Credibility of Social Institutions and Real Costs of Economic Reforms
—Privatisation and Currency Crisis in Russia, 1998—*

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The 1998 crisis in Russia, if viewed exclusively in financial categories, represents a typical currency crisis. But as no crisis happens without structural reasons, I argue here that the design of the Russian privatisation was more to blame for the crisis than the experiments with fixed exchange rate system. The design of the privatisation as well as the exchange rate system were indirectly influenced by the lack of public confidence in social institutions at the early stages of transition to market reforms. Although often considered as a burden by liberal economists and politicians, building social institutions is a long-term necessary investment rather than a simple cost that could be easily eliminated from deficit budget.

1. Introduction

The series of peaceful (if not to count the Romanian uprising) revolutions in 1989 marked the beginning of the collapse of the communist system in Central and Eastern Europe. The fall of the Berlin Wall became a powerful symbol marking the end of the division imposed on the continent after the World War II and the return to "normality". But this return to

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normality involved also a social and economic experiment of an unprecedented scale; one socio-economic system (communist dictatorship) was going to be replaced by another one (liberal market democracy) in a peaceful manner without violent struggle, revolution etc.

The end of communism in the former Soviet Bloc countries was accompanied by huge waves of public optimism. Despite of an enormous task of transforming the entire system neither the public nor the reformers themselves expected the process to last more than a few hundred days (it was somehow fashionable to announce start of 300 day plan, 500 day plan etc.). Needless to say, nobody expected serious economic problems ahead. But the reality brought a huge disappointment. Instead of widely expected justice and prosperity, the first years of transformation process produced poverty, wide income disparities, inflation, unemployment and, in some former communist countries, primitive "bazaar" type of capitalism rather than modern economies.

With our current knowledge we can argue now that the reforms were based on the naïve assumption that simple liberalisation would create the market economy by *fiat*. The neo-liberal logic may work perfectly in an already functioning market systems (as it indeed happened in case of policies the Thatcher administration was implementing) but it neglects the fact that the market is a complicated *institution* that has been created during hundreds years of capitalism evolution. Re-creating it after 40 years (or as in Russia after 70 years) of communist central planning could not be achieved by just allowing people to do what they wanted to do because the results would be always the same; chaos of destruction of the old system accompanied by the antics of a "new wild capitalism" resembling the atmosphere from Emil Zola's novels. Viewed by ordinary people eyes it must have been a horrible experience. However discussions surrounding the beginning of reforms in 1989 and 1990 in Central Europe and later in Russia (mainly 1991 and 1992) were concentrating primarily on the speed of implementing particular policies. There were two main approaches at that time. One advocated a radical "shock therapy" aimed at rapid establishing free market mechanisms in formerly communist countries even if it was to happen at high social and economic costs. The costs (i.e. substantial decrease in real income, emerging high unemployment, bankruptcies of state owned firms and so on) were considered to be an unavoidable part of the transition process. The other approach advocated a "slow but steady" pace of reforms. Slower pace of reforms would allow to avoid culminating costs of reforms and for that reason, as it was assumed, the pain associated with transition reforms could be reduced. Jeffrey Sachs is often considered as a leading proponent of the radical approach (as he used to be an economic advisor to reformist governments in Czechoslovakia, Poland, and Russia), while advocating the slower pace of reforms is usually associated with a Hungarian economist Janos Kornai. The differences between them were mainly based on the intensity of implemented policies rather than on their substance. Both approaches were based on three economic policy "pillars": economic stabilisation of internal imbalances, liberalisation of economic activities, and privatisation of state property but both equally tended to neglect the institutional side of reforms.

