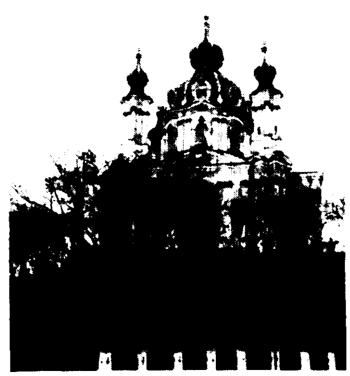
The Political, Economic, and Social Context of Reform 6

Economic reform in the societies of the former East Bloc is a tremendously complex process. The post-Communist transition is not just a process of economic restructuring and modernization-the reforms under way involve fundamental changes in the political and social orders of the societies of the former East Bloc. The relationship between economic reform and energy technology transfer is an interactive one. Although the introduction of new energy technologies can facilitate reform, undue slowness in economic restructuring can undermine the effectiveness of energy technology transfer. Without the adoption of market structures and business practices, the modernization of facilities, technologies, and techniques in the production and consumption of energy will be extremely difficult.

To understand the prospects for economic and energy sector reform, especially in the former Soviet Union (FSU), we must consider the larger context in which the transition from Communist authoritarianism is taking place. This transition involves several distinct but closely interrelated processes: the conversion to capitalist economies, sectoral economic restructuring, the establishment of democratic political orders, the design of a new set of state institutions to regulate political and economic relations, the implementation of new methods of social protection, and the development of the broader "cultural" changes necessary for successful transition from Stalinist dictatorship to market democracy.

Of all these processes of transformation, the most important change is the establishment of a new political order that embodies a popular consensus about the need for economic reform. Without" a stable and popularly recognized political order it is difficult to achieve popular consensus and then to translate it into political



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action on questions of economic reform. Governments that attempt to move too quickly without substantial popular and political support for their programs run the risk of failure. As economist Stanley Fischer has observed, "[T]he pace of reform cannot get too far ahead of its political base."[1]

Democratization may not be an absolute prerequisite to the establishment of this popular consensus and the enactment of an effective economic reform program. However, it is not surprising that the Central European countries, which have moved most quickly to replace old Communist-era political structures with new constitutional orders and popularly elected governments, have also made the most progress in pursuing economic reform. Other former East Bloc countries, where there is less popular consensus about reform and which have yet to consolidate new political structures, have moved much more slowly and less successfully to stabilize their economies and lay the foundations for a new economic system. The result has been a multi-tiered portrait of reform in the region, with three groups of countries at different levels of transformation.

As chapter 8 will discuss, it is important for U.S. policymakers to consider a country's progress toward reform, because the degree of success in economic and political restructuring will affect the appropriateness of U.S. policy. In particular, assistance for those countries that have made the least progress toward reform will be most useful if it emphasizes policy changes, while the more advanced countries can benefit more from development assistance. Similarly, trade and development programs may be more effective and appropriate in promoting U.S. goals in those countries that have already made substantial progress in reform.

THE VANGUARD: COUNTRIES IN THE FIRST TIER OF REFORM

Poland, the Czech Republic, and Hungary occupy the first tier of reform. They were the quickest to establish a political consensus on the need for democratic and market transformations and to translate this political will into effective mechanisms for the implementation of reform programs. They can assimilate the broadest range of U.S. programs in the region.

| Historical and Political Background

The Poles, Czechs, and Hungarians moved so quickly and decisively for several reasons, among the most important of which is their historical legacy. Between World War I and World War II, these countries were politically independent, operated functioning (though problematic) representative constitutional orders, and had market-based economies. The memory of this period has been strong, providing a base of experience in the operation of participatory political institutions and market economies, as well as previously tested models for reform.

Another factor in the rapid pace of economic reform in Poland and Hungary is the fact that their economies were never fully "sovietized." Polish agriculture remained, for the most part, in private hands. Hungary developed a strong semiprivate service and small-scale manufacturing sector that has been an important factor in economic transition. Also, an underground economy thrived in both countries.

The close proximity of the Polish, Czech, and Hungarian lands to Western Europe also provided an impetus for reform.

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[1] Stanley Fischer, "Socialist Economy Reform: Lessons of the First Three *Years,''AEA Papers and Proceedings, vol. 38, No. 2* (May 1993), p. 393.

Finally, the geographically small and ethnically homogeneous nature of these countries has bolstered efforts to break decisively with Communist-era institutions and policies (perceived as having been forced upon the area from outside), promoted social stability, and facilitated the construction of representative political institutions.[2]

| Poland

Poland launched the earliest, most radical, and to date, the most successful reform program. Under "shock therapy," the state drastically cut subsidies to industry, placed strict controls on the budget, checked the inflationary growth of wages, and raised interest rates. Backed by an International Monetary Fund-sponsored currency stabilization fund, the government devalued the zloty and introduced currency convertibility. Simultaneously, Poland started the process of privatization. Finally, prices were freed and laws on foreign trade and investment were liberalized to encourage capital investment and export activity.

The initial costs of the Polish program were quite high: industrial output declined initially by 24 percent, and unemployment, almost nonexistent in Communist times, shot up to 15.7 percent by the end of 1993. However, inflation, which had reached 2,000 percent in late 1989, is currently running at about 35 percent.[3] After several years of economic contraction, Poland's gross domestic product (GDP) rose in 1992 by 1 percent, and industrial production expanded by 4.2 percent-the first economic growth in any post-Communist country. In 1993, Polish GDP grew by 4 percent.[4]

Even more important are the structural changes the Polish economy has experienced. The private sector is now the engine of Polish economic growth. Although privatization of large-scale industry is just beginning in earnest, almost all small-scale retail business and most medium-sized enterprises have been privatized. Employment in Poland's non-agricultural private sector, which accounted for only 13 percent of the work force in 1989, has expanded to 45 percent. And, in 1992, the expansion of private employment (500,000 jobs) completely compensated for the loss of state-sector jobs. Private employment now constitutes almost 60 percent of the total Polish work force.[5]

Nevertheless, the nature and speed of Poland's transition have produced political problems. Although the country appears to have turned the economic comer, and significant numbers of Polish citizens have prospered under the new program, large portions of the population, especially senior citizens and the hundreds of thousands of workers still employed in unreformed sectors of the state economy, have suffered and face uncertain futures.

During 1992 and 1993, dissatisfaction with the disproportionate benefits of economic reform, and nostalgia for the social protections provided by the previous state-sponsored economy, fueled resistance to the reform program in Poland's politically fractured parliament In May 1993, President Lech Walesa dissolved parliament after the reformist government of Hannah Suchocka lost a no-confidence vote to Solidarity-led forces demanding pay and pension increases. In elections in September 1993, a coalition of ex-Communist and peasant parties came into power.

Although these post-Communist parties campaigned on a populist, antireform platform, they

2 Czechoslovakia split apart because Of the ethnic division between Czechs and Slovaks and the more radical approach to economic reform advocated by the more economically advanced Czech lands of Bohemia and Moravia. Although the split entailed large economic and social costs, the Czech Republic is now freer, as a result of the breakup, to pursue a program of radical economic change.

