elections, when voters were asked to approve President Yeltsin's proposed new constitution and elect a new legislature (the Duma). The election results were mixed. Voters approved the new constitution, which strengthened the presidency vis-à-vis the legislature and increased the independence of the Bank.203 At the same time, voters rebuked Yeltsin and registered their protest against the pain of economic reforms by electing a conservative new parliament.

With the pro-subsidy Agrarian Party in control of a significant bloc of seats in the Duma, Yeltsin's lead reform economists, Yegor Gaidar and


203. The new "Constitution contains some disturbingly strong Executive powers, in some cases stronger than those exercised by the American President." Official Codification With Commentary, supra note 77, at 1-54. Because the constitution does not set forth the topics on which the parliament can enact laws, it is unclear whether the legislature has any authority to legislate in certain areas. In contrast, the constitution gives the president broad powers to issue binding decrees and executive orders without legislative approval. When the parliament does legislate, the president can delay the enactment of a bill indefinitely by not signing it. Similarly, the president can appoint cabinet ministers without legislative approval and can "appoint a new Prime Minister, dissolve the State Duma, and call new Legislative elections if his first three choices for Prime Minister are rejected." Id. (citing articles 83 and 111). See Alyushin, supra note 200, at 65.

The 1993 constitution and subsequent legislation instituted additional checks and balances to promote the independence of the Central Bank of Russia from the parliament as well as from the rest of the government. The chairman of the Bank and the other members of its board now serve for four-year terms upon nomination by the president and approval by the Duma. See Constitution of the Russian Federation § I, ch. II, art. 83(d), in Official Codification With Commentary, supra note 77; id. § I, ch. V, art. 103(1)(c); 1995 Amendments to the Law on the Central Bank, supra note 138, ch. I, art. 5, ch. III, arts. 12-13. The Duma can remove the chairman only upon motion of the president and only in case of incapacitating illness, criminal conviction or breach of applicable banking laws. The Duma can remove other Bank directors only upon motion of the chairman of the Bank. See Constitution of the Russian Federation § I, ch. II, art. 83(d), in Official Codification With Commentary, supra note 77; id. § I, ch. V, art. 103(1)(c). Neither legislators nor members of the Russian Federation government may serve on the board of the Bank. See 1995 Amendments to the Law on the Central Bank, supra note 138, ch. III, art. 17. The efficacy of those provisions, however, was subsequently called into doubt by the circumstances surrounding the ouster of chairman Gerashchenko. See infra note 207.
Boris Fedorov, resigned from the government in January 1994. Their departures removed what had been a significant constraint on chairman Gerashchenko's proclivity for subsidies. By early summer 1994, Gerashchenko had authorized the Bank to resume subsidized credits to farms, northern territories and the government.\textsuperscript{204} The Bank showed such largesse that the ratio of directed credits to total government subsidies actually increased between 1992 and 1994.\textsuperscript{205}

By the summer of 1994, Russian banks were laboring under such high bad debt loads as a result of directed credits that prognosticators began to warn of a coming financial crisis.\textsuperscript{206} Soon after, monthly inflation flared up to fifteen percent for the fourth quarter of 1994, fueled by the outflow of subsidies. After the Bank devalued the ruble and dropped the real interest rate to nearly zero, Gerashchenko's free-wheeling spending finally triggered the financial crisis that led to his demise. With foreign reserves near depletion, the value of the ruble collapsed on “Black Tuesday,” October 11, 1994, and massive interventions were required for the ruble to recover. The press reviled Gerashchenko for his role in the collapse, finally giving President Yeltsin the political leverage he needed to force out Gerashchenko and appoint Tatyana Paramonova as acting chair.\textsuperscript{207}


\textsuperscript{205.} See Alfandari et al., supra note 164, at 6. “[S]oft financing” in the form of “government subsidies, bank loans, and payment arrears (in particular due taxes) . . . dropped substantially [but] still accounted for 6 to 7 percent of GDP in 1994.” Alfandari & Lee, supra note 175, at 11.


\textsuperscript{207.} See Åslund, How Russia Became A Market Economy, supra note 65, at 205-06; Transition Report Update April 1995, supra note 202, at 10; Baidina & Baidin, supra
The events of 1993 and 1994 proved to be of profound significance for the future of economic reforms. Although President Yeltsin had been equivocal toward subsidies in the past, the October 1993 assault on the White House showed that if inflation made the political stakes sufficiently high, he would defend the anti-inflation campaign to the point of force. Similarly, Black Tuesday and Gerashchenko's ouster showed that no one man could suppress the economic consequences of subsidies, including inflation and the debasing of the ruble. Black Tuesday was thus the first economic crisis to demonstrate that market effects alone could generate sufficient political opposition to discredit the chairman of the Bank and the pro-subsidy cause.

Those developments, however, came at high cost to the future credibility of reform. Yeltsin undermined the principle of constitutionalism through his brute show of force. Likewise, Black Tuesday revealed a degree of market instability that was thoroughly frightening to a citizenry accustomed to a controlled economy. The crisis-prone nature of the battle against subsidies would continue and would eventually undermine Gerashchenko's reform-minded successor, Tatyana Paramonova, as well.

C. Paramonova's Campaign for Reform

If 1993 and 1994 witnessed the rise of the anti-subsidy forces, 1995 witnessed their triumph. In 1995, under pressure to cut inflation, the Central Bank of Russia reduced inflation by more than half through stringent subsidy cutbacks and severe monetary restraint. Reforms, moreover, were not restricted to the Bank. That same year, the Duma passed the first major banking reform law since 1990. The single most important impetus for those reforms was Black Tuesday and its fallout.

When the little-known chairwoman Paramonova took the helm of the Bank, the banking industry was in a tailspin and her own permanent appointment was by no means assured. By every account, she should have been a lame-duck appointment, lacking sufficient political independence from the Duma. Within six months, however, Paramonova confounded those who underestimated her seriousness about economic reform.

When Paramonova took office, she inherited a banking industry that was undergoing serious deterioration. The day of reckoning for poor credit underwriting and loan rollovers had finally arrived. At numerous banks, the volume of nonpaying loan renewals was so high that loan revenues had note 115, at 11-12. Gerashchenko tendered his resignation to President Yeltsin on October 14, 1995, and Yeltsin then issued a decree dismissing Gerashchenko. Under article 103 of the constitution, the Duma has authority to dismiss the chairman of the Bank upon the recommendation of the president. The Duma delayed its vote on Gerashchenko's dismissal indefinitely. In the meantime, on October 18, Yeltsin circumvented the requirements of article 103 by appointing Paramonova as acting chair. The Duma voted to refuse to confirm Paramonova in November 1995 on the grounds that it had not yet confirmed Gerashchenko's ouster. See Constitution Watch, 4 E. Eur. Const. Rev. 2, 23 (1995). If the constitution required the Duma to confirm Gerashchenko's resignation—a proposition that is not without doubt—then Yeltsin's actions would appear to have skirted the new constitution.
practically vanished. By year-end 1994, Russia was still suffering from the repercussions of Black Tuesday and at least one-fifth of Russian banks were estimated to be unprofitable.208

In the Duma, Black Tuesday gave Paramonova the leverage she needed to push through legislative reforms. The Duma also was no doubt motivated to cooperate by Russia's pending negotiations for a new $6.3 billion standby credit with the IMF. With Black Tuesday still freshly in mind and fearful that bank failures could bankrupt depositors and alienate voters, the Duma enacted major new reforms to the 1990 banking laws in mid-1995. On April 12, 1995, the Duma passed amendments to the Law on the Central Bank, which President Yeltsin signed into law.209 That summer, on July 21, 1995, the parliament enacted amendments to the Law on Banks and Banking.210

The 1995 amendments constituted a major breakthrough in reform efforts to impose hard budget constraints upon the banking system. At a macroeconomic level, the legislation clamped down on the Bank's ability to finance the budget deficit and to forgive delinquent refinance facility loans. The amendments, for example, prohibit the Bank from financing the budget through credits, "except in the case provided for by the Federal Law on the Federal Budget."211 This provision still permits the Duma to enact

208. See Josh Zander, Banking Shakeout Expected, RUSSIAN BUSINESS NEWS UPDATE, Mar. 1995. See also Åslund, How Russia Became A Market Economy, supra note 65, at 214; Baidina & Baidin, supra note 115, at 10; Begg & Portes, supra note 187, at 233; Blommestein & Lange, supra note 109, at 17; Hansson, supra note 140, at 77; Rostowski, supra note 112, at 72; Jacek Rostowski, The Inter-enterprise Debt Explosion in the Former Soviet Union: Causes, Consequences, Cures, 5 COMMUNIST ECONOMIES & ECON. TRANSFORMATION 131, 141-42 (1993); Rostowski, supra note 73, at 447. Author Grigorii Khanin had predicted this turn of events several years earlier. See Grigorii Khanin, The Soviet Economy—from Crisis to Catastrophe, in THE Post-SovIET Economy, supra note 81, at 9, 15-16, 18 (noting growth of loan arrears in 1991).