As it often happens in social sciences the judgement about particular policies differs depending whether the analysis has been made ex-ante or ex-post. Nowadays critics of liberal reforms have known what happened after the reforms had been implemented and provide numerous explanations why some countries failed while other succeeded on their way to market economy and democracy. Depending on the political association of their authors one can find a plethora of theories blaming particular policy implementation, insufficient (or opposite excessive) toughness of policies, too much or too little of government intervention, insufficient institutional efforts and so on. Some tend to blame failures of democracy (e.g. not many politicians would be willing to implement unpopular policy measures facing re-election etc.), corruption, or even international conspiracy. Perhaps various factors have played different role in various countries but the critique applied ex-post does not change the judgement that neo-liberal reforms were the only available policy choice ex-ante.

While letting various (including some "revisionist") theories to flourish, one must not forget about two basic conditions for any reforms to be successfully implemented. First, the reforms must not run against the basic logic of the system they are supposed to improve and, second, the reforms must be understood and approved by general public. While the first condition depends mainly on the construction of the reform programme itself, the second condition is much more difficult to fulfil as it requires the communication with and cooperation from the general public. Needless to say, it is much easier to obtain the public's approval for the (often) inconvenient reforms if there exist means of explaining to the public the basic logic, the supposed time-table, costs and benefits etc. (communication or in other words free and trusted public media would help here) and when the public knows that its rights will be protected, the benefits will be transferred to those who are supposed to receive them, there will be a civilised way of solving conflicts etc. (efficient financial markets, social safety net, independent and efficient justice system and so on). This amounts to a standard set of social institutions that can be called a civil society that is an indispensable part of each democratic system.

I argue here that lack of credibility of social institutions had a great influence on the transformation reforms in Russia as it deprived the authorities the necessary amount of public trust. Therefore the reforms there were lacking necessary credibility and the Russian public had to be "bribed" into the reforms. This had a huge impact on the design of the reforms and in the end it made Russia to pay a huge price in real terms; it became a factor mainly responsible for the 1998 currency crisis. The remaining of the paper is organised as follows. The next section briefly discusses the rationale for privatisation in a transition (formerly centrally planned) economy. Then the basic elements of the Russian privatisation programme of 1992 will be presented. The consequences of the programme in the form of capital flight will be discussed in section 4 that concludes the paper.

2. Privatisation in an Economy in Transition

There may be many justifications for creating a vast public sector in the economy. Governments may decide to intervene into market activities because of market failures (such as economies of scale, presence of public goods, and information asymmetries), for ideological reasons, for fiscal reasons (expanding budget revenues), for maintaining low unemployment levels etc. In addition there is no satisfactory statistical evidence that public enterprises have a lower technical efficiency level than private firms operating at the same level of operation. Private ownership leads to the efficiency growth only when a firm is managed directly by its owner. Otherwise eventual conflict of goals between owners and agents is likely to take place. Not ownership per se, but the way in which the firm's goals are related to profitability decides whether private or public ownership proves more efficient. The construction of an incentives system, often conflicting goals set ahead of the state owned companies, a lack of management independence, a soft budget constraint, and all kinds of problems resulting from the presence of state owned monopolies[1] are the main reasons why, although the principles of public sector intervention are clear, reality rarely conforms to those principles. Thus privatisation itself is not an ultimate panacea for inefficiency problems troubling state owned enterprises. For that reason, opponents to the sales of public property often argue that simply restructuring public enterprises can produce exactly the same results as their privatisation does. Without embarking on complicated change of ownership one can consider some of the following measures[2]:

a) Change in a legal from. An enterprise, although still controlled by the government by a virtue of its share ownership, may become a fully independent unit in the managerial sense.
b) Change in managerial staff. Simply replacing inefficient managers may increase the enterprise's efficiency without change in owner-

(1) Temptations of monopoly power are not exclusive to the private sector and a state owned monopoly behaves similarly to a private one. And while private monopoly does not last forever (because in a dynamic economy competition ultimately undermines all monopolies), a government does have incentives to defend a state monopoly against an undermining competition (at least for fiscal reasons).
(2) See more in Bös (1993).

ship (it could have brought a significant efficiency improvement in the former communist countries where all managers used to be appointed based not on their managerial skills but on their political loyalty)

c) Reduction in the labour union power by, for instance, splitting a large state owned company into smaller units.

d) Creating a real competition in the economy.