3 Organization for Economic Cooperation and Development, *Regional Development Problems and Policies in Poland* (Paris: 1992), p. 19; FBIS, *Eastern Europe Report*, *FB1S-EEU-94-021* (Feb. 1, 1994), p. 9.

4 *RFE/RL Research Report*, vol. 2, No. 32 (Aug. 13, 1993), p. 43; FBIS, *Eastern Europe Report*, FBIS-EEU-94-021-A (Feb. 1, 1994), p. 8.

5 "'Poland Stays the Course Despite Political Turmoil," *RFE/RL Research Bulletin*, vol. 10, No. 17 (Sept. 7, 1993), p. 1.

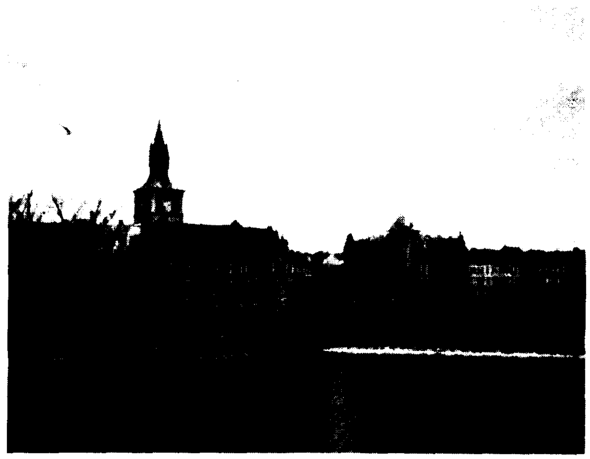
have been moderate in their legislative plans. The new ruling coalition has raised taxes on entrepreneurs and increased spending to mitigate social hardships. But a retreat on the core issues of economic reform is unlikely because all parties know that critical international financial support for Poland would dry up if the country pursued fiscally irresponsible policies. In fact, in late December 1993, Prime Minister Pawlak stated that despite campaign pledges to reverse the economic policies of the previous government, his government would continue the economic policies instituted by its predecessors.[6] In March 1994, the new coalition passed a fiscally conservative 1994 budget that limits the deficit to 4.1 percent of the GDP.

Prognosis for Reform

Poland is well on the way to market reform. So much progress has already been made in restructuring and stabilizing the economy that many observers feel that the country has passed the point of no return. The biggest threat to continued success in economic transformation is political backsliding in the legislature. But even this potential reaction against reform would only delay economic progress, not reverse the course of reform.

Czech Republic

The Czech economy, which once was one of the leading industrial powers of Europe, has been very responsive to change. The Czech Republic entered into a program of fiscal austerity and shock therapy and in some ways enjoys better economic conditions than Poland. In 1992 and 1993, it had the lowest regional inflation rate. Its per capita indebtedness is much lower than that of Poland or Hungary. The country ran a $268 million trade surplus in 1993. Unemployment stood at just 3.5 percent at the end of 1993. Monetary policy has been tight, the koruna has maintained its value against Western currencies, and the Czech banking system is the most highly developed in the region. Virtually all consumer service enterprises have been privatized, mostly through private sales and auctions.



JOANNE SEDOR

Vltava River, Prague, Czechoslovakia

Due to a more cautious approach toward economic transformation, however, the Czech economy has not experienced the expansion that Poland has. Moreover, several political and economic shocks have hindered progress. First, the economy suffered a severe shock from the division of Czechoslovakia into two countries.[7] Further, a national value-added tax, introduced in January 1993, had a greater-than-expected effect on the inflation rate, which ran at 20 percent in 1993, compared with 11 percent in 1992. GDP fell by 7 percent in 1992 but remained steady during 1993. Industrial production fell by over 5 percent during 1993.[8] And finally, despite levels of unemployment that are among the lowest in Europe, economists suspect that levels of real underemployment and unemployment are higher.

The Czechs are counting on privatization as the basis of economic transformation. Privatization is particularly important in the Czech Republic be-

[6] *RFE/RL Daily Report* (Dec. 30, 1993).

[7] GDP dropped by 2.3 percent in the first quarter of 1993. *Financial Times*, Aug. 6, 1993, p. I I.

[8] *RFE/RL Research Report*, vol. 3, No. 1, Jan. 7, 1994, p. 73. *RFE/RL* Daily *Report*, Aug. 19, 1993; *The Economist*, Dec. 18, 1993, p. 58. FBIS, *Europe Economic Review*, Nov. 16, 1993.

cause, unlike its neighbors, the Czech private sector was virtually nonexistent during the Communist era. The Czechs have undertaken two ambitious and innovative waves of privatization, involving 1,500 state firms, based on the distribution of privatization vouchers to all Czech citizens. By distributing vouchers to all adults, the Czechs solved two problems. They created a capital market where there had been very little liquidity, and they gave each citizen a chance to participate in the privatization process. The Czechs' voucher scheme was the first of its kind and is serving as a model for privatization in Russia.

Although privatization has proceeded more slowly than planned, it has produced substantial results. Over 50 percent of the country's 10 million citizens have bought shares. By the end of 1993,60 percent of the country's large enterprises had been privatized. The Czech private sector accounted for almost half of 1993 GDP and 23 percent of total employment.[9]

Yet there are questions about the privatization process and the depth of change in the Czech economy. High-pitched speculation in vouchers and unrealistic promises about returns on investment funds may have created serious financial risks. If large investment funds are unable to fulfill their high-yield promises, the government may have to step in to restore liquidity to capital markets or bail out bankrupt funds. This would place severe stress on the state budget and slow economic recovery. Economists are also concerned about high levels of inter-enterprise debt and the fact that one-third of all privatized enterprises are in de facto bankruptcy.

Prognosis for Reform

Despite the tremendous political and economic shocks of the past two years, the Czechs have made substantial progress in introducing structural and institutional change, as well as stabilizing the economy. Czech entrepreneurism has shown new vibrancy in an energetic private economy. Like Poland, the country has laid a firm basis for future growth.[10] Potential short-term setbacks in the areas of privatization and finance should not threaten the success of long-term transformations already well under way.

Hungary

Although Hungary was at the forefront of Central European economic reform during the Communist era, the country currently lags behind Poland and the Czech Republic. Hungary's problems are due partly to the high levels of foreign debt (at $2,000 per person, the highest in the world) that it inherited from the Communist era. The country has also suffered from the influx of 100,000 refugees from the Yugoslav civil war and the disruption of trade ties caused by the trade embargo on Yugoslavia.

But Hungary's economic problems are also caused by the choices it has made with regard to reform. Instead of launching economic shock therapy, like the Poles and Czechs, Hungary pursued a deliberately more cautious strategy, hoping to minimize the social costs of change. Precisely because there has been no economic "big bang" in Hungary, the costs of reform have been strung out and even accentuated. Hungary is experiencing many of the negative effects of economic reform without many of its benefits.