209. 1995 Amendments to the Law on the Central Bank, supra note 138. The original bill, which was drafted in spring 1994 under the direction of Boris Fedorov, then the chairman of the Duma sub-committee supervising the Central Bank of Russia, was twice passed by the Duma and twice voted down by the Federation Council before finally passing. See Yelena Kolokoltseva, Yeltsin Approves Banking Law, Moscow NEWS, May 5, 1995, available in LEXIS, Europe Library, Allnews File.


211. 1995 Amendments to the Law on the Central Bank, supra note 138, ch. IV, art. 22. The purpose of that provision was to shift financing of the budget from the Central Bank of Russia to tax revenues, bond issues, and international loans. See Julie Tolkacheva, Credits Crackdown, MOSCOW TIMES, Mar. 5, 1995, at 30. See also Central Bank Is Pleased with Newly Adopted Law, CURRENT DIG. POST-SOVIET PRESS, Feb. 22, 1995, at 23.
legislation authorizing the Bank to extend inflationary credits, a loophole that later proved to be a serious weakness during the 1996 presidential election.\textsuperscript{212} At the margins, nonetheless, the passage of a law requires more effort than had the previous, self-executing provision in the 1990 law that allowed the Bank to finance the budget through indirect means on its own initiative. Similarly, the amendments ban the Bank from renewing or extending the maturity dates of its credits unless the board of directors specifically approves.\textsuperscript{213} As long as Bank loans continue to be pegged at market rates of interest, the practical effect of this provision will be to outlaw Bank subsidies.

At the microeconomic level, the 1995 legislation contains landmark provisions that regulate shareholder loans for the first time. Under the amendments, total credits, guarantees and sureties by banks to their shareholders may not exceed twenty percent of a bank's total funds, and the Bank may further reduce that cap.\textsuperscript{214} Similarly, the amendments permit the Bank to review bids for bank control. Under the new provisions, any individual or group seeking to purchase more than five percent of a bank's shares must notify the Bank. The Bank can veto acquisitions of blocs of over twenty percent within thirty days of notification where the purchasers' financial condition is unsatisfactory or where the purchasers have violated antimonopoly or other federal laws.\textsuperscript{215} Admittedly, both of these provisions are crude first steps because the terms and conditions of shareholder loans are not regulated by legislation, let alone prohibited outright.\textsuperscript{216} Nevertheless, both provisions demonstrate an important shift in attitude acknowledging the dangers of shareholder loans.

Paramonova also pursued reforms on the administrative front. She directed the Bank to take aggressive enforcement measures to forestall widespread bank failures. Paramonova's most controversial step in that regard was increasing mandatory reserves, both to reduce inflation and to provide a surrogate for deposit insurance. On January 18, 1995, the Bank sharply increased mandatory reserves and raised them again in May 1995, forcing banks to raise additional funds or cut their loan portfolios by a third. Additionally, the largest banks, those with capital in excess of ten billion rubles, were required to report their activities on a daily basis.\textsuperscript{217}

Paramonova instituted other anti-inflationary measures as well. Under her aegis, the Bank reduced credits to finance the budget deficit and finally

\begin{itemize}
  \item \textsuperscript{212} See infra notes 266-68.
  \item \textsuperscript{213} See 1995 Amendments to the Law on the Central Bank, supra note 138, ch. VIII, art. 48(5).
  \item \textsuperscript{214} See id. ch. X, arts. 61(12), 72.
  \item \textsuperscript{215} See id. ch. X, art. 60; 1995 Amendments to the Law on Banks and Banking, supra note 138, ch. I, art. 11.
  \item \textsuperscript{216} Cf. Black et al., supra note 115, at 274 (proposing that insider loans should be prohibited in the general corporate context in Russia).
\end{itemize}
brought those credits to a halt as of April 1, 1995.\textsuperscript{218} Paramonova's strong anti-inflation policies, including tough reserve requirements, positive real refinance rates, sharp reductions in subsidies generally and the stabilization of the ruble against the dollar, succeeded in reducing annual inflation from 841\% in 1993 to 131\% in 1995.\textsuperscript{219}

By the summer, however, Paramonova's daring reversal in course had turned her into a lightning rod for industry criticism, jeopardizing her prospects for permanent appointment. Banks castigated Paramonova for raising the mandatory reserve requirement.\textsuperscript{220} Paramonova's political stock further dropped as inflation fell, worsening the financial condition of banks. Before, in 1992 and 1993, banks had thrived because the Bank's refinance rate had been artificially low, interest rates on loans had been deregulated and inflation was rising. Under those conditions, banks made enormous profits on currency speculation and loans because of the high spread between the low interest that banks paid the Bank for refinance loans and the returns they earned on currency arbitrage or loans. Similarly, when inflation had been at its worst, loan portfolio quality had not been such a problem because cheap interest and eroded principal made it easier for borrowers to repay.\textsuperscript{221}

\textsuperscript{218} See Central Bank, MONITOR (Nov. 9, 1995) <http://www.jamestown.org>; Delyagin,\textit{ supra} note 181, at 18. In the first quarter of 1995, the government had borrowed 5 trillion rubles from the Central Bank of Russia at 10\% per year, a fraction of the normal annual refinance rate of 180\%. See Alexander Gordeyev, \textit{Credits Pledge Broken, but Little Fallout Predicted}, MOSCOW TIMES, Jan. 8, 1995, at 44. Chapter IV, article 22 of the 1995 Amendments to the Law on the Central Bank,\textit{ supra} note 138, formalized Paramonova's ban by forbidding the Bank from financing the government budget through credits.


\textsuperscript{221} See Baidina & Baidin,\textit{ supra} note 115, at 10; Gurevich & Yasina,\textit{ supra} note 150, at 7; Reform or Ruin?, THE BANKER, Sept. 1993, available in LEXIS, Europe Library, Allnews File (noting that a "popular way to make money through banking activity is
But when the Bank became serious about fighting inflation under Paramonova, bank profits suffered. With lower inflation, interest rates dropped and banks could not charge borrowers enough interest to repay the banks' previous, high-interest loans from the Bank. Similarly, banks experienced increasing problems on the asset side of the ledger. Borrowers who had repayment difficulties could no longer count on accelerating inflation to inflate away their debts. Firms conspired with each other to pressure the Bank and the government for subsidies by refusing to pay each other and then complaining that they did not have enough revenues to repay their bank loans. Increasingly, firms defaulted on their bank loans.

Based on the difference between the deposit interest rate, the interbank interest rate and the commercial credit interest rate). Simon Johnson, Heidi Kroll and Scott Horton, in a survey of private Ukrainian banks in 1991 and 1992, reported no instances of default by borrowers. See Johnson et al., supra note 34, at 195; accord Pullen, supra note 30, at 184.


See Schaffer et al., supra note 111, at 10.

Privatization meant that for the first time, unprofitable firms could "borrow" from their suppliers by simply not paying their bills. In a collective action problem, firms stopped paying their bills, then demanded that the state pay. In 1992, Gerashchenko turned those demands into a vicious cycle by netting out inter-enterprise debts and financing the balance with state credits. The government exacerbated the problem by reneging on payments for government procurements. See Åslund, How Russia Became a Market Economy, supra note 65, at 189, 191, 210-11; Calvo & Kumar, supra note 109, at 21; Mullineux, supra note 109, at 13-14; Mullineux, supra note 112, at 23; M. Afanas'ev et al., The Payments Crisis in Russia, 39 PROBS. ECON. TRANSITION 5 (1996); Begg & Portes, supra note 187, at 234-36; Fedorov, supra note 73, at 63-64; Hansson, supra note 140, at 77; McKinnon, supra note 37, at 121; Rostowski, supra note 208, at 144.

The inter-enterprise debt problem in Russia has grown to staggering proportions. In the first four months of 1992, trade debts grew from under 100 billion rubles to 1,800 billion rubles, resulting in arrears in about half of all sales. Rostowski, supra note 208, at 131. In late 1994, approximately half of all trade credits owed by Russian firms were overdue. See Qimiao Fan & Une Lee, Averting Debt Crisis in the Russian Economy, TRANSITION, Nov-Dec. 1994, at 3. The sluggish Russian bank payment system worsened matters by delaying those payments that were sent. See Rostowski, supra note 208, at 132-33, 154 n.11. The new Russian Civil Code seeks to redress this problem through provisions designed to improve the reliability of trade credits and bank settlements. See Civil Code of the Russian Federation, pt. 2, arts. 807-821. Recent new decrees taxing bank transactions and blocking corporate bank accounts, however, pose a serious obstacle to an effective bank payment system. See supra notes 148, 177.