The efficiency argument applies also to the former communist economies. But there are also some specific reasons why privatisation was considered to be an indispensable part of market reforms there. First, privatisation was thought to help in re-establishing rational capital and resource allocation in the transition economies. Heavy distortions, the centrally planned economies suffered from, were likely to be carried out into the post-socialist economy unless the formal links between the government and the enterprise were broken up. A soft budget constraint is more likely to survive longer as governments are more likely to subsidise firms that belong to the state rather than private firms. And once the public pressure for reduction of unemployment becomes stronger subsidies for state enterprises are likely to return. Also a policy of restructuring inefficient industries (unavoidably accompanied by necessary redundancies) would likely meet more efficient resistance in state owned enterprises than in a private sector. And because of wide presence of inefficient enterprises there was a great need for such a restructuring. Hughes and Hare (1990) estimated that the shares of output with negative value added at quality adjusted world prices reached a very high level in Soviet Bloc economies (Table 1).

With notable exception of Poland (partially as the result of restructuring reforms carried out already in the 1980's), the inefficiencies prevailed in one third to half of Central and Eastern European industries.

Table 1. Share of Output with Negative Value Added in Five Eastern European Countries

Country	
Bulgaria	50.8%
Czechoslovakia	34.8%
Hungary	34.6%
Poland	8.4%
USSR	22.3%

Source: Hughes and Hare (1990).

Second, economic activity in communist economies was concentrated in huge monopolistic enterprises. Table 2 illustrates the scale of industry concentration in the former USSR as compared to the United States and Poland. Three quarters of all workers employed in the USSR worked in enterprises with more than 1,000 employees (more than one in five firms employed more than 10,000 employees). By any standards it means an enormous size of those companies. The size of the enterprises had two important consequences. First, such a mammoth enterprise could easily monopolise the entire market once it was freed from direct controls typical for a central planning economy. Second, workers grouped in such a giant enterprise wield tremendous political power that could be dangerous even for a central government(3). Privatisation could be an efficient mean of dividing those monopolistic enterprises.

(3) For instance Soviet coal miners' strikes in summer 1991 or political unrest led by Romanian miners in 1990.

Table 2. Size Distribution of Employment (Percentage of all Workers)

Country (year)	1–99	100–499	500–999	1,000 and more
USSR (1988 [a])	1.8	13.2	11.7	73.3
USA (1985)	27.6	33.8	12.7	25.8
Poland (1986)	10.0	25.0	15.0	51.0

a - 15,6% in firms between 5,000 and 10,000 workers and 21,5% in firms of more than 10,000 workers.
Source: Fischer (1992).

Third, vast networks of personal connections and complicated political changes made sometimes removing the old communist time management an impossible task. That management, selected on base of its political loyalty was neither efficient nor trusted by the public. A change of ownership was in eyes of the reformers a chance to replace the communist era managers with the new breed of specialists that would meet the needs of market economy.

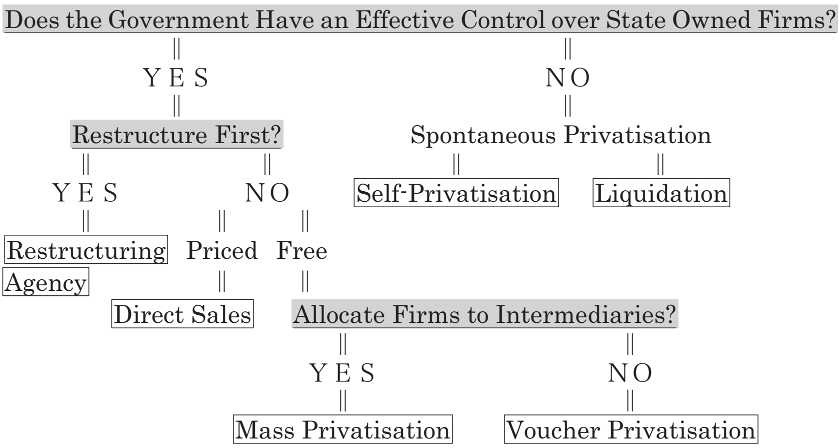
Fourth, employers rarely accept public criticism and independence of their employees. Governments as main employers do not tolerate lack of political loyalty from their employees (either public officers or workers at state owned enterprises). There is no accident in the fact that most of dictatorship nations are characterised by high percentage of public enterprises. Therefore privatisation was, in some sense, a precondition for democratisation.