Despite a sizable private sector (estimated at 40 percent of GDP) and the highest levels of foreign investment in the former East Bloc, the economy remains in recession. A privatization program has been launched, but it is proceeding slowly, in part because Hungary has depended on foreign capital to provide funds for the privatization process and has not developed the financial structures necessary to underwrite and support the process from

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9 *RFE/RL Research Report*, vol. 2, No. 32, Aug. 13,1993, p. 50; also, vol. 3, No. 1, Jan. 7, 1994, P. 72.

10 The Vienna Institute for Comparative Economic Studies and Commerzbank predict 3-percent GDP growth in the Czech Republic during 1994. *The Economist, Dec. 18, 1993,* p. *58.*

within the country. As a result, less than 17 percent of the 1992 work force was employed in the private sector.[11]

There are signs, however, of stabilization and the beginnings of economic growth. Hungarian GDP, which fell by an estimated 5 percent in 1992, may have leveled off in 1993.[12] Industrial production increased by over 3 percent in 1993.[13] Hungary's annual inflation rate remained steady at 23 percent in 1992 and 1993. Throughout 1993, unemployment hovered at about 13 percent.[14] The government tried to remedy some of its problems in 1992 with the passage of a strict bankruptcy law. And in March 1994, the government announced the Small Shareholders Program, a new mass privatization program that will lend citizens about $1,000 each to buy shares in privatized state enterprises.

The political situation is a greater cause of concern than the economy. During 1993, the government coalition, led by the Hungarian Democratic Forum (HDF), came under increased pressure from both left and right. On the left, as in Poland, thousands of pensioners and workers hurt by the economic decline demanded that the government spend more money on social protection measures. This fueled renewed support for the Hungarian Socialist Party (HSP), the successor to the Communists, which, in alliance with trade unions, advocated a social-democratic type program,

On the political right, an increasingly nationalistic tone in Hungarian politics manifested itself in exchanges of criticism with Slovakia and Romania over the status of Hungarian minorities living in those countries. The emergence of Istvan Csurka, a right-wing politician pressing for policies more favorable to "native Hungarians," may further inflame tensions within the country and with Hungary's neighbors.

The country's economic ills and political troubles reduced support for radical reform in the parliament. Political maneuvering in preparation for 1994 general elections and government disputes with the independent media also impeded efforts to push ahead more aggressively with restructuring. One of the major issues of the 1994 Parliamentary election was the proper balance between the requirements of economic transformation and the need to provide social protections to the many people adversely affected by the reforms.

In the first round of elections in May 1994, the HSP led with one third of the vote. The HDF came in third with only 12 percent. The HSP is likely to form a governing coalition when the elections are complete.

Prognosis for Reform

Despite Hungary's problems, the country's emerging market economy and high engagement with foreign investors place it firmly within the vanguard of regional economic reform. Like both Poland and the Czech Republic, Hungary is building a sound legal and institutional infrastructure for long-term economic growth.[15] The victory of ex-communists at the polls may further complicate reform, but is unlikely to undermine progress already made.

SLOW REFORMERS: COUNTRIES IN THE SECOND TIER OF REFORM

Kazakhstan and Russia occupy the next tier of reform. Whereas the Central European states have

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[11] *RFE/RL Research Report,* Aug. 13, 1993, p. 52.

[12] The size of Hungary's black market, estimated at about one-quarter of GDP, makes it difficult to measure GDP exactly. In January 1994, the country's finance minister announced that economic growth had finally begun. *Financial Times,* Jan. 19, 1994, p. 2.

[13] FBIS, *Europe Economic Review,* Dec. 28, 1993, p. 50.

[14] *RFE/RL Daily Report,* Dec. 28, 1993.

[15] Commerzbank predicts 1 percent GNP growth for 1994. *The Economist,* Dec. 18, 1993, p. 58.

established new political orders and have embarked on programs of radical economic reform, the course of change has not yet been decisively resolved in Almaty or Moscow. This indecisiveness over reform will limit U.S. policy options, making it more difficult to promote reform and energy sector modernization simultaneously.

Historical and Political Background

Kazakhstan is a Central Asian country with no legacy of prior independence. The second largest republic of the FSU, Kazakhstan is an ethnically diverse country in which only 40 percent of the population is native Kazakh, while 38 percent of its citizens are ethnic Russians. The population is also differentiated geographically and occupationally, with Russians concentrated in the northern part of the country in industrial, scientific, and administrative positions. Ethnic Kazakhs are concentrated in the south and are more heavily represented in agriculture, health care, and other lower paying sectors of the economy.

Under Soviet rule, Kazakhstan was industrialized (though not to the extent of the Slavic republics), and its economy was closely integrated into the Soviet system. Both Kazakhstan's industry and agriculture are oriented toward and heavily dependent upon the other republics of the FSU, especially Russia, for markets and for supplies of raw materials and manufactured goods. However, Kazakhstan's huge reserves of oil and minerals make the country an attractive prospect for foreign investment and economic development.

Soviet Russia saw itself as the rightful inheritor of the empire built by the tsars and remained the center of the Soviet multinational state.

Russia was also the center of Soviet economic development. Although Moscow pursued economic policies that made the republics highly dependent upon one another for supplies of raw materials and manufactured goods, Soviet economic policies favored the European portion of the country, which was consistently better supplied with goods and which experienced higher and more integrated forms of economic development. Other regions-especially the non-Slavic areas and much of Siberia-were often over-exploited for one product such as oil and were turned into economic dependencies, supported by subsidies and material aid from the center.

When the Soviet Union broke up, this complex system of economic inter-relations was tom apart, leaving 15 separate countries with highly interdependent economies based on economically irrational systems of pricing, distribution, and manufacture. Although Moscow is no longer the center of the Soviet empire, it is still by far the most important economic and political entity in the FSU. While the Central European countries may already be too far advanced economically and too independent politically for events in Russia to seriously threaten their stability, the nature of Russian economic reform and the battles over Russia's future are of crucial importance to all the other countries in the region. A successful, comprehensive, and peaceful transition to a market economy and representative democracy in Russia could greatly facilitate similar processes in all the remaining countries of the FSU. Conversely, the failure of Russian economic reform or continued "muddling along" could promote economic and political instability, not only in Russia, but among all of its neighbors.

Kazakhstan

Independence has come hard to Kazakhstan. The country faces two major sets of problems: an economy still highly integrated into the FSU and suffering from the disintegration of inter-republic economic ties, and the conflicting political interests of newly emergent Kazakh national forces and the large contingent of ethnic Russian residents. The country's president, Nursultan Nazarbaev, has pursued a delicate economic and political balancing act, seeking to introduce economic reform and establish a multi-ethnic state while maintaining economic and political stability.