See Kokorev & Remizov, supra note 182, at 45; Mikhail Leontyev, The Bank Crisis Has Yet to be Overcome, SEVODNYA, Aug. 29, 1995, at 1, reprinted in CURRENT DIG. POST-
As loan delinquencies rose, banks began to have difficulty repaying their inter-bank loans. By mid-1995, significant arrearages appeared in the inter-bank market. By August 22, 1995, reports began to circulate that some of the largest Russian banks (including Inkombank, the second largest Russian bank) had defaulted on their inter-bank loans. Within days, the entire banking industry was thrown into a liquidity crisis, as banks refused to lend to other banks and the market for inter-bank credit dried up. Numerous Russian banks experienced interruptions in service and runs as depositors rushed to withdraw their accounts. The crisis passed only after the Bank pumped 1.6 trillion rubles into the banking system.

The August 1995 inter-bank crisis sealed Paramonova's fate with the Duma. Paramonova had the support of President Yeltsin, who valued her for reducing inflation and who twice nominated her for permanent appointment. Nonetheless, enmity against her ran deep among bankers, largely because of her actions in raising mandatory reserves. In a striking show of strength, the banking community successfully lobbied against her reappointment in the Duma, which consistently voted her down. Left with no choice, President Yeltsin finally dismissed Paramonova in November 1995 and nominated former acting finance minister Sergei Dubinin as per-

SoviET PRESS, Sept. 27, 1995, at 4. In 1992, overdue loan payments rose twice as quickly as the origination of short-term loans. See From the Annual Report of the Central Bank, supra note 169, at 29. By June 1, 1994, about one-quarter of bank loans were overdue and bank loan arrears comprised 5.7% of total enterprise arrears, up from 4.6% on October 1, 1993. See Alfordari & Lee, supra note 175, at 12; Fan & Lee, supra note 224, at 5. As a proportion of total credit, overdue bank loans rose from 9% in late 1993 to 34% in early 1995. See Schaffer et al., supra note 111, at 5. At some banks, the percentage of delinquent loans was as high as 50%. See Baidina & Baidin, supra note 115, at 9.

226. The president of the Russian Bank Association estimated that as of June 29, 1995, almost 80% of overdue debts to banks consisted of inter-bank debts, with the remainder constituting delinquent loans to non-bank businesses. See Thomas Sigel, Banking Sector Non-Payments Overdue, OMRI DAILY DIG. (June 29, 1995) <http://www.omri.cz/Publications/Digests/DigestIndex.html>. See also Baidina & Baidin, supra note 115, at 9-10.


The inter-bank crisis came as no surprise. Commentators previously had predicted that when smaller banks began to fail, the large banks that had lent them money in the inter-bank loan market also would be at risk. See Leonid Bershidsky, Bankers Blame Government for Looming Credit Crisis, Moscow Times, July 17, 1994, at 55; Vysman, supra note 67, at 278.
manent chairman of the Bank. The Duma confirmed Dubinin shortly thereafter by a vote of 344 to 1, with two abstentions.

Undoubtedly to the dismay of the pro-subsidy forces, Dubinin not only continued Paramonova's reforms, but instituted structural changes designed to place the operations of the Bank on a more permanent market footing. Key in this regard was Dubinin's reform of the Bank's refinance facility, which under Gerashchenko had served as the conduit for directed loans. In February 1996, Dubinin announced that instead of setting interest rates by fiat, the Bank would henceforth use competitive auctions to set the interest rate on short-term loans to commercial banks (the "repo rate"), as well as Lombard rates, the rate at which commercial banks can borrow unlimited sums of money from the Bank. Dubinin further announced that the Bank would henceforth require commercial banks to post government treasury bills as collateral for refinance loans from the Bank. The Bank also required bank liabilities to consist entirely of customer deposits by 1999 in order to wean banks off of central bank credits.

Dubinin similarly used the Bank's new enforcement powers to crack down on insider loans. According to Dubinin, eighty percent of all banks examined after the August 1995 crisis were in violation of banking laws,
often due to free or low-interest shareholder loans.\textsuperscript{231} In a statement fore-
shadowing stricter loan underwriting standards, the Bank admonished
commercial banks to tighten their lending standards and base lending
decisions "on real results rather than friendly relations."\textsuperscript{232}

The events of 1995 thus demonstrated both the strength of the camp-
aign against subsidies and its continued political volatility. 1995 was the
first year that anti-subsidy forces decisively prevailed. They were swept to
victory principally on the coattails of Black Tuesday. The rising string of
bank failures similarly drove home the toll of Gerashchenko's former pro-
gram of directed loans. In 1994 and 1995, hundreds of banks capsized
due to bad debt loads and hundreds more found their solvency
impaired.\textsuperscript{233} Financial disaster thus provided the catalyst for reform.

The success of monetary reforms generated widespread political sup-
port for low inflation. Under Paramonova, subsidies were banned long
enough to permit the public to savor a large and continuous decline in
inflation, a decline which has continued. During that period, anti-subsidy
reforms were institutionalized to a much greater degree than before. For
the first time, restrictions on subsidies and shareholder loans were not just
a matter of agency decree but were elevated to legislative mandate. Positive
real interest rates had prevailed for over a year with little sign of slippage.
Dubinin strengthened the instrumentalities supporting market interest
rates (and insulated the refinance facility from serving as a subsidy con-
duit in the process) by instituting credit auctions and by requiring banks to
post collateral.

Nonetheless, Paramonova's short and stormy tenure showed the con-
tinued political divisiveness of subsidy reforms. In the wake of the August
1995 inter-bank crisis, pro-subsidy forces gained enough momentum to
oust her from office. Those forces gained additional momentum as public

\textsuperscript{231} See Julie Tolkacheva, \textit{And Then There Were None . . .}, \textit{Russia Rev.}, Jan. 29, 1996,
at 24.

\textsuperscript{232} See Lev Makarevich, \textit{Central Bank Resolutely Rejects Criticism}, \textit{Finansovye Izves-
at 17. The Russian Civil Code attempts to discipline delinquent borrowers by authorizing
banks to deny further credit disbursements when circumstances make it clear that
amounts lent will not be timely repaid. See Civil Code of the Russian Federation, pt. 2,
art. 821 \textsuperscript{111} (1996).

\textsuperscript{233} In 1995 alone, the Central Bank of Russia revoked the licenses of 12% of all
Russian banks (315 institutions), restricted operations of another 16% (423 banks), and
appointed temporary managers at five institutions. See Tolkacheva, \textit{supra} note 231, at
24. In 1996, the Bank assumed management control of several major banks, including
Avtovazbank, Natsionalnyi Kredit, Tveruniversalbank, and Unikombank, hoping to
restore them to financial health. \textit{See Central Bank Takes Control of Financial Institutions,
Doing Business in Eastern Europe}, Mar. 1996, at 58; Poul F. Larsen, \textit{To the Rescuel,
Russia Rev.}, July 29, 1996, at 20-21; Poul F. Larsen, \textit{Government to the Rescue, Russia
Rev.}, June 17, 1996, at 26; Steve Liesman & Neela Banerjee, \textit{Russia's Regulators Step in to
Notwithstanding those actions, banking industry observers criticized the Bank for slow-
ing down the pace of bank closures for political reasons in the first half of 1996. \textit{See
protests mounted over unemployment and wage arrears. While Dubinin's permanent appointment may help him weather political buffeting better than Paramonova, the forces that swept her out of office will not soon disappear.

D. Levers of Law Reform

[The main result of the Russian reform experience is a common understanding that the Russian economy reacts to market and monetary levers in a standard way. It is especially important that this postulate is no longer being debated in the government . . . .

– Yegor Gaidar234]

In the five scant years since price liberalization in 1992, the Russian banking industry and the Central Bank of Russia have lurched from a Soviet-style system of loan subsidies to a bank finance system with distinct market features. Today, the rudiments of monetary policy are in place, inflation has been sharply reduced and directed credits have yielded to competitively priced refinance loans conditioned on repayment. In one of the most significant emblems of this change, shareholder loans are now discouraged by law and are subject to increasingly harsh quotas.

Despite the Russian banking industry's manifest problems, the rapidity and depth of these changes is impressive. Lurking beneath the surface, however, are serious questions about the legitimacy and permanence of these Russian economic reforms. The shift from subsidies to a market-driven system of bank finance was accomplished at extremely high political cost, including derogation of the old constitution, ousters of central bank chairmen and outright bloodshed.