Finally, on ideological grounds, reformers hoped through privatisation to break ties between an old communist elite and national property.

Unfortunately, the obstacles to the privatisation that could have been expected by reformers went largely neglected. A lack of efficient financial markets constituted not only a major problem for share distribution but also for basic calculation of privatised property value (due to distortions that prevailed under central planning the real value of firms differed substantially from their book value). The lack of domestic capital was likely to create a vacuum on the side of potential buyers (all that could be generated from sales was the flow of current savings). Another neglected problem was the fact that the idea of both the property rights and the state itself, as understood in the West, did not necessarily exist in a post-communist society. After years of practical implementing a political dogma of the social ownership of means of production, property rights were effectively uprooted in those societies. It means that educational and legal efforts were needed to re-establish a proper environment for the existence of private property there *before* any privatisation could take place.

Figure 1.

Privatisation in a Previously Centrally Planned Economy



The way of choosing a privatisation method in a transition economy can be summarized as flow chart in Figure 1. Given the highly centralised character of a centrally planned communist economy, the first question may look quite strange but in some cases the decomposition of the old system is so advanced that a central government did not have an effective control over its own firms[4]. Then, there is no choice but to allow for a spontaneous privatisation. But if a government has an effective control over the privatised firms, then it can choose between restructuring them before privatisation and privatising them as they are. The only pure restructuring path was chosen in Germany where authorities established a special restructuring agency (Treuhandanstallt) for the purpose of dealing with its East German firms. Other transition economies chose mainly privatisation without restructuring. The next choice, the authorities face, is the decision whether to sell state assets or to allocate them freely to the public. Hungary and Poland, the most successful of the transition economies, chose a combination of priced and free privatisation while Russia and the Czech Republic followed a path of free allocation to the public. The next section presents the main characteristics of the Russian privatisation programme.

3. Privatisation in Russia AD 1992

The main part of privatisation in Russia took place between October 1992 and July 1994 when more then 80 percent of state owned medium and large enterprises was privatised. The parliament passed the privatisation law on June 11, 1992. All citizens of the Russian Federation (including chil-

(4) Beksiak and Czarniawska (1982) show that the decomposition processes in centrally planned economies had already been well advanced in the 1970s.

dren to be born before September 1, 1992) were eligible to receive privatisation vouchers. The vouchers could be used to buy shares in privatised enterprises or could be sold (even to foreigners). Between October 1, 1992 and December 31, 1992, for a small registration fee of 25 roubles one could obtain a voucher worth 10,000 roubles (approximately two months' average salary in mid-1992). The vouchers then could be used to acquire property at the prices on the last balance sheet appraisals of enterprises (i.e. 1991 book value) throughout the entire 1993.

Mineral and water resources, military property, the central bank, and radio and television stations were excluded from privatisation. Permission was required for privatisation in some specific areas (weapons, machinery for nuclear power industry, fuel and energy, alcohol, banking, rail, water and air transport etc.) as well as for privatisation of firms bigger than 10,000 employees.

Although often classified as a voucher privatisation, the Russian privatisation programme was placing an emphasis on the priority for "insiders". "Insiders" understood as existing workers and managers had three options to be decided by the majority of two-thirds of employees at each state owned enterprise. In case no agreement could be reached option 1 was selected by default.

1/ 25 percent of (non-voting) shares were allocated to workers who had an option of purchasing 10 percent of ordinary (voting) shares at 30 percent discount on the 1991 book value. Vouchers could be used for that purchase. Managers had the option of buying 5 percent of voting shares at the 1991 book value.