The breakup of the Soviet Union and the economic instability of Russia have had devastating effects on the Kazakhstani economy. Still highly dependent upon Russia for markets for agricultural and manufactured products, the economy has contracted as markets and sources of supply have dried up. In 1993, Kazakhstan's GDP fell by 15 percent.[16] This decline, combined with rapidly escalating energy prices and ruble instability, has contributed to a soaring inflation rate—about 1,500 percent in 1992 and about 30 percent per month in 1993.[17]

Progress toward reform has been slow. Most prices have been freed, but subsidies remain for some items, especially food and energy products. Substantial progress has been achieved in enacting a legal framework for privatization and market relations, as well as in the conversion of small service and retail establishments to private ownership. But the privatization of medium- and large-scale enterprises is only just beginning. And although Kazakhstan has been a leader within the FSU in opening its economy to foreign investment, sectoral development outside the oil and gas sector has been limited.

The slowness of Nazarbaev's reform strategy has been deliberate. He and his economic ministers have criticized the effects of rapid economic reform programs in Poland and Russia and have given greater priority to slowing the growth of wages and prices, increasing state industrial productivity, and directing a slow, "controlled" privatization process.[18]

The pace of democratization has also been slow. Although there is a multiplicity of parties of all political orientations—possibly more than 100-only three parties have been permitted to register officially. In early 1993 a constitution was enacted, guaranteeing basic rights, but political and press freedoms have been restricted. Morover, the parliamentary elections of March 1994 were criticized by West European and Russian observers for arbitrariness, media harassment, and favoritism toward ethnic Kazakh candidates.

Nazarbaev has maintained what has been called a "mild authoritarianism," partly in response to the political tensions plaguing the country. With the advent of independence, tensions developed between newly emergent Kazakh nationalists and ethnic Russians over political power and the socioethnic character of the Kazakhstani state. One of the biggest issues of contention has been language. Ethnic Kazakhs have demanded that their language be recognized as the only official language, while Russians have advocated giving both languages legal status. Nazarbaev has backed a compromise, making Kazakh the official tongue, but establishing Russian as the language of "inter-ethnic communication. " The conflict over language is symbolic of a larger tension within Kazakhstani society: the extent to which ethnic Russians will adapt to Kazakh ways, which includes not just language, but schooling for their children, new interpretations of history, and asserting Kazakhstan's interests against those of Russia.

Although the emergence of Kazakh nationalism has raised concern in Russia and the West about the possible rise of radical Islamic fundamentalism, Kazakhs are not like] y to take the fundamentalist path. Other ties, such as those of clan or region, are strong and compete with Islam as a means of cultural identification among ethnic Kazakhs. A more serious nationalist danger may come instead from Kazakhstan's ex-Communists, who may join with Kazakh nationalists and coopt the nationalist agenda. The "partocrats," intent on restoring the old relations of power, may try to undermine Nazarbaev and the Western-oriented reformers by accusing them of "selling out" to the

16 The *Economist*, Dec. 18, 1993, p. 58.

17 Ahmed Rashid, "The Next Frontier," Far *Eastern Economic Review*, Feb. 4, 1993, p. 49; *RFE/RL Daily Report*, July 21, 1993.

18 The minister of the economy has spoken of the need not to "lurch" from one extreme to another, from a Soviet-type economy to laissez-faire policies. FBIS, *Central Eurasia Bulletin*, FBIS-USR-93-086, July 13, 1993, p. 78.

Russians.[19] This kind of politics could stir large-scale emigration of ethnic Russian specialists and managers from Kazakhstan, with catastrophic effects on the economy.

One other issue threatens Kazakhstan's economic prospects in general and the full development of its oil export industry in particular. Kazakhstan's oil can be exported only through other countries. At present, the only practical route is through Russia. However, Russia has arbitrarily restricted exports through its Transneft pipeline system to one-third of Kazakhstan's present export capacity. The Russian oil industry (which considers itself the heir of the Soviet-era industry) has also recently demanded a 30-percent share in revenues from all oil-export ventures in former Soviet republics. Russian restrictions and demands contributed to a recent decision by Chevron to curtail its ambitious development program for the Tengiz field.

Alternative pipelines to the Black Sea via Iran and Turkey or Azerbaijan and Georgia have been proposed, but both are polically problematic and may be possible only in the long term. Moreover, Turkey will not permit the large increase in oil tanker traffic through the straits (two tankers per hour) that would be required to develop oil exports fully.

Thus, surmounting Russian opposition to increased Kazakhstani exports and controlling Russian economic demands will be vital to Kazakhstani economic development. This is likely to require sustained U.S. policy pressure.

Prognosis for Reform

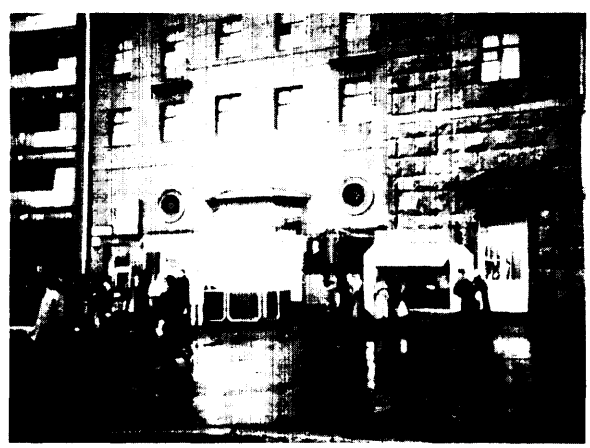
Political and economic uncertainties, together with Nazarbaev's cautious approach toward market reform, render it difficult to make firm predictions about Kazakhstan's prospects. Although the current energy bonanza provides grounds for optimism, oil development is extremely capital-intensive and will have only a limited effect in the short term. As a result, international institutions such as the World Bank do not expect the Kazakhstani economy to start growing substantially until the second half of the 1990s.

Russia

Politics of Reform

Russia has not yet established either the popular consensus or the vast legal and regulatory structure that are vital to successful economic transformation. Instead, since the coup attempt of August 1991, Moscow has been in the throes of a complex battle about the country's future. Westerners have too often viewed Russian politics in simplistic and bipolar terms as a fight between democratic, capitalist modernizers and Communist, nationalist reactionaries. Instead, Russia is experiencing a multifaceted struggle over questions of a more fundamental nature: power, sovereignty, property, and the nature of the future socioeconomic order.

The central arena in this struggle is economic reform, where principled disagreements also exist between political and social constituencies over the nature and course of reform. These debates about the best course of reform are anchored firm-



Moscow, the "kiosk" economy

[19] For a discussion of these issues, see Martha Brill Olcott, "Central Asia on its Own," *Journal of Democracy*, vol. 4, No. 1, January 1993, pp. 92-103.

ly in Russia's uniqueness. Unlike the relatively small and ethnically homogeneous states of Central Europe, Russia is a gigantic country with a much larger, more complex, and more deeply troubled economy. As a result, Russia is less amenable to the types of Western-sponsored aid and trade programs that have been instrumental in the transformation of the economies of Central Europe. Whereas multinational lending has had a profound impact in Central Europe, Russia's size makes its capital requirements much larger. Moreover, success in Russia depends on the conversion of the immense defense sector to civilian production. Finally, Central European countries had a history of market economic relations before and during Communism, but the legacy of the market in Russia is much weaker.