Many have assumed that this turbulence and the resulting political toll were due to the imposition of reforms upon an unwilling citizenry by neoliberal international financial institutions, in particular the IMF. That assumption, however, begs the question of whether there was significant domestic support for monetary reforms from segments of the Russian business community or populace. The answers to these questions are essential to understanding both the preconditions for and permanence of Russian banking reforms.

1. International Intervention

There can be no dispute that in recent years international financial institutions such as the IMF have served as a major catalyst for Russian banking reforms. Indeed, Boris Fedorov specifically noted that economic reformers within Russia used outside economic pressure from international financial institutions as a key political tool:

We adopted an aggressive style and used pressure from the "international community" to fight for reform. Money from the West was never crucial, but

influence on policy definitely was. Messages coming from Western advisors and international financial institutions were listened to, sometimes more than what domestic reformers admit. Because the mild academic style was found ineffective, the reformers' aggressive stance was a forced necessity.\(^2\)

At the same time, as Fedorov's remarks suggest, it would be overly simplistic to assume that international financial institutions were able to foist monetary reforms on post-socialist countries such as Russia in complete disregard for domestic support. To the contrary, the IMF made virtually no headway in its monetary goals for Russia until the domestic anti-subsidy coalition gained the upper hand in 1995.

Since the breakup of the Soviet Union, international financial institutions, most notably the IMF, the World Bank and the European Bank for Reconstruction and Development (EBRD), have aggressively provided technical advice and finance to Russia to facilitate monetary and financial reforms. In the banking sphere, Russia has received substantial technical assistance and funding from the West to revamp commercial banking practices.\(^3\) The most ambitious project to date has been the $600 million Financial Institutions Development Project, jointly sponsored by the World Bank and the EBRD in conjunction with the Central Bank of Russia, to improve the allocation of bank financing. The project seeks to upgrade the forty strongest Russian banks through computerization, improved accounting systems and tighter loan underwriting to create a core group of Russian banks that meet international banking standards and qualify for reciprocal privileges.\(^4\)

235. Fedorov, supra note 73, at 61.

236. See generally Greene, supra note 124, at 71-73; So Many Banks, So Few Bankers, Moscow News, June 16, 1995, available in LEXIS, Europe Library, Allnws File. Cf. Vysman, supra note 67, at 276-77. International financial institutions, the United States and the European Community have furnished such assistance. In June 1991, for example, the Federal Reserve and top American banks formed the Russian-American Bankers Forum to offer advice on retail banking and payments systems in Russia. As part of that program, the Federal Reserve and American banks furnished technology and skills and offered "twinning" arrangements to train Russian bankers. See Caprio & Levine, supra note 109, at 25-26; SOVIET/AMERICAN BANKING LAW WORKING GROUP (SABLAW), The 1992 MOSCOW CONFERENCE ON BANKING: THE ECONOMIC ROLE, OPERATION AND REGULATION OF BANKS (1992); Grammara Ajani, By Chance and Prestige: Legal Transplants in Russia and Eastern Europe, 43 Am. J. Comp. L. 93, 111 & n.54 (1995); The Emerging Russian Commercial Bank Sector, supra note 123, at 1, 2-3; Robert J. McCartney, Fed, Banks Plan Mission to Russia; Americans to Help Build New System, WASH. POST, June 20, 1992, at C1; Russia Pulls the Shutters, THE BankER 8 (Feb. 1993); Russian Banks Play Catch-up, A.B.A. BANKING J. 9 (May 1993); Vysman, supra note 67, at 283, 285-86. The European Community also put up 2 million ECU ($2.2 million) to revamp payment systems in Russia and improve transparency in financial reporting by banks. See EC to Oil Rusty Soviet Banking System, AGENcE FRANCE PreSSe, Jan. 26, 1994, available in LEXIS, Europe Library, Allnws File; Rudnick, supra note 112, at 157.

237. To date, approximately 30 of the strongest Russian banks have qualified under this program for loans to finance computerization and foreign technical assistance. See Banking and Finance, RUSSIAN Far EAST UPDATE, July 1995, at 3; Tools of the Trade, RUssIA REV., Sept. 23, 1996, at 8, 10. A new supervisory body formed by the Central Bank of Russia, known as "OPERU-2," supervises this group. Selection for OPERU-2 supervision is considered a sign of financial strength and stability. See McKay, supra note 136, at 27. See generally Ajani, supra note 236, at 110-11 & n.52; From the Annual Report of the
But by far the biggest player has been the IMF, which has exerted enormous influence on Russian economic reforms through loans premised on conditionality. The IMF has pursued a high-stakes strategy in this regard, for Russia as well as for the IMF. From the IMF's perspective, its financial stake in Russia is second only to its record $17.8 billion standby facility to Mexico in 1995. From Russia's perspective, IMF financing is so essential that Russia cannot bridge its budget deficit today without IMF support.238

However important IMF funding is to Russia, the question remains: was the IMF capable of unilaterally imposing monetary reforms in the face of near-total domestic resistance? The facts suggest not. The IMF did not make a noticeable dent in Russia's monetary policy until 1993, when Russia gained IMF membership and the IMF approved a three billion dollar Systemic Transformation Facility, which was Russia's first major IMF loan.239 Even then, Russia's compliance with the monetary conditions attached to that facility was highly unsatisfactory. Apart from a few short-lived gestures at reform, the Central Bank of Russia made no serious attempt at monetary discipline until Black Tuesday, October 11, 1994, when the value of the ruble collapsed. It was only after Black Tuesday, with Gerashchenko's ouster and his replacement by Tatyana Paramonova, that

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238. See Euan Craik, Economy May Fail Without Key Loans, Moscow Times, Jan. 15, 1995, at 49; Michael R. Gordon, Russian Aide Calls for Higher Tariff, Reneging on Vow, N.Y. Times, March 2, 1996, at 1; IMF Will Loan Russia $10.1 Billion Over 3 Years, Wall St. J., Mar. 27, 1996, at C17; Dirk Willer, Why Russia Still Needs the IMF, Russia Rev., Dec. 16, 1996, at 25; Central Banking Technical Assistance to Countries in Transition 33-35, 39-61 (J.B. Zula et al. eds., 1994). Now that the Central Bank of Russia has largely stopped subsidizing the budget deficit, the government is in desperate need of other sources of financing. In addition to IMF loans, other potential revenue sources include higher tariffs; proceeds from the sale of government assets, including privatization sales; sales of treasury bonds; and improved tax collection. See Gordon, supra, at 1. Cf. Delyagin, supra note 181, at 18.


Previously, in 1992, the IMF had imposed conditions in the course of negotiations over Russia's admission to the IMF. Russia made substantial progress on some of those conditions, particularly price deregulation and the privatization of industrial and retail establishments. On the monetary side, however, Russia fell seriously short of its 1992 commitments. In particular, the Central Bank of Russia reneged on its promise to increase loans to commercial banks by no more than 15%. Instead of reducing directed credits, the Bank flooded the market with such credits while keeping interest at negative real rates, fueling inflation. The only new monetary tool that the Bank successfully implemented in 1992 was a 20% reserve requirement, a relatively crude monetary tool. It comes as no surprise that communist-era bankers agreed to require reserves because they closely resembled blocked accounts from Soviet times. See Åslund, How Russia Became A Market Economy, supra note 65, at 182; 1 IMF, supra note 20, at 66; Yavlinskiy et al., supra note 81, at 73; Åslund, supra note 12, at 24; From the Annual Report of the Central Bank, supra note 169, at 20-21, 44; Rostowski, supra note 73, at 446; supra notes 49-52 and accompanying text.
As soon as Paramonova was in place, the IMF gambled on improved prospects for reform by opening negotiations with Russia for a $6.4 billion standby credit, at the time its largest loan to Russia. Doubtlessly the prospect of that funding strengthened the Duma's resolve in passing the 1995 amendments to the 1990 Law on the Central Bank, which prohibited government financing through Bank credits. Paramonova also paved the way by bolstering positive real interest rates, slashing subsidies, and increasing mandatory reserves. Those measures were successful and resulted in IMF approval for the standby credit in the spring of 1995, on the condition that the government control the budget deficit, liberalize trade policy, abolish tax privileges and lower inflation. Wary of Russia's past lapses, however, the IMF insisted on an extraordinary proviso restricting disbursements to monthly rather than quarterly tranches.240

Russian compliance with IMF conditions improved markedly when it reduced inflation in 1995. Based upon that performance, the IMF approved a new, three-year $10.2 billion extended fund facility for Russia in March 1996. This latest credit, like its predecessor, is limited to monthly tranches and is conditioned, among other things, on widespread banking reforms and monthly inflation of one percent. Although the IMF insisted otherwise, observers interpreted the loan as a show of support for President Yeltsin's June 1996 bid for re-election. President Yeltsin, in fact, bragged in his election campaign that it was his clout and Russia's prestige that secured IMF financing. For his part, IMF Managing Director Michel Camdessus publicly warned that IMF loan disbursements would be halted if the Communists captured the presidency and nationalized private industry or otherwise reversed economic reforms.241

In Russia, thus, the IMF served as a crucial catalyst to banking system reforms in at least two respects. First, the enormity of the IMF's financial investment in Russia—and Russia's dire need for that assistance—gave Russian reformers the financial clout they needed to push through monetary reforms. Second, the IMF and its sister institutions, the EBRD and the World Bank, provided badly needed technical assistance as Russia retooled for a market economy. IMF assistance was especially important in formulating monetary targets and developing new tools of monetary policy.