2/ workers and managers could buy 51% at 1.7 times their 1991 book value (up to 50% paid in vouchers). The remaining shares to be sold at auction to the general public (of these 35% could be paid in vouchers and the remaining in cash). Employees could also participate in the auctions.

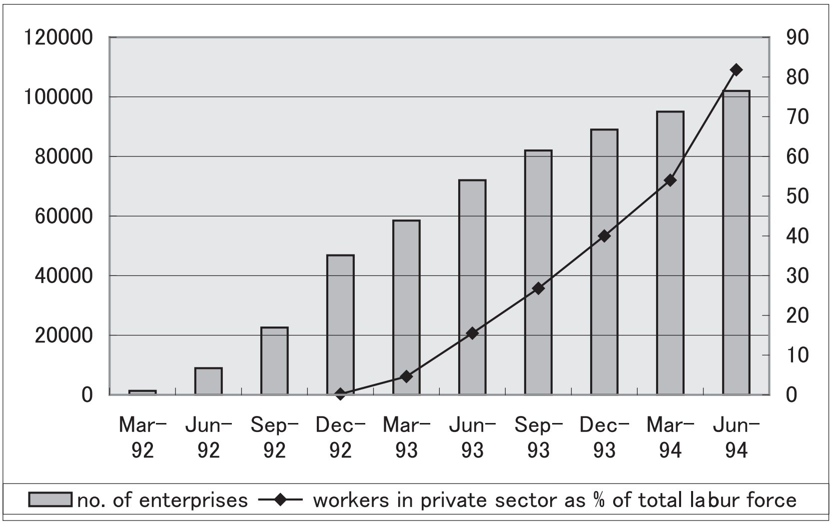
3/ a group of employees (not necessarily all) could reorganise their company. Personal money of at least 200 times minimum wage of each member had to be invested. They could acquire 20% of shares at face value and in addition 20% could be acquired as in option 2 (for all employees).

The privatisation proceeded at a very fast pace. By the end January 1993, 96 percent of population had received their vouchers. More than 70 percent of all enterprises selected option 2 and another 21 percent chose option 1. Two-thirds of shares ended in hands of employees of privatised enterprises (Jeffries, 2002). By the end June 1994 total of 102,000 firms (with 81.8 percent of industrial labour force employed) had been privatised. The share of the private sector in the country's GDP reached 70 percent in 1997 (Stirböck, 2001). Figure 2 presents the total number of privatised firms (left scale) and percentage of industrial workers employed in private enterprises as compared to the total labour force (right scale).

There are a few factors that greatly influenced the design and character of the Russian privatisation programme. As the country had hundreds of thousands of state owned enterprises to be privatised, privatisation through sales could take a very long time and due to the insufficient domestic capital resources it would be difficult to find willing investors. The fact that the most successful privatisations in the industrial countries (with Thatcher administration serving as the prime example) managed to

Figure 2

Privatisation in Russia



Source: based on data from Jeffries (2002)

sell not more than a few dozen of firms at time was an important argument. On the contrary, rapid privatisation was expected to change the structure of the economy making the entire process of market reforms irreversible.

Although the restitution of property to its former owners could be also considered as a well-grounded method of privatisation, it was ruled out for two reasons. First, it was assumed it would be unpopular with the general public as breaking the rule of egalitarianism. Second, because of long time since expropriation, the former owners could not be easily located, companies had been transformed and their value changed etc.

It was believed therefore that coping with it would a very time consuming process.