The dilemmas raised by Russia's uniqueness are reflected in a struggle between several different and competing visions of economic reform, some more radical than others, but very few of which envision a return to the old system of centralized state ownership and planning. Among a multiplicity of approaches to economic reform, three main blocs have emerged.[20] The first bloc, centered around President Boris Yeltsin and officials of the 1992 and 1993 Russian government, includes the liberal democratic reformers, who advocate a rapid and radical program of economic transformation based on the Polish model.

The second group, the centrist opposition, includes a broad spectrum of Russians, some affiliated with enterprise managers, others representing disadvantaged social groups, a portion of whom identify themselves as Communists. These Russians favor the transition to a market economy but advocate a more gradual approach to economic change. They would prefer a transition in which the state maintains greater levels of support for large industrial enterprises and managers receive greater powers over the direction of industry. They also endorse a much more active program of state-sponsored social protection. Representatives of this group, led by Prime Minister Viktor Chemomyrdin, appear to have replaced reformers in the Russian government in the winter of 1994.

The third group, the "irreconcilable opposition," is a small but vocal collection of ultranationalists and some ex-Communists who oppose both market reform and democratization. Although Vladimir Zhirinovsky, the most well-known member of this group, enjoyed parliamentary electoral success in the December 1993 elections, neither he nor the other parties that share his view point have articulated a specific economic program.

In addition to divisions over economic reform, Russia is also riven by disagreements over the country's future internal and external political course. This struggle has expressed itself in several ways. The power struggle between Boris Yeltsin and Ruslan Khasbulatov, which culminated in the battle of October 4, 1993, was on one level a personal political rivalry. At the same time it was an institutional struggle for power and political legitimacy between the executive and legislative branches of the Russian government. The struggle also reflected at least two different visions of Russia's future geopolitical orientation. Advocates of one vision hope for a Russia more oriented toward the West, with Western-style political and economic institutions, cooperating as a partner with the United States and Europe in matters of foreign policy. Advocates of the other vision are Russian nationalists who suspect the motives of Western governments, want Russia to establish a powerful independent identity, see Russia's foreign policy interests separate from those of the West, and wish to find a distinctly "Russian" course of governmental and economic reform. These more fundamental issues have yet to be resolved. This struggle and its eventual resolution will have profound effects on Russia's openness to foreign assistance and investment in the energy sector.

20 This group conceptualization is based in part on a framework in Stuart D. Goldman, *CRS Issue Brief: Russia* (Washington, DC: Library of Congress, May 3, 1993), pp. 4-5.

In fact, the victory of Vladimir Zhirinovsky's party in the December 1993 elections indicated the extent to which questions of both Russia's economic and political future remain unresolved. Zhirinovsky's strong electoral support was widely interpreted a sign of disenchantment with declining standards of living and with Russia's reduced world stature. It served as a warning to radical reformers, as well as to moderates, of the need to find compromise solutions to avert catastrophe.

Another component of the struggle over political and economic reform is the battle over sovereignty and property between Moscow and Russia's ethnically and geographically autonomous regions. The devolution of power from Moscow may be a healthy development if it resuscitates moribund local governments and opens the way for innovative reformers to take initiatives from below. But demands for local autonomy, sovereignty, and even independence, endanger the viability and integrity of the Russian state. Until the interests of the central government are balanced against those of the regions within a workable and commonly accepted constitutional framework, attempts to promote democratization and economic stabilization will stagnate.

Progress Toward Reform

On January 1, 1992, under the direction of acting prime minister Yegor Gaidar, Russia entered into a rapid program of economic stabilization and reform similar to Poland's shock therapy. The first results of Russian reforms were quite promising. Despite huge price hikes for many staple items, a large assortment of previously unavailable goods appeared for sale in state retail outlets and in a rapidly expanding network of private establishments. The initial inflationary effects of the price rises were mitigated by tight state monetary policies.

The effects of the rest of the economic program were more negative. Instead of laying off underemployed workers, modernizing production, and changing their product mix to adapt to market conditions, Russian enterprises entered upon a massive spree of borrowing. Initially, without central bank credits, firms simply borrowed from one another, and the size of inter-enterprise debts skyrocketed. Later, enterprise managers asserted their political power and forced the Russian Central Bank to issue massive new credits and to forgive old debt.

The results of the liberalization of prices and the explosion of state and inter-enterprise credit were a hyperinflationary spiral and a huge devaluation of the ruble. By the end of 1992, inflation had reached 2,000 percent per year, and the ruble/dollar exchange rate had soared from 100 to near 1,000. Simultaneously, the steady contraction of Russian production accelerated. During **1992,** Russian economic output fell by about 20 percent.

The spring of 1993 brought some hopeful signs. After a year of bickering over monetary policy, the Russian government came to an agreement with the Central Bank to limit credits to state enterprises. Inflation was reduced to a lower, though still unacceptable, level. Despite a sudden rise in October 1993, inflation fell to 12 percent per month by the end of the year.[21] Although the ruble/dollar exchange rate continued to climb, the ruble moved closer to the dollar in purchasing power parity, and average salaries more than doubled their hard-currency value.

However, industrial production continued to decline during 1993 and GDP fell by 12 percent.[22] Industrial production in the first quarter of 1994 was 25% below the same period in 1993. Simultaneously, the payments arrears crisis worsened considerably. By the winter of 1994, arrears totaled 32 trillion rubles, one half of which was owed to enterprises in the energy sector. Moreover, a January 1994 International Labor Organization (ILO) study placed the level of real

21 *RFE/RL Daily Report,* Jan. 4, 1994.

22 FBIS, *Central Eurasia Bulletin, USR-94-015,* Feb. 17, 1994, p. 24.

unemployment in Russia at over 10 percent, much higher than the official level of 1-2 percent.[23] Although inflation fell to 10 percent per month in the beginning of 1994, Russia's economic situation remains highly uncertain.[24]

Nevertheless, reformers can point to one area of real success: Russia's private sector. In mid-1992, the Russian government announced a two-year program to privatize state firms based on a Czech-type voucher system. That fall, vouchers were distributed to all Russian adults. Russians can use the vouchers to purchase shares in privatizing enterprises directly, to buy shares in investment funds, or to sell on the open market. Although the privatization process started slowly and the value of vouchers fell by as much as 60 percent, they now exceed their nominal value (unadjusted for inflation), and the pace of privatization has accelerated. By the end of 1993, over two- thirds of Russia's small service enterprises had been privatized through conversion to employee ownership or public sale. Of Russia's 14,500 large state enterprises, 11,000 had been converted into joint-stock companies, of which 7,000 were fully privatized.[25]

Russia's new private sector has also undergone a huge expansion in the past year. The development of new private enterprise is even more important than the privatization process because, as experience in Central Europe has shown, the new private sector is the true engine of economic growth. Although the size of the private sector is hard to measure, it is estimated that private enterprise constitutes about 20 percent of Russian gross national product (GNP) and employs over 15 percent of the Russian labor force.[26]

However, the character of private sector development has been extremely problematic. Although many small and large Russian enterprises have been formally "privatized," ownership of shares has remained concentrated in state hands. Moreover, the types of new private enterprises that have developed under the market reforms have been characterized as a type of "kiosk" economy—small businesses importing Western goods to be sold at a high markup. Relatively little has been done to reform the manufacture of domestic goods and stimulate market-oriented production at home.