That said, it is evident from the historical evidence that the IMF was powerless to push through monetary reforms on its own before domestic support developed for those reforms. During the first phase of IMF involvement in 1992, when negotiations were underway but before Russia won IMF membership, inflation was just taking off and the anti-inflation lobby had not yet coalesced. Almost no progress was made toward monetary reforms during that period (apart from mandatory reserves), because there was little domestic support for market-based interest or the cessation of subsidies.

More progress was made during the second phase of IMF involvement in 1993 and 1994, after Russia joined the IMF and the Fund disbursed its first loan. During the eighteen months preceding Black Tuesday in October 1994, the government agreed to monetary targets, real interest rates became positive, the Credit Commission became active and subsidies were partially pared. Nevertheless, improvements lagged because the linchpin of monetary policy—the Central Bank of Russia—remained in Soviet-era hands. It was only when domestic outrage over Black Tuesday forced Gerashchenko out of office in October 1994 that the Bank finally threw itself behind reforms.

As recent Russian experience shows, the IMF would have been largely ineffectual had it not been for the Russians' own support for monetary reforms. While it is true that the monetary targets were largely imposed by the IMF from above, those targets could not have been fulfilled without pressure from the business community and the populace to reduce inflation. The genesis of that domestic support is therefore key to understanding the political dynamics of market discipline measures.

2. Domestic Forces for Reform

However instrumental the IMF and international financial institutions were in instituting Russian economic reforms—and their role in that regard was concededly enormous—it would be a mistake to conclude that such reforms were accomplished without internal Russian support. Indeed, as the experiences of 1993 and 1994 showed, without domestic support, IMF monetary conditions were worth little more than the paper on which they were written. It was only when a domestic coalition formed against inflation that IMF conditionality truly took hold.

The first Russians to oppose subsidies publicly were reform economists in the Yeltsin administration, including Fedorov, Gaidar and Chubais, who vocally militated for economic reforms. In contrast with the reformers' rapid strides towards privatization and price liberalization, however, they made little headway with monetary reforms in the early stages of the transition. The fact that the Central Bank of Russia eluded their control until late 1994 only impeded their effectiveness. But the more important reason why the intelligentsia found themselves stymied was that there was virtually no public support for halting subsidies until inflation exploded in 1992 and 1993.
In the earliest stages of reform, mass unemployment was the problem that the Russian government was most intent on avoiding, and that policy exerted pro-inflationary pressure on the government. But as inflation began to soar and citizens' savings began to erode, popular sentiment began to coalesce in favor of reducing inflation.

To be sure, the message was mixed, with many groups continuing to take the stance that higher transfer payments were the cure for inflation. Nonetheless, popular sentiment against inflation gave Russian reformers the political impetus they needed to institute anti-inflationary measures. By 1993, inflationary pressures were so severe that even the conservative Prime Minister Viktor Chernomyrdin was berating Gerashchenko for stoking inflation and thereby undercutting the administration's popular support.242

In the meantime, the subsidy experience paradoxically demonstrated that Russia could withstand large-scale layoffs without violence in the streets. By 1993, the touted rationale for subsidies—revived production—had been discredited at the worst-off plants. Poor sales, graft and runaway costs had shown that no amount of money could turn those firms around.243 As the inevitable happened, workers at the worst plants found their salaries frozen or were laid off entirely yet massive uprisings did not occur. To the contrary, numerous laid-off workers entered the entrepreneurial ranks by securing private employment or starting small businesses on their own.244 Necessity thus provided the reassurances that

242. See Grigoryev, supra note 181, at 12; Lloyd, supra note 204, at 2. Inflationary pressures ultimately caused Gerashchenko to raise the refinance rate to 100% per annum in March 1993. See Gerashchenko, supra note 123, at 13.

243. See ASLUND, HOW RUSSIA BECAME A MARKET ECONOMY, supra note 65, at 309; Delyagin, supra note 181, at 18 (“Each cycle destroyed inviable enterprises and gave the rest an incentive to modernize . . . .”).


Kudrov noted in a related vein:

I am certain that we are living better and that the slump in production is less than indicated by these statistics. Who is taking entirely into account all production in the private sector, "shuttle" imports, interest earned by the population at commercial banks, the appreciable increase in foreign business travel, and mass private housing and vacation cottage construction? Against the background of the general slump in production, trade and banking—real enclaves of initial capital accumulation—have experienced unprecedented development. And it will not be long before this capital will enter production.

Kudrov, supra note 152, at 63-64. See also Betsy McKay, Russia's Little Guys Cast a Long Shadow: Entrepreneurs Help Establish a 'New Middle Class', WALL ST. J., May 7, 1996, at A14. There is evidence that Russians consider inflation a greater evil than unemployment. A recent survey concluded that six out of every ten Russians considered inflation the greater threat, largely because inflation affects all citizens, whether they are employed or unemployed. See Richard Rose & Christian Hearpfer, Fears and Hopes—New
economic theory could not: that insurrection was not the necessary price of layoffs and that full employment came at a high fiscal cost.

In the interim, the better-run firms began to speak out against inflation. Once real interest rates became positive at the end of 1993, a rift opened among factory managers, as viable firms and entrepreneurs began to voice demands for an end to subsidies. By then, enough time had elapsed that some understanding of monetary and fiscal principles had filtered down to the managerial class. In dire need of bank loans to replenish their depleted working capital, the better-run firms came to realize that interest rates would not fall unless inflation fell as well.245 As entrepreneurs came to realize how inflation harmed them, those realizations translated into political demands.246


245. Anders Åslund described this dynamic in mid-1994:

[T]he monetary squeeze divided the enterprises... into three parts. One group of big enterprises had come close to a standstill and eventually had to be closed. Another group was doing well and would survive, while the third experienced serious trouble but could be restructured with considerable effort. The losers were down and out, marked by their failure. They still demanded cheap credits, but they could no longer convincingly argue that they were viable enterprises for the future. The winners, on the other hand, suffered from a shortage of working capital, which had been run down by inflation. They needed to replenish it with ordinary bank credits, but in the spring of 1994, positive real interest rates hovered at around 150 to 180 percent a year. The winners began to realize that real interest rates would stay high until the budget deficit was reduced. As a result, they no longer supported general demands for cheap credits, and they wanted to cut the state budget deficit. The directors lobby had been severely split because of decisive state measures.


246. See Vincent Koen & Michael Martese, Stabilization and Structural Change in Russia, 1992-94, in ROAD MAPS OF THE TRANSITION 53, 56, 58 (IMF Occasional Paper No. 127, Sept. 1995); Mikhail Leonyev, Reformers: 'Permanent Bandit' on the Road to Stabilization—Comments Made During an Economic Conference, SEVODNYA, Apr. 22, 1995, at 3, reprinted in CURRENT Dig. POST-SOVIEt Press, May 17, 1995, at 9, 11 (reporting Sergei Vasilyev's comment that "numerous lobbying groups are competing among themselves, seeing to it that no one group gets more than it 'ought to'” in state subsidies); see also Cheryl W. Gray & Kathryn Hendley, Developing Commercial Law in Transition Economies 2, 8 (World Bank Policy Research Working Paper No. 1528, 1995). Other economic developments relieved the pressure for subsidies by easing the financial squeeze on viable firms. Price liberalization permitted firms with attractive wares to boost their revenues by charging what the market could bear. Similarly, businesses took measures to prevent trade arrears from getting worse. In addition to conditioning delivery on prepayment, firms began to cut off further supplies to delinquent customers, to charge interest on overdue bills, to institute collection either through the courts or through private security services and to trade IOUs with trustworthy buyers. See Åslund, How Russia Became a Market Economy, supra note 65, at 189, 210-11;
The same dynamic was at work in the commercial banking industry. As early as 1992, Sergey Yegorov, the president of the newly founded Russian Banking League, publicly stated: “Inflation is our biggest worry. It hurts us, and it hurts the customers who owe us money.” That same year, some of the larger, better-capitalized banks took a controversial stand against subsidies by refusing to participate in the Bank’s directed credit program altogether. Concerned that targeted loans would turn sour and impair their liquidity ratios, those banks decided that the long-term cost of serving as a conduit for directed credits outweighed the benefit. In 1993 and 1994, the wisdom of that stance was vindicated, as the Bank of Russia began revoking bank licenses and imposing fines on their competitors for failures to repay directed credits. The Bank’s sudden reversal in course broadened the sentiment against subsidies by making sanctioned banks wary of serving as conduits for directed loans in the future.