Distribution of wealth in the late years of the Soviet Union was very uneven. Even under egalitarian communist regimes, there were always relatively wealthy, as compared to the rest of the society, groups. They included communist elite as well as participants in black market activities. The disparities within Russian society increased dramatically in late Gorbachev times when some members of the public found it easier than others to profit from the new reality (this does not necessarily mean illegal or immoral activities). Because of extreme egalitarianism that prevailed in the communist society, those activities were usually labelled as criminal. Now, if the sales of state assets were to be implemented, those people, along with the old communist elite and foreign prospective buyers, would grab the lion share of state property put on sale. No need of saying that the idea of selling state property to foreigners, ex-communists, and criminals could not prove to be very popular with general public. Opposite, free (almost, if not to count the registration fee) participation in allocating state property was supposed to create a large constituency in favour of privatisation and economic reforms(5). Ordinary Russians had rather bad image of their government officials (many of whom had been serving at their posts since the

(5) Needless to say, the constituency was supposed to be supporting the politicians who sponsored the privatisation (the ongoing struggle between the Russia's president and its Soviet era parliament was not without importance). Giving away chunks of state property, one may indeed expect support for transformation to market to be rising. But interestingly, the study on public support for privatisation in Hungary revealed that although 77% of Hungarians indeed supported privatising the country's vast public sector, only 54% answered positively when asked whether their own firm should be privatised (Inotai, 1992).

communist times). This was yet another reason for a low appeal of sales of state property. As Boycko et al (1994) put it plainly; the public expected proceeds from sales of public property to be immediately stolen by corrupt bureaucrats. As Russia has been regularly placed at the top of all international corruption lists, this argument cannot be easily dismissed.

Some disadvantages of voucher privatisation were also considered. One of major problems arising from implementing voucher privatisation is its negative impact on the country's budget stability. Compared to sales privatisation the revenue is very small. Indeed cumulative revenues from voucher privatisation in Russia by the end of 1994 amounted to 1.3 percent of GDP while Poland's revenue from sales privatisation amounted to 6.7 percent, in Hungary and Estonia 13 and 13.7 percent of GDP respectively (Stirböck, 2001). Similarly to the Czech Republic (privatisation revenues amounted to 3.3 percent of GDP), Russian authorities chose to sacrifice the revenue for the speed and popularity of reforms.

Russian authorities were also aware of another potential problem resulting from the voucher privatisation. As the privatised companies had not been restructured (as it happens in case of sale privatisation), their old management dating back to the Soviet times was not replaced. Consequently, the firms' management style was not going to change and the managers were allowed to continue the insider control over their firms. There are at least two reasons why the authorities allowed for this to happen. During the years of Gorbachev's policy of perestroika, many managers took de facto control of their enterprises (as shown back in Figure 1). Then putting a brave face, the government chose the privatisation as means to transfer the managers' de facto rights into the ownership. The fact that many of the managers themselves were closely tied to the government also helps to explain the logic of this policy. In my opinion, privatisation with old management intact allowed for presenting changes that had been already ongoing in the Soviet society without loss of face. The second reason for neglecting insider problem is related, in my opinion, to the simplistic belief that the presence of money and financial instruments (shares of the privatised enterprises) would allow for instant creation of financial markets (creating capitalism by *fiat*). Russian authorities expected that, as time passed, the free market transactions would gradually reduce the insiders' power. Unfortunately this expectation did not materialise.

There was still one more important weakness of voucher privatisation that was unfortunately largely neglected. Free (voucher) allocation of state assets creates a big single group of shareholders, namely the workers themselves. This in turn results in some serious implications for the future performance of the privatised economy. First, the risk of unemployment and the risk of capital loss are concentrated on one group. This is likely to result in a rent-seeking behaviour of this group at a political arena. Second, workers, who prefer quick pay-off actions to building up capital stock, can dominate economic decisions of firms and impede attempts of structural adjustment. Third, the ownership of firms is spread excessively and for that reason the ownership control becomes ineffective leaving too much power in hands of management (effectively leaving the fate of a firm and its owners=workers to the dictatorial power of a manager). Finally, uncertainty about the value of firms and public's lack of experience in stock transactions may result in excessive waves of speculation at stock exchange that could seriously affect the market stability[6].