Moreover, in the absence of strong governmental authority and freely functioning markets for capital and goods, criminal elements (commonly referred to as the Russian Mafia) have proliferated and corruption by government officials assigned to supervise market relations has been rampant. The proliferation of organized criminal power is dangerous not only for the type of market that is developing in Russia, but also for the negative public perceptions of capitalism that are being created in the process.

Finally, high levels of inflation, political uncertainty, and ruble instability have led to enormous levels of capital flight that dwarf the size of Western aid proposals.[27] Until Russian capitalists can be persuaded to invest their capital at home, little progress can be made in building a larger, more vigorous market.

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23 Only a small fraction of the unemployed actually register with government agencies because the process is difficult, benefits are small, and job-seekers are given little help finding new employment. *RFE/RL Daily Report*, Feb. 1, 1994.

24 Margaret Shapiro, "IMF Agrees to Release $1.5 Billion, Says Russia," *Washington Post*, Mar. 23, 1994, p. A24.

25 *RFE/RL Daily Report*, Dec. 29, 1993.

26 Keith Bush, "Light at the End of the Tunnel?," *RFE/RL Research Report*, vol. 2, No. 20, May 14, 1993, p. 61.

27 During 1993, capital outflow from Russia was estimated at $ I billion per month, far exceeding inflows of private capital and Western development assistance. "The Russian Investment Dilemma" *Harvard Business Review*, May-June 1994, p. 36.

Prognosis for Reform

Despite the impressive strides that have been made in price reform and private-sector growth, the Russian economy is in a state of limbo. The central problem blocking progress in reform is Russia's crisis of state authority—that is, the lack of a political consensus on issues of political power, property, institutional and regional sovereignty, and the nature of the future socioeconomic order. Unless Russia resolves this crisis and its government pursues consistent and coordinated monetary and fiscal policies, it will not achieve the type of solid economic stabilization that is an absolute prerequisite to economic reform and growth. Until then, Russia will at best flounder or muddle through reform.

FOOT-DRAGGERS: COUNTRIES IN THE THIRD TIER OF REFORM

Despite the profound economic and political changes occurring in the FSU, one group of countries has barely taken even the first steps down the road of economic reform. The reasons for this substantial lag are fundamentally political—none of these states has achieved a political and social consensus about the need for market reform.

| Historical and Political Background

Ukraine, Turkmenistan, Uzbekistan, and Azerbaijan differ in profound ways. But they share some fundamental characteristics that promote irresolution about reform.

Ukraine is a Slavic country in the European portion of the FSU. Unlike its neighbors in Central Europe, Ukraine has not had significant experience in modern times as an independent, state. For the first time in their history, Ukrainian citizens can elect their own leaders, choose policies, and decide a host of political, economic, and social questions never before within their purview. Ukraine has also had to resist what it perceives as undue Russian influence in its affairs while maintaining (or restoring) economic stability based on existing ties to the FSU. Finally, Ukraine faces the difficulty of defining and asserting a national ethnic identity in a multinational state.

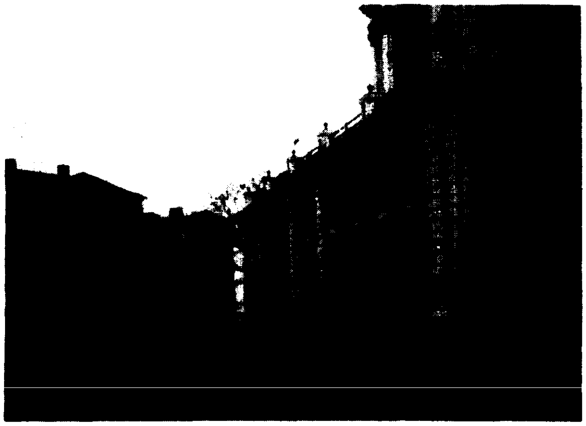
Unlike Ukraine, Turkmenistan and Uzbekistan are Central Asian, Muslim countries. Turkmenistan emerged from the Soviet era as one of the poorest countries in the FSU. An overwhelmingly agricultural country, Turkmenistan concentrated during Soviet times on the cultivation of cotton, which occupied over half of all arable land. Soviet planners also created a cotton monoculture in Uzbekistan (cotton still employs 40 percent of Uzbekistan's labor force), which is the third largest producer of cotton in the world. Low levels of industrial development in both countries, especially Turkmenistan, have left them extremely dependent upon economic and political ties to Moscow

Azerbaijan is a country at war. Since the mid-1980s, Azerbaijan has been locked in a struggle with neighboring Armenia over the status of the predominantly Armenian area of Nagorno-Karabakh. After the breakup of the Soviet Union, the conflict worsened considerably. Since May 1992, Armenians have achieved military control over the territory and have sought to consolidate their position by conquering Azeri areas bordering on Karabakh. Despite international efforts to mediate the conflict, cease-fires have not held, the parties have not yet been willing to agree to peace terms, and Azerbaijan's military losses have promoted domestic political disarray.

| Ukraine

Since it attained statehood, Ukraine has been plagued by a debilitating competition for political power and by an escalating process of economic disintegration. The mixed nature of the Ukrainian economic and political record is symbolized by Leonid Kravchuk, the former head of the Ukrainian Communist Party, who outmaneuvered his nationalist rivals and won election to the Ukrainian presidency in December 1991.

Kravchuk's victory was not just a personal triumph. It also represented the victory of an entire cadre of state apparatchiks behind him: bureaucrats who had maneuvered to survive the transition from Communism to nationalism, more interested in protecting their state positions than reforming the economy. The result of this phe-



JOANNE SEDOR

Podol district, Kiev Ukraine

nomenon, along with Ukraine's preoccupation with nationality issues and the attention to squabbles with Russia over the legacy of Soviet-era property and weapons, has been the neglect of economic reform. Despite the efforts of prime minister Leonid Kuchma, who was forced to resign in the summer of 1993, the Ukrainian parliament spent 1992 and 1993 debating competing reform proposals without implementing a systematic program.

Consequently, despite some monetary, fiscal, and regulatory reforms, major elements of the state economy remained in force (e.g., price controls and public ownership of most land and property), and the authority of Kiev to manage the process of economic change eroded substantially. Economic reform in the provinces was characterized not by conversion to private ownership, restructuring, or modernization, but by a process of "spontaneous" privatization whereby the majority of state enterprises were converted to the de facto ownership of managers and workers through the abuse of a very liberal law on leasing. Simultaneously, in both the capital and the provinces, corruption proliferated.