In lieu of subsidies, the more market-oriented banks lobbied for trade protection in the form of other, non-monetary types of public goods. Early on, both competitive and captive banks agreed on the utility of entry controls in the form of higher minimum capital requirements. Later, profit-oriented banks called for implementation of stricter Western banking standards in a move to squeeze out their financially-pressed competitors.

Some of those same banks instituted hard budget constraints by denying

Alfandari & Schaffer, supra note 177, at 24-25; Kharkhordin & Gerber, supra note 133, at 1078-81; Julie Tolkacheva, Unpacked IOUs Ease Debts, Moscow Times, July 17, 1994, at 49. For a useful discussion of other private dispute resolution mechanisms in Russia that helped ease payment arrears, see Rubin, supra note 115, at 17-25, 34-47. 247. Fairlamb, supra note 143, at 83. 248. See Rudnick, supra note 112, at 160 (quoting Mosbusinessbank as “hardly making any use of the Central Bank’s resources” and Credo Bank to the effect that “[o]ne of our key principles is to refrain from any use of centralized credit resources”). See also Mau et al., supra note 245, at 43. In its 1992 annual report, the Central Bank of Russia cited yet another reason why some commercial banks had “refused to grant preferential credits,” which was the Bank’s long delay in compensating commercial banks for targeted loan disbursements. The Bank conceded that such “delays caused commercial banks to lose income and sustain losses.” From the Annual Report of the Central Bank, supra note 169, at 28. 249. See Bershidsky, supra note 227, at 55; Bershidsky, supra note 222, at 52; Fedorov, supra note 73, at 62; Mekhriakov, supra note 131, at 85; Rudnick, supra note 112, at 157. The Bank’s new-found enthusiasm for collection infuriated banks that had accepted directed credits, which complained, often disingenuously, that the government had pressured them in the first place to funnel those credits to failing firms with no opportunity for underwriting. Gerashchenko tried to mollify the banks by floating a proposal (which was never adopted) to convert overdue directed credits into state debt. See Grigoryev, supra note 181, at 12. Notwithstanding that trial balloon, the Central Bank of Russia commenced collection efforts in January 1994. By that July, the Bank had revoked licenses of 53 banks and fined another 79 for failing to repay their Bank loans. Bershidsky, supra note 227, at 55; Bershidsky, supra note 222, at 52. 250. See Frydman & Rapaczynski, supra note 112, at 195; Pohl & Claessens, supra note 83, at 9, 12; Michael Gulyayev, Cash Crunch Continues for Many Banks, Moscow Times, Sept. 10, 1995, at 27 (quoting Stolichny Bank president Alexander Smolensky as calling for stricter Central Bank of Russia regulation). Cf. Weingast, supra note 145, at 6 (noting in a related context that federalism reduces rent-seeking because “firms outside” a locale that offers regulatory protectionism have “a competition advantage over those being regulated”).
new loans to delinquent borrowers, by restructuring borrowers' manage-
ments and by forcing such borrowers into bankruptcy under the new Rus-
sian bankruptcy law.251

In short, inflation and the volatility of the ruble were the decisive fac-
tors that generated domestic political support for monetary reforms. It
took time for inflation to appear. Once it did, it took time for anti-inflation
forces to mobilize, and still more time for those forces to prevail. This his-
tory suggests that bank reforms that are completely at odds with long-
standing social norms will be almost impossible to adopt at the initiation
of reforms. Concomitantly, this sequence of events suggests that
macroeconomic shocks may generate political support for monetary
reforms where none existed before. Such shocks can do so by driving
home the high social costs of old, inflationary modes of finance. They can
also do so by illustrating the improvement in conditions when monetary
reforms are instituted. In the past four years, Russia has passed through
both phases, giving Russians a large vested stake in low inflation. Whether
Russians feel that they have a vested stake in the cessation of subsidies that
is necessary for lasting reforms, however, remains unclear.

VI. Russia at the Crossroads

For all of the manifest problems in the Russian banking system, too little
credit has been given to the enormous strides in Russian banking reforms.
The Central Bank of Russia has sharply curtailed subsidies, the market
now sets interest rates, the law has begun to regulate conflicts of interest
and the deficit is largely financed through the sale of government bonds
and IMF loans, rather than through the printing presses. This transforma-
tion, however, was achieved at enormous socio-political cost, including
extreme economic privation on the part of Russian citizens, the collapse of
the ruble, the failure of hundreds of banks, the ouster of three successive
chairs of the Bank of Russia and a constitutional crisis that culminated in
military force and bloodshed. What does this tumultuous landscape augur
for the permanence of reforms?

There are some grounds for optimism about the future course of
reforms. Over the past five years, Russian citizens have gained a personal
stake in at least some reforms, having endured the trade-offs of widely dis-

251. See Peter Rutland, Bankruptcies Loom in St. Petersburg, OMRI DAILY DIG. (Nov.
Menatep Bank's plans to force Petersburgskii Tekstil into bankruptcy); Financing
Problems for Amurastal, RUSSIAN FAR EAST UPDATE, Jan. 1996, at 3 ("NAKBank could force
Amurastal ([a major steel mill]) into bankruptcy courts, if a negotiated settlement with a
new investor does not take place"); Vladimir Gurevich, Bankers Navigate New Economic
File; Betsy McKay, King of Turnarounds, CENT. EUR. ECON. REV., June 1996, at 12; Schaf-
fer et al., supra note 111, at 13 (finding that "[chronic loss-makers] do find it signifi-
cantly harder to obtain short-term bank credit, even when controlling for size and
industry"); Julie Tolkacheva, Don't Call Me. Call My Lawyer!, RUSSIA REV., Jan. 15, 1996,
at 18; We Asked . . . Could NakBank Force Amurastal into Bankruptcy?, RUSSIAN FAR EAST
parate economic policies through hard personal experience. Citizens now know that subsidies plus price controls will result in shortages and that price liberalization will restore goods to the shelves. They suffered through runaway inflation, and their protests pushed inflation to the top of the political agenda. Hearing these voices, the government slashed annual inflation from 131% in 1995 to 21.8% in 1996. Inflationary pressures have noticeably eased and citizens now know inflation can be controlled. Thus, among citizens at large reforms have generated broad popular support for low inflation, coupled with unbridled access to consumer goods.

Moreover, citizens at large are not the only ones with a stake in continued low inflation: the government and significant segments of the business community have large stakes too. One of Yeltsin’s biggest trump cards going into the 1996 presidential campaign was the government’s success in reducing inflation. The prospect of major new IMF funding was a major spur towards low inflation as well. Similarly, the lobbying might of politically powerful banks and enterprises weighed in decisively against inflation.

Another encouraging sign has been the formation of new market institutions that placed monetary reforms on a more secure footing. The creation of the reform-minded Credit Commission, for example, provided a key counterweight to the Central Bank of Russia under Gerashchenko, which was too imbued with the mentality of soft budget constraints to relinquish subsidies on its own. The Credit Commission’s success in cutting subsidies over the Bank’s objections showed that reforms could be launched, even in the face of obstructionism, if assigned to new agencies unburdened by the old Soviet mindset. Likewise, the Bank’s grant of increased independence through the 1995 amendments was designed to insulate the Bank, at least in theory, from political pressures for future subsidies.

New instruments of monetary policy similarly took pressure off the Bank to finance the budget and the economy through inflationary subsidies. The introduction of government bonds was crucial to converting the government to a non-inflationary means of budget financing and to enabling the government to wean itself off of Bank credits. Dubinin’s institution of commercial auctions to set the repo rate and Lombard rate was similarly important in institutionalizing market-based rates of interest.

