

## What Went Wrong?

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By mark whitehouse.

When economic reforms began in Russia more than five years ago, Harvard University was one of Anatoly Chubais' best friends. Moving from one powerful Kremlin post to the next, Chubais worked closely with Harvard advisers as he effected some of the most radical and controversial changes that have ever occurred in a country's economy.

Then suddenly a beautiful relationship went bad. In a terse letter last month, Chubais asked the U.S. government to cut all its funding for Harvard's market reform work in Russia and last week announced that "it is not convenient for me to have business with this kind of institution."

Meanwhile, Jonathan Hay and Andrei Shleifer, two of Harvard's most successful and influential foreign advisers to the Russian government, publicly fell from grace. Accused of misusing U.S. government resources, they were stripped of their jobs at the Harvard Institute for International Development and held up before society as defilers of American ethics.

"In 40 years of HIID activities this case is basically unparalleled," said Jeffrey Sachs, director of the Harvard institute.

Chubais' apparent divorce with Harvard, however, is much more than a matter of two individuals' ethical mistakes. It is a barometer of how deeply the country has changed since its first heady days of reform and has implications for both the future role of U.S. aid in Russia's economy and the shape of one of the world's most attractive emerging stock markets.

When progressive Russian outsiders and a fledgling government were trying to break the command economy, they welcomed all the help they could get, foreign or otherwise. Technical assistance from the West played a key role in launching Russia's massive privatization drive and in the birth of its capital market.

But as those outsiders became seasoned insiders and sophisticated politicians, their demand for foreign advice dwindled along with the political importance of Western aid. Chubais, who developed a power base among Russia's wealthy commercial banks, ultimately needed U.S. aid and advisers less than they needed him to justify their existence to the U.S. Congress.

"Chubais got tired of the Americans," said one Western analyst, who asked not to be named. "They were using him, invoking his name."

On this background, Chubais didn't need much prompting to oust Harvard. The impetus appears to have been a bureaucratic turf war over control of Russia's stock market, in which the Harvard advisers found themselves on the weaker side. The investigation by the U.S. Agency for International Development that led to charges against Hay and Shleifer played conveniently into the hands of Russia's economic elite.

"It is really distasteful that USAID investigators should get involved in Russian politics because of U.S. standards," said Anders ueslund, a senior associate at the Carnegie Foundation for International Peace who knew the two advisers well. "This is something that is done because someone has really been tracking [Hay and Shleifer] to get them."

Following is the story of how the Harvard Institute for International Development, with help from USAID, became a key player in Russia's economic reforms, and how it was outgrown by its first Russian partner, Anatoly Chubais.

### THE IDEALISTS

Hay and Shleifer arrived in Russia at a time when anything seemed possible. The August coup attempt had

just failed, the Soviet Union was collapsing around them and a group of young Russian reformers was preparing to take over and launch the country into a new economic reality.

Hay was among the first of a group of young experts who came in late 1991 and early 1992 to join Harvard professor Shleifer in preparing for the mass sell-off of government assets. This small band of foreigners set up their offices in the dark halls of the State Property Committee, an organization set up by the Supreme Soviet. It was to become the first power base for Chubais, his right-hand man Dmitry Vasilyev and a group of reformers from Chubais' native St. Petersburg.

In the beginning the Western advisers had minimal funding, mainly from the Ford Foundation in the United States and from the Swedish government.

"We had paltry salaries for our staff," said ueslund, who worked at the time on macroeconomic policy with professor Sachs, one of the most influential early architects of Russian economic reform. Sachs and ueslund quit as advisers in January 1994 over the government's economic policy.

"Our operation was very much an idealistic operation," said ueslund.

Soon after Russia freed prices in January 1992, international financial organizations took notice and money began pouring in. The operation at the State Property Committee, or GKI, grew rapidly as young Western lawyers and economists arrived to help Vasilyev write the laws and regulations under which stores and factories across the nation would be turned over into private hands.

"They did a lot of really good work," said Stanford University professor and leading Russia analyst Michael McFaul.

#### THE MONEY

The United States got involved in late 1992, when Congress passed the so-called "Freedom Support Act," under which the U.S. government earmarked more than \$1 billion for aid to the Newly Independent States. Suddenly, USAID had tons of money to spend on Russia, but very little idea of how to do it.

"USAID did not have the established organization, contacts and expertise to accomplish this unprecedented task," says a recent report on USAID's activities in Russia by the U.S. Government Accounting Office, an independent auditor.

Harvard was the only U.S. institution already on the ground that had the resources and Russian-speaking staff to fulfill USAID's needs, so the agency granted HIID a \$2.1 million contract in October 1992 to work on privatization. Led by Shleifer and Hay, the institute became part of the team at GKI just as Chubais launched voucher privatization, which distributed to every man, woman and child throughout Russia a check that entitled each to a piece of the former Soviet Union's property.