The increasing economic chaos caused a precipitous decline in production and stimulated hyperinflation. According to the World Bank, output (measured in net material product, NMP) has been falling continuously since 1990 by 16 percent in 1992 and at the same rate throughout 1993.[28] By December 1993, inflation was running at 200 percent per month and 9,000 percent for the year as a whole.[29]

The economic crisis has been felt acutely in the energy sector. The Ukrainian government has been unable to pay hard currency prices for imports of natural gas from Russia and Turkmenistan. In the winter of 1994, Turkmenistan cut off gas supplies to Ukraine for nonpayment of $700 million in gas debt. Ukraine's energy debt to Russia is even higher: $900 million. However, since 90 percent of Russia's gas exports to Western Europe travel through Ukraine, the Russians cannot simply shut off gas supplies to Ukraine. Instead, Russia's Gazprom has restricted gas supplies to Ukraine in an effort to pressure payment, either in cash or in the form of energy-related assets.

Complicating these issues is the fact that Ukraine is not ethnically homogeneous. Almost one-quarter of the Ukrainian population is Russian. The Russians are concentrated in coal-mining regions in the east and in the Crimea in the south, an area that became part of Ukraine only in 1956. Although ethnic Russians in the past have generally been supportive of Ukrainian independence, Russian miners struck in June 1993, demanding wage increases, greater local autonomy, and a referendum on Kravchuk's leadership and the performance of parliament. The strike contributed to a

28 World Bank, Ukraine: *Country Economic Memorandum* (June 2, 1993), p. 2. The Vienna Institute for Comparative Economic Studies measured the contraction of GDP at 18.5 percent in 1992 and 15 percent in 1993. *The Economist (Dec. 18, 1993),* p. *58.* The Ukrainian Ministry of Statistics reported a 14-percent drop in GDP for 1993. FBIS, *Central Eurasia Bulletin, FBIS-USR-94-024* (Mar. 14, 1994), p. 36.

29 The *Economist*, Dec. 18, 1993, p. 48. BISNIS, "Ukraine-Economic and Trade Overview" (Washington, DC: U.S. Department of Commerce, April 1994), pp. 4, and Simon Johnson and Oleg Ustenko, "Ukraine Slips Into Hyperinflation," *RFE/RL Research Report, vol. 2, No. 26,* June 25, 1993, p. 24. Inflation ran at 4,000 percent in 1992 (an average of 35 percent per month). FBIS, *Central Eurasia Bulletin*, FBIS-USR-94-018, Feb. 28, 1994, p. 21.

summer-long political crisis in Kiev, to Kuchma's resignation, and to new elections in March and April 1994. Thus, a resolution to Ukraine's crisis is not likely for quite some time.

Prognosis for Reform

Ukraine is in the throes of a possibly catastrophic economic crisis. Unless a political consensus is reached in Kiev over questions of political and economic policy, the economy will continue to contract, and hyperinflation will spiral even further out of control. The political consequences of such economic disintegration could be extremely serious, including the assumption of power by an authoritarian leader and/or secession efforts by non-Ukrainians.

Turkmenistan

Political and economic reform have not yet come to Turkmenistan. Instead, the country is dominated by its president, Saparmurad Niyazov, an authoritarian ruler who has created a Stalin-like cult of personality around himself and who has suppressed potential political opposition. Niyazov has imposed official censorship, restricted freedom of speech, and harshly repressed political opposition.

Although Niyazov has negotiated potentially very lucrative gas and oil extraction deals, the country has remained one of the poorest in the FSU. Its 1991 GNP was less than 1 percent of that of the FSU, and poverty is endemic.[30] Niyazov has pursued economic reform and the introduction of private property rights very slowly. There has been some attempt at reducing the country's dependence on cotton, but Niyazov does not envision a process of radical economic reform or diversification. Rather, he has advocated a very gradual process of change in which state-owned enterprises will co-exist with an emerging private economy for quite some time. For example, in his economic plan for the next 3 to 5 years, the oil, gas, mineral, and agricultural sectors—which constitute 80 percent of the economy—will remain under state ownership and control.

As in Kazakhstan, the potential for an Islamic fundamentalist movement is low. Turkmenistan is characterized by intense clan loyalties that inhibit not only the spread of Islamic fundamentalism, but also the formation of a strong common Turkmen national identity.

Prognosis for Reform

In theory, its vast gas and oil wealth presents Turkmenistan with an excellent opportunity to overcome the economic distortions of the Soviet era, develop a diversified agricultural, industrial, and commercial economy, and build the physical and social infrastructure that the country so sorely lacks. Energy revenues, however, may be squandered through corruption and the operation of Niyazov's self-aggrandizing political machine. The result may very well be the development of a small, wealthy elite, loyal to the Niyazov political regime, in a country that retains high levels of poverty and underdevelopment.

Uzbekistan

After Turkmenistan, Uzbekistan is the most politically repressive state in Central Asia. Uzbekistan is a good example of what can happen when the partocrats retain power in a post-Soviet country. The country is headed by president Islam Karimov, Uzbekistan's Soviet-era president, and the Popular Democratic Party (PDP), the successor to the Uzbekistani Communist Party. Karimov has suppressed almost all other parties, jailed opposition activists, enforced press censorship, and stifled the development of democratic politics. Citing the civil wars in Tajikistan and Afghanistan, he justifies his repressive political policies by saying that only he and the PDP can ensure stability in Uzbekistan. Karimov openly asserts that

[30] Congressional Research Service, *Turkmenistan: Basic Facts* (Washington, DC: Library of Congress, Mar. 16, 1993), p. 5.

law and order must take priority over the propagation of democratic values.

Since the breakup of the Soviet Union, economic conditions in Uzbekistan have deteriorated but have been moderated by state policies that maintain many of the characteristics of the Soviet-era economy. Although prices were liberalized in January 1992, the prices for most basic items are still regulated. Heavy subsidies for goods sold through the state retail sector and for staple foods keep these products cheaper than those sold on the open market, thereby creating supply problems. Large state subsidies have also contributed to a substantial budget deficit, which constituted about 5 percent of GNP in 1993.[31] Despite some diversification away from cotton, the country still depends on imports of grains, cooking oil, and other staple products from FSU countries.

Karimov has moved with deliberate slowness in the area of economic reform. His stated goal is to create "market socialism," a combination of the old and new orders. Accordingly, any type of shock therapy has been rejected. Privatization has barely started and is destined to proceed very slowly. Industry and almost the entire retail sector remain in state hands, and the private sector produces less than 10 percent of GNP.