Despite these encouraging signs, however, Russia is in the throes of a powerful political backlash that could easily endanger reforms. In this regard, it would be a mistake to assume that because the Russian citizenry has a stake in some reforms, it has a stake in all. To the contrary, the severe economic privation that the economic austerity plan imposed bred deep-seated public resentments. Unemployment is rampant and job security is precarious, largely because industrial output in Russia has steadily

dropped since 1989.253 Between 1990 and 1994, full-time employment fell 10%, while the number of employees who were laid off or whose work-
hours were reduced rose more than 250%. In 1994, only 70% to 80% of
the workforce was utilized.254 On average, laid-off workers found new jobs
within six months, but the average length of unemployment has continued
to increase.255

As one might expect in view of these statistics, Russians saw their real
disposable incomes fall between 1992 and 1995.256 On top of unemploy-
ment and inflation, part of that drop was attributable to wage arrears, the
tactic managers used to goad workers to lobby for subsidies. For the unem-
ployed, unemployment benefits have not closed the gap. Benefits paid have
been pitifully low (averaging 15% of average wages) and are not enough to
escape poverty.257

Hence, for ordinary Russian citizens difficult economic straits have
been a painful day-to-day reality since the break-up of the Soviet Union. To
be sure, the economy improved in some respects in 1996: private sector
jobs are more plentiful, real wages are finally increasing and the number of
people in poverty has dropped.258 Goods are plentiful and increasingly
affordable. But for the average Russian, employment remains volatile and
life remains hard. Matters are worse for those who have no other source of
private income, such as pensioners and workers in the Arctic, on farms and
in one-company towns.

Consequently, while Russians have a large stake in low inflation, their
attitude toward the monetary reforms necessary for low inflation is at best
deply ambivalent. Like their counterparts in Western economies, most
Russian citizens want low inflation and subsidies and see no inherent con-
\footnote{253. See \textit{Transition Report} 1995, \textit{supra} note 90, at 205; \textit{Bad Numbers} \ldots, \textit{Russia Rev.}, Apr. 8, 1996, at 28; Klugman, \textit{supra} note 177, at 6, 8; \textit{Russian G.D.P. Fell 6% in
\footnote{254. See Alfandari \& Lee, \textit{supra} note 175, at 11. See also Black et al., \textit{supra} note 115, at 12 n.19; Kharkhordin \& Gerber, \textit{supra} note 133, at 1083 (describing layoffs).}
\footnote{255. See Klugman, \textit{supra} note 177, at 7-8. In 1996, unemployment continued to rise, reaching 9.3% by year-end. See Penny Morvant, \textit{Unemployment Up, Arrears Problem
\footnote{257. See Klugman, \textit{supra} note 177, at 7-8.}
That anger has five targets. The first is the IMF, whose presence in Russia has been criticized by liberals and conservatives alike. Reformers have lambasted the IMF for its lenience in the face of Russia's repeated failures to live up to IMF conditions. Conservatives blame the Fund for Russia's economic decline, for harshness and inflexibility, for the appearance of partisan support for President Yeltsin and for Russia's financial dependence on IMF aid. As such, the IMF is a principal object of Russian xenophobia, and its activities have helped to spark a resurgence of Russian nationalism.

Company managers are the second target, based on suspicions that higher-ups are diverting loans and profits to personal foreign bank accounts. Such suspicions have been all too often justified. Aggregate capital outflows from Russia have been so large, and industrial output in Russia has declined so steeply, that numerous specialists have concluded that a large percentage of investment funds never reach their intended destination.

The third target is the banking industry, which has never enjoyed the public's trust and is continuing to experience high rates of failure. The latest round of bank insolvencies was triggered by unpaid loans and by bank speculation in short-term domestic government bonds, which turned sour when interest rates on the bonds fell. As a consequence, the total number of Russian commercial banks shrank by nearly one-fifth in 1996, bolstering depositors' fears and hampering the banking industry's ability to serve as a true financial intermediary.

The obvious fourth target is President Yeltsin. Ever since he stormed the parliament in October 1993, Yeltsin has been the subject of public disenchantment, which only deepened with the war in Chechnya, continued economic difficulties and reports of Yeltsin's drinking, declining health and corrupt associates. The public registered that disenchantment in the 1993 and 1995 parliamentary elections, when Yeltsin's legislative allies suffered defeat at the hands of conservative forces. Yeltsin was able to continue the reforms in part because the December 1993 constitution considerably

261. See, e.g., Black et al., supra note 115, at 27-28; Glinkina, supra note 127, at 386-87; Shelley, supra note 127, at 828, 831.
strengthened the presidency’s powers vis-à-vis the parliament. But Yeltsin averted losing the presidency to the Communists in the summer of 1996 only because of ward-heel politics and because a majority of voters feared a return to communism even more than the Yeltsin alternative.

The final targets are the fiscal and monetary reforms themselves. Subsidy cut-offs were never popular with the general public, and President Yeltsin, in the heat of the presidential campaign, succumbed to pressures to restore handouts. In the feverish last months before the presidential election, Yeltsin distanced himself from reform economists as much as possible and used the powers of the presidency to raise pensions and pay long overdue wages to public workers. The administration’s decision to forbear from collecting tax arrears, both before the election and after, has caused the IMF to delay the payment of successive tranches.

Many of Yeltsin’s pledges were nothing but empty promises, however, until the waning days of the presidential campaign. Then, Yeltsin pushed through a law forcing the Central Bank of Russia to lend money to cover the budget shortfalls caused by those pledges. In early June 1996, Yeltsin convinced the parliament to enact fast-track legislation commanding the Bank to advance five trillion rubles (approximately $990 million) to cover the government’s deficit spending. The Bank strongly protested the move, both on grounds of its independence and due to fears of renewed inflation. With Chairman Dubinin away in the hospital for minor surgery and not available to wage a fight, however, the Bank quickly capitulated and trans-


Many observers interpreted the forced resignation in January 1996 of Yeltsin’s top economic official, Anatoly Chubais, as a move by Yeltsin to publicly disavow economic reforms. Chubais, forced out after a scandal over Yeltsin’s loans-for-shares privatization plan triggered charges of bid-rigging and corruption. His resignation disconcerted the IMF, which had relied on Chubais’ presence as a mainstay of economic reforms. After his dismissal, however, Chubais continued to exert influence behind the scenes as Yeltsin’s presidential campaign manager. See Neela Banerjee, Russian Communists Exploit Loan Flap: Swaps for Shoes, Backed by Yeltsin, Are Example of Privitization, WALL ST. J., Feb. 14, 1996, at A10; Cherkassov, supra; Sigel, supra note 241, at 1, 5-6.
ferred the funds.266

Yeltsin's raid on the Bank's coffers was deeply disturbing in a number of respects, not the least of which was its disregard for the Bank's autonomy. Yeltsin's actions in that regard revealed a fundamental weakness in the 1995 amendments to the Law on the Central Bank, which provide that the Bank cannot finance the budget deficit through credits "unless provision is made . . . in the law on the federal budget."267 As it turned out, once the president made up his mind to raid the Bank's coffers, the pro-subsidy Duma was only too eager to comply. That turn of events revealed how easy such legislation is to enact and how fragile the Bank's real autonomy remains. It further revealed Yeltsin's propensity for subverting laws he deems inconvenient, particularly because it is not clear whether the 1995 amendments permit the parliament and the president to force the Bank to furnish credits it does not wish to lend. To compound matters, the transfer exceeded the Bank's 1995 profits three-fold, requiring the Bank to dip into mandatory reserves that had been earmarked for emergency loans to troubled Russian banks.268

Despite these troubling developments, Yeltsin's high-level appointments immediately after the election indicated that the subsidy surge might be short-lived. The reappointment of Viktor Chernomyrdin as Prime Minister and the appointment of Anatoly Chubais as Chief of Staff and


later as First Deputy Prime Minister, who together forged the government's anti-inflationary policy in 1995, is an encouraging sign of greater fiscal restraint. Similarly, Yeltsin has shown an increased commitment to economic reforms between elections and particularly after electoral victories. Consequently, now that the election is past, monetary reforms may gain some breathing room.

Yeltsin's very ability to recapture the presidency, however, was jeopardized due in large part to the toll exacted by those reforms. Notwithstanding his victory, the communist threat will not go away and can be expected to rear its head in the 1997 parliamentary elections. Thus, despite reforms there is still no consensus in favor of market principles, and Russia's economic course remains deeply divisive. Consequently, it is worth considering whether Russia is consigned indefinitely to a purgatory of political turbulence or whether public goods theory can offer a way out of the apparent impasse between low inflation and employment.

In the first years of the Russian Federation, democracy's challenge was to foster support for monetary reforms where there was none. Public goods theory is useful in understanding how the collapse of central planning, and the macroeconomic shocks that ensued, triggered the breakdown of the old pro-subsidy consensus. It further explains how major market discipline measures came to be legislated and how inflation fell as a result. Now that the anti-inflation forces are close to realizing their goal, their numbers can be expected to increase. As inflation drops, savings will increase, working capital will stretch further and a more favorable climate will develop for viable businesses. With an improved business climate, the number of new businesses should grow and the anti-subsidy segment of the Russian business community should grow as well. Pro-subsidy forces, in the meantime, will dwindle as businesses come to grips with hard budget constraints and failing firms are shut down.