Predictably, the reality of the privatised Russian economy differed greatly from expectations. Privatisation solidified the power of insiders and allowed for the effective takeover of the firms by their managers. Insiders' knowledge allowed them to purchase firms at rock bottom price and repurchase shares of outsiders[7]. Needless to say, the power of insiders effectively prevented the outsiders from undertaking significant investment efforts. Domestic capital had to find other ways of employment for itself and this was one of the reasons for the subsequent capital flight.

As opposite to Poland and Hungary, no serious effort was done to ensure the market competition between firms (in other words to demonopolize the highly concentrated structure of the Russian economy) nor to develop a reliable mechanism to discipline those managers who did not act in the interest of shareholders nor a mechanism able to transfer control rights in firms to those who are best able to use them (neither executive compensation system, nor the threat of hostile takeover, nor the managerial competition was at work in Russia at that time). Managers, interested mainly in managing their private interest, unable to raise capital, often unable or not interested in restructuring their firms, resorted to strategies of asset stripping, paying workers late or not paying at all and so on. At the

(6) Authorities could limit the negative influence of this phenomenon by distributing rather proceedings from sales of state assets instead of distributing vouchers, shares etc. (Schmieding, 1992). Unfortunately it was not a viable policy option for Russia's public.

(7) Due to the hyperinflation that reached 1,526 percent in 1992 (875 percent in 1993 and 311 percent in 1994) the original face value of privatised assets was diminishing quickly. Taking advantage of their knowledge many insiders managed to purchase stock at a fraction of its real value. See more in Boycko et al (1996), Wintrobe (1998), Jeffries (2002) and others.

same time, wielding an enormous power resulting from the scale of concentration in the Russian industry, the quasi-monopolistic companies still were able to receive large subsidies in the form of soft credit (Treisman, 1995).

The results for the Russian economy were rather unpleasant. The country's industrial output fell by roughly a third between 1993 and 1996 despite a slight increase in the country's total consumption goods and services. The employment in the privatised firms fell, over the same period, by 23 percent and despite of that those companies still operated at barely half of their capacity as imported goods replaced their produce (Wintrobe, 1998). The privatised enterprises did not meet their tax obligations as well. For that reason the central authorities had to look for alternative ways to finance their budget expenditures and they resorted to increased emissions of government bonds. In order to maintain high confidence of potential buyers the government embarked on risky policy of fixed exchange rate (dollar peg).

4. The "Currency" Crisis

Russia was in a very peculiar condition in 1998. Moscow was becoming one of the most expensive cities in the world. Those who benefited from the system transformation were becoming more and more affluent. World top expensive goods were best selling items in Russian capital. Foreign capital was pouring in thanks to consecutive loans from western governments, thanks to the IMF economic assistance programmes, and thanks to the inflow of foreign private capital looking for profitable investment chances after the Asian currency crisis eliminated one of the most attractive investment markets. Those who know the sequence of events of that summer like comparing it to "Titanic" steaming with full illumination through darkness towards her destiny.

But that image of Russia AD 1998 was only what the western media and politicians wanted to believe in. In reality, the country's condition more resembled a leaking barge rather than a luxury liner. Not far from the capital an ordinary Russian (the one that failed to grab his share of state property before 1994) was facing poverty, unemployment, barter transactions, crime, corruption, lawlessness, mafia, human rights violation etc. Law enforcement units were scarce and helpless, justice system corrupt and inefficient, army still licking its wounds after its defeat in Afghanistan and later in Chechnya. The farther from Moscow the conditions were worse. Local governors were wrestling power from central government, big company bosses scolding the country's prime minister about his duties, and the president was on permanent sick leave. The parliament after the 1993 military stand off with president Yeltsin was not a power to reckon with (and has remained such even today). There was already the writing on the wall.