Prognosis for Reform

Like Turkmenistan, a rich energy endowment gives Uzbekistan excellent potential for economic recovery. But the entrenchment of partocrats in power and their determination to retain many of the fundamentals of the old system bode poorly for Uzbekistan's economic future. Energy revenues are much more likely to be squandered through corruption and wasted on old, state-centered economic structures, rather than used to modernize Uzbekistan and build a market economy. And continued political repression in the face of rising opposition from democratic, nationalist, and Islamic fundamentalist forces raises the possibility of violent conflict in the future.

Azerbaijan

Systematic economic reform has also not yet begun in Azerbaijan. Instead, the country's attention has been diverted to the military conflict with Armenia. With tens of thousands of Azeri refugees demanding retribution and a foreign power occupying 10 percent of the country, it is difficult to focus on imperatives for domestic economic restructuring and political reform.

However, Azerbaijan's domestic political troubles are not rooted just in the conflict with Armenia. Strategically located at the crossroads between Russia, Turkey, and Iran, Azerbaijan has also been a target of the political, economic, and social ambitions of its neighbors. Although Azerbaijan has some economic ties with Iran, the Iranians have not been successful in their attempts to spread Islamic fundamentalism in the Caucasus. Turkey gained commercial and political influence in Azerbaijan during the short tenure of President Abulfaz Elchibey, who attempted to reorient the country's economy away from the FSU. But in June 1993, Elchibey was overthrown by the forces of Colonel Suret Huseinov, in concert with former Azerbaijan Communist Party leader Geidar Aliev. Elchibey lost power in large part due to his military failures in Karabakh and a drastically worsening economic situation. Huseinov and Aliev enjoyed the support of Moscow against Elchibey and have reoriented government policy toward Russia and the rest of the FSU.

In light of the tumultuous domestic military and political situation, economic reform has received relatively little attention. Despite the proliferation of small-scale capitalism and negotiations with foreign companies to develop the Caspian's energy resources, there has been no systematic program of economic reform. Instead,

[31] *BISNIS*, "Uzbekistan-Economic and Trade Overview" (Washington, DC: U.S. Department of Commerce, January 1993), p. 3.

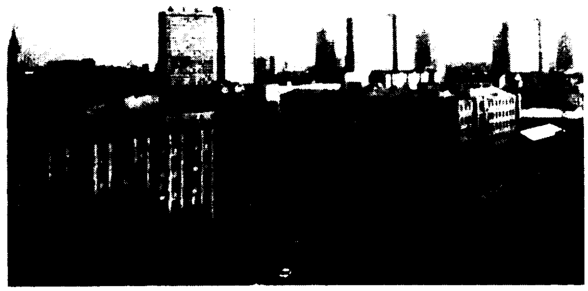
corruption and a highly lucrative illicit trade in oil and other valuable raw materials have proliferated. Despite a relatively low government budget deficit and modest foreign trade surpluses, inflation has hit rates of 1,500 percent, and the government has been criticized for incompetence, for rampant corruption, and for merely substituting its own people for the old *nomenklatura,* instead of building a new system.

Prognosis for Reform

In the short to medium term, Azerbaijan may be able to maintain a semblance of economic stability, supported by ad hoc deals with Western oil companies and semilegal exports of raw materials. But until reform-minded leaders assume power in Baku, the country is unlikely to enact the sweeping legal and structural changes needed to convert to a market economy. U.S. oil companies could participate in the development and improvement of Azerbaijan's oil production with considerable mutual benefit. However, that cooperation is unlikely to be a major force for reform until the political situation stabilizes. Furthermore, Azerbaijan resents the U.S. prohibition on assistance imposed in response to the conflict over Nagomo-Karabakh.

BUILDING NEW SOCIETIES-THE CULTURE OF REFORM

Despite their differences, the countries of the former East Bloc share a similar set of problems in the transition from Communist authoritarianism to market democracy. One such problem is providing social protection during the transition period. These countries will need to transfer traditional responsibilities for housing, medical care, and pensions from enterprises to the state, while devising systems to deal with new problems, such as unemployment and job retraining. This will be particularly difficult, because new expenditures must be justified in light of the pressures of fighting inflation and the need to adhere to the monetary and fiscal requirements of the International Monetary Fund, the World Bank, and other multilateral institutions.



JOANNE SEDOR

Moscow skyline

These states also face an even broader set of cultural problems in building societies based on new political and economic orders. To make the transition from state-directed economies to markets, they will have to overcome a broad lack of understanding of market principles. After decades of Communist rule, at least some of the principles of socialist economic relations have sunk strong roots in the popular psyche or resonate with already extant popular values of communalism and preferences for state-directed economic relations. For example, if market relations are to work effectively, people must learn the function of distributive prices and the harmful effect that subsidies and price controls can have on the rational distribution of goods.

If the goal is to promote a thoroughgoing capitalist system, the mentalities and characteristics of the old system must also be eliminated. After decades of state economic planning and direction, it will be difficult to adjust to the idea that the individual, not the state, is most responsible for his or her own fate. Instead of a system where personal contacts and access to resources are paramount, citizens must also build and become accustomed to a system where money, personal initiative, and merit determine success. Communist-era customs of lackadaisical work must be overcome, entrepreneurship must be nurtured, and firms-in retail and other sectors—must become much more customer oriented.

Unfortunately, this process is complicated by the character of newly emergent market relations, which often creates a negative image of capitalism and highlights its worst aspects. The appearance of wide disparities in income and personal wealth in societies that previously were noted for economic homogeneity has created feelings of unease and perceptions of injustice. The conspicuous consumption of many of the area's new capitalists in the face of mass economic misery incites popular anger. Finally, the rapid growth of violent, organized crime has produced deep anxiety about personal security and may further poison popular attitudes toward capitalism.

Cultural adjustment is also an important subject on the political level. After the initial euphoria about the achievement of national independence, these new states must now deal with a fractious set of new political issues. Independence has brought new conflicts between various ethnic groups and the rise in some countries of new radical right-wing parties. In the countries understudy here, the most serious national conflicts have occurred in Azerbaijan. Nevertheless, although there have been fewer disputes over national boundaries than might have been expected, questions over border areas and disputes over land and ethnic minorities continue to smolder and threaten long-term regional stability.

Perhaps as serious is a more general mass disillusionment with politics and a growing political apathy. This is compounded by a lack of experience among the political leadership with democratic institutions.

Finally, the huge drop in living standards and the political chaos of the post-Communist era has led to a crisis of identity in many areas of the FSU, especially Russia. Before the decline of Communist economies and the breakup of the Soviet Union, Soviet people felt themselves to be citizens of an economic, political, and military superpower. With Russia and the other FSU countries now in an extremely weak position on the world stage, with economies in collapse, with crime on the rise, and with citizens wearing hand-me-down clothing and earning paltry incomes, nostalgia for the old system has grown. The perception is that no matter how repressive or stagnant the old system was, it still provided basic levels of sustenance, security, and national pride. Unless these countries start achieving economic and political progress soon, this nostalgia is bound to grow, and the popular support or social consensus needed for the transition to democratic politics and market economics will evaporate.