Public goods theory explains this turn of events by focusing on the coalition-building potential of inclusive goods. Low inflation is an inclusive public good that lends itself to broad-based support because everyone in society benefits from it, at least to some degree. As the Russian experience demonstrates, those coalitions will be able to organize, despite their large size, if inflation is so severe that citizens' economic survival is at stake. The more that those coalitions succeed, moreover, the more supporters they can win to their cause. Conversely, as proponents of exclusive goods in the form of subsidies seek to limit those who receive such subsidies, their opponents can exploit the resulting social resentment to attract


270. Already, the curtailment of subsidies has forced firms to compete with private financing. See Betsy McKay, Down to Basics, CENT. EUR. ECON. REV., Mar. 1997, at 8, 11.
new supporters. These dynamics give anti-subsidy forces added potential to prevail over time.

That said, for pro-subsidy sentiment to fall, unemployment fears must be assuaged. As inflation drops, business growth should create new jobs, which should ease job concerns as workers from failing plants find new work in the entrepreneurial sector. As job security grows, low inflation should increasingly replace unemployment as workers' fundamental concern. The results of the 1996 presidential election provide some evidence (albeit evidence that is admittedly ambiguous) that this process has already begun.

That is not to say that this course of events is unalloyed or even inevitable. The Yeltsin government is highly unstable, Yeltsin's own health is questionable, millions of workers remain unpaid, joblessness is rampant and there is renewed talk of an insurrection or a coup.

But even if Yeltsin were ousted, reversing reforms would not be easy for the new regime. Any new leader would face the same political pressures in managing the economy that Yeltsin faces. As Gerashchenko's tenure showed, a significant rise in subsidies would re-ignite inflation and fuel public protests. The only way to hold down inflation without slushing subsidies would be to confiscate bank accounts, provoking panic, or reinstitute price controls, resulting in a resurgence of lines and shortages. In the brief lifespan of reforms, however, Russian consumers have acquired a taste for plentiful goods which would be politically difficult to squelch. Furthermore, any resumption of subsidies to ailing factories would do nothing to fix the basic problem underlying Russia's industrial decline, which is its sheer lack of competitiveness. For as the past five years have shown, subsidies will not restore moribund factories to profitability where their output consists of obsolete products that no one wants to buy.\textsuperscript{271}

Consequently, the only way a new regime could resume subsidies without ruinous inflation would be through subversion of law and through force. If subsidies were resumed, the Central Bank of Russia would be under enormous pressure to provide the necessary financing because the government lacks sufficient revenues to finance even its own operations. Such pressure would increase if the IMF curtailed funding, as it has done episodically in the recent past. Accordingly, a new regime most likely would pressure the Bank for the necessary funds, provoking a renewed confrontation with the Bank and likely subverting banking laws in the process.

Assuming subsidies \textit{were} restored, a new regime would similarly have to deal with their inflationary consequences. To do so, it would have to intervene through such means as price controls, import bans or possibly even industry renationalization. In the latter case, consumers once again would be consigned to shortages and inferior goods.

\textsuperscript{271} In a similar vein, Barry Weingast noted that local authorities in China exploited fears of unemployment and other detrimental fiscal consequences to successfully block the central government's attempts to reverse economic reforms after Tiananmen Square in 1989. \textit{See} Weingast, \textit{supra} note 145, at 23.
In sum, it would be possible to revert to revanchist practices, but not without a struggle. A return to the old economic status quo would inevitably provoke fierce public opposition, which either would find expression in the streets and the polls or else be brutally put down. But as the failed August 1990 coup attempt and protests against the war in Chechnya have shown, no regime can have total assurance that it will control the army and hence that mass protests can be suppressed through military force. Thus, any attempted return to the past would accomplish very little at an extremely high cost. Those costs are an added inducement against a rash reversal of market discipline reforms.

This discussion culminates in the question: could efforts to reduce inflation in Russia have been instituted any faster? In Eastern European countries such as Poland, the Czech Republic and Hungary, where once-thriving traditions of capitalism were only displaced by communism after World War II, the prospects for fast-track law reforms were somewhat more encouraging, if simply because market discipline and its benefits were a real memory for older citizens. In contrast, at the outset of reforms, Russians had no acquaintance with market discipline and no groups were poised to lobby for its benefits. Nor could Russia's economic reform wing simply impose economic reforms through military conquest, as had been the case in post-war Germany and Japan. For all of these reasons, market discipline provisions, whether they consisted of conflict-of-interest rules, tough bankruptcy laws or other provisions, were virtually impossible to enact before the onset of economic reforms in Russia's nascent democracy. But that is not to say that reforms could not have proceeded at a faster pace.

For instance, Gaidar and other reformers in the Yeltsin government took a serious misstep in April 1992 by lending their support to renewed subsidies by the Central Bank of Russia. In fact, their support was so well publicized that the press dubbed the subsidies “Gaidar” credits. Similarly, the reform wing missed a valuable opportunity to induce Gerashchenko to resign immediately after the parliament was dissolved in October 1993. Had the reformers acted decisively, instead of waiting until Black Tuesday in 1994, inflation might have been curbed a full year earlier. That wasted time, which was practically an eternity in Russia's telescoped political climate, supplied another year of economic pain and another year for backlash to grow.

The IMF also made a major mistake in not supporting generous unemployment benefits sooner. Unemployment pay admittedly has an inflationary effect, but that effect would have been less costly than keeping obsolete plants afloat, with their attendant added costs for supplies and overhead. Similarly, significant unemployment pay would have gone a long way toward reducing potential backlash by alleviating the human pain of...

272. See Åslund, How Russia Became a Market Economy, supra note 65, at 97, 163-65, 189, 191.
273. See, e.g., Frydman & Rapaczynski, supra note 112, at 195 (“jobs ‘saved’ must be maintained later, whether or not they are efficient”); John H. Cochrane & Barry W.
layoffs and closures once subsidies were finally cut. A transition that had shown such concern for the real human toll of reforms would have moved much further toward securing true political legitimacy for market-based reforms.

Conclusion

As this Article has discussed, economic liberalization and its discontents, including inflation and market crises, proved to be the single most important catalyst for market discipline reforms. That catalyst, however, was a double-edged sword. On the one hand, the Russian experience gives grounds for concern. It suggests that market discipline can only be legislated when public disenchantment with the distortions resulting from market manipulation has set in and the public demands a change. Thus, the attitudinal changes that must precede market discipline reforms will necessarily be borne out of cynicism. The Russian experience further suggests that measures to instill market discipline, while not incompatible with democracy, nevertheless have the potential to generate civil strife, to provoke disregard for democratic procedures during times of crisis and thus to risk undermining democracy.

At the same time, the Russian experience gives grounds for guarded optimism, with its message that earlier attitudinal impediments to law reforms can be overcome through market forces. In this sense, recent Russian history reveals a dynamic relationship between severe macroeconomic shocks and changing patterns of collective action that has barely been explored. Particularly in transitions from planned to market economies, such shocks can alter the public's perception of subsidies as a social good. As a consequence, old coalitions in favor of subsidies are likely to become unstable and fragmented while opposition coalitions that support low inflation will experience a surge in momentum. This observation may help illuminate a path out of the economic impasse that has characterized transition economies in the past five years.

As market forces take hold and reshape citizens' attitudes towards public goods such as subsidies, old economic ideologies will recede among growing segments of the population. The old attitudes had significant force in large part because they were part of a broader ideological vision. Once those attitudes begin to change, however, the larger ideologies that fostered them will increasingly lose coherence.

Finally, the Russian experience suggests that the normative attack on public goods theory as immoral may be premature. As Russian events show, in certain situations the narrow self-interest of smaller groups—in this case, the Russian entrepreneurial sector—may well comport with the broader social good and can build on broad-based support to achieve those

Ickes, Macroeconomics in Russia, in ECONOMIC TRANSITION IN EASTERN EUROPE AND RUSSIA 65, 102 (Edward P. Lazear ed., 1995).

274. For treatments of this issue by legal scholars in other settings, see Miller, supra note 9, at 87, 130; Macey & Colombatto, supra note 2, at 414-16.
ends. As Macey and Colombatto concluded in their recent work on Eastern European currency reforms, I also conclude that public goods theory need not necessarily be reduced to the nasty and the brutish. To the contrary, at least in certain circumstances, public goods theory suggests that inclusive public goods can be wealth-maximizing in the aggregate and can serve the larger social good.

275. See Macey & Colombatto, supra note 2, at 415-16.