Appalling condition of Russian state affairs caused some investors to call an early retreat. Loukine (1998) calculates that the estimated amount of capital flight from Russia in 1994 was $20.7 billion, in 1995 $18.2 billion, and estimates that in 1996 the total amount of capital which left Russia was not less than $40.2 billion (in total approximately $158.2 billion left between 1992 and 1997). His estimations do not differ significantly from the IMF Balance of Payments data. This means that the domestic crisis of confidence had begun soon after the structural reforms (i.e. voucher privatisation) were implemented. Interestingly, while in the Paul Krugman's (1979) world there is no distinction between the foreign and domestic capital that flees the country (because money does not have nationality), in Russia's crisis it was the domestic capital that started leaving the country well before the first of the "Asian Tigers" was culled by foreign speculators in 1997 Asian crisis. And when practical Russians ("outsiders" not able to invest at home) were locating their capital in safe haven abroad (mainly Cyprus and Caribbean at that time), foreign investors (including hedge funds like the LTCM and George Soros' Quantum) were still buying Russian government bonds (used instead of raising tax revenue) and other securities. They believed in Russia's ability to maintain its dollar peg that would protect them from foreign exchange risk (and they were those who suffered the heaviest losses when the Russian government defaulted)[8].

When on August 17, 1998 the Russian government announced that it was no longer able to honour its exchange rate and debt commitments, the crisis was quickly classified as "currency crisis" together with Mexico, Thailand, Indonesia, and other nations that experienced this phenomenon in the 1990s. Adequately, the advice for recovery was also often concentrating on monetary aspects of the crisis; exchange rate arrangements (e.g. discussion surrounding costs and benefits of currency board), optimal degree of capital account liberalisation, strengthening banking system etc.

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(8) However the composition of foreign capital inflows to Russia was somewhat symptomatic. While the total inflow of foreign capital was indeed substantial (more than $45 billion between 1994 and 1998), the country's foreign direct investment reached only 63 percent of what much smaller Poland received during the same time ($13.5 billion versus Poland's $21.3 billion). It is yet another proof that "outsiders" (no matter whether domestic or foreign) were not able to invest easily in the "post-voucher" Russian economy.

Unfortunately, much less discussion surrounded the lack of basic social institutions in the country (i.e. judiciary, law enforcement, human rights condition, basic economic and legal education and so on). But had the country developed a civilised way to solve conflicts, with less corruption and cronyism in legal system, police, armed forces, with basic democratic institutions present, then there would much less incentives for capital flight, for "insider" privatisations etc. Russia is not the only formerly communist nation that undertook its journey to a free market democracy. But it is one of those that paid the highest price for its transition. In other, more successful, transition economies voters dissatisfied with the performance of their democratically elected representatives were allowed to vote them out of office (almost all of transition economies witnessed at least once a democratic transition of power). The Russia's political system did not give its public such a chance. It entrusts close to dictatorial powers with the office of the country's president. Reforms, let it be economic or administrative are not subject to democratic discussion. Cronyism and corruption goes often unpunished while political dissent is hardly tolerated. This specific political culture, partly inherited from the past, results in a low level of public confidence in the country's social institutions and cynical attitudes among the Russian public.

5. Have We Learned Anything from Russia's "Currency" Crisis?

After 1998, as time passed, foreign governments, the IMF, and international capital reached agreements with Russian authorities about their debt repayment schedule. The revenue from oil and gas exports increased and became sufficient for the debt repayment and the industrial world lost its interest in the condition of Russian state. Only on occasions when conflicts within the boundaries of the former Soviet Union (let it be Caucasus or Ukraine) suddenly worsen, major disaster happens (another nuclear submarine sinks off the coast of Norway), or murky weapon deal is uncovered, some unpleasant comments about the pity state of democracy in Russia are uttered and soon everything returns to business as usual.

Not much has changed since 1992. The floating exchange rate is perhaps easier to manage but it has also some dangers on its own. Social and market institutions are still incomplete, Russian public may be approving strong rhetoric of its president as a sign of a strong state but the cynical attitude towards own country has not changed much and capital outflow has not subsided very much[9]. Unfortunately, it does not seem that we have learned very much from the 1998 crisis.

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(9) With the difference that those who once were "insiders" seek the "outside" investment chances. The purchase of a major British football team is not much different from practices of late 1990s.

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