By the time voucher privatization had ended in July 1994, the Russian government had sold off some 15,000 enterprises and created 40 million shareholders. Compromises were made along the way, and many Russians today feel that they gained little or nothing from the program. But it is still seen in the West as a great success for foreign technical assistance.

Shleifer and Hay "have done an enormous and an extremely good job," said ueslund. "They have all along been the major advisors on Russian privatization."

#### THE POLITICS

The privatization drive formed strong bonds among Chubais, his fellow reformers, USAID and the Harvard advisers, bonds that found expression in USAID's explicit financial and political support.

"The U.S. assistance program was driven by the desire to support reformers whose agenda was consistent with U.S. objectives," states the GAO report.

The Russian Privatization Center, a semi-private organization founded by presidential decree in November 1992 and financed by USAID, became a sort of clearing house for direct support to the reformers. Chubais, Vasilyev and ally Maxim Boiko all served on the board, according to a recent report by George Washington University professor **Janine Wedel**.

USAID's approach, Wedel says, concentrated too much power in the hands of the Chubais clan "at the expense of processes and institutions."

"By largely putting their eggs in one basket and allowing much aid to be used as the tool of one group, aid planners and politicians have alienated non-Western oriented reformers and opened themselves to suspicion and cynicism about aid programs, capitalism and the West," says Wedel.

The most blatant example of Russian politicians using USAID money for their own ends come during the advertising campaign for voucher privatization, which coincided with the 1993 campaign for parliamentary elections. According to Wedel, the slogan "Your voucher, your choice" in radio and television spots paid for by USAID was changed to "Your choice, Russia's Choice," a slogan for Chubais' political party. USAID fired the public relations firm it had contracted to run the campaign.

Nonetheless, most analysts agree that USAID had little choice but to support those politicians who appeared to have the mindset and resources to effect positive change, given the need to act quickly and decisively at a key point in Russian history.

"In order to be effective you have to work with people who understand the goals of reform," said Peter Oppenheimer, an Oxford University advisor with the European Union's TACIS technical assistance program.

USAID has also been criticized by the GAO for lax oversight of the Harvard activities that it was funding.

Emmy Simmons, director of USAID's office of program and project development in Moscow, concedes that the agency did not have an adequate local management system in place until about June 1995.

The agency was "so busy starting up new activities in 1994 that it was hard to spend a great deal of time managing those activities that were already ongoing," said Simmons. "The oversight wasn't as tight as it perhaps could have been and certainly as it has been since then, since 1995."

#### THE SEPARATION

Encouraged by the success of voucher privatization, USAID gave the Harvard institute more money and an important role in coordinating technical assistance for economic reforms in Russia.

The roles of Shleifer and Hay also grew, with the professor acting as the program's strategic leader in Massachusetts, and Hay becoming the institute's Moscow director, leading projects that included post-privatization restructuring, legal reform and the creation of capital markets. The value of Harvard's contracts with USAID grew to about \$57 million.

But while the Harvard advisers worked closely with Vasilyev, Chubais kept climbing the political career ladder, gaining influence and power far greater than his foreign friends could ever have offered.

"They are not very close to Chubais now," said Ueslund. "It's that Chubais has been doing other things. It's also that Dmitry Vasilyev is not as close to Chubais as he used to be."

One of the other things Chubais did was loans-for-shares privatization, a scheme widely recognized to have given control of some of Russia's most valuable enterprises to powerful banks at bargain-basement prices. Those same banks returned the favor during the 1996 presidential campaign, when Chubais needed big money for a superhuman, and ultimately successful, effort to get Boris Yeltsin re-elected.

Chubais' ascendance to power meant that foreign advisers' significance to him, and to the political landscape in Russia, was declining.

"Politically, from Chubais' point of view, these guys are peanuts," said one Western analyst, who asked not to be named.

Meanwhile, Western sponsors such as USAID, facing growing political opposition in Congress to foreign aid spending, only increased the pressure on foreign advisers to prove their value.

"People are under pressure to demonstrate their effectiveness," said Oppenheimer. "It is very difficult to prove in ways that don't risk exaggerating your importance. In general I know of cases where the Russians have been irritated by statements by advisers claiming both status which they didn't have and credit for decisions."

#### THE DIVORCE

Chubais let Harvard and its advisers know just how important they were when they found themselves on the wrong side of a political battle for control of Russia's stock market.

Hay and Shleifer, supported by USAID, had been working closely with Vasilyev on building a foundation for capital markets. The centerpiece of this work was the Federal Securities Commission, or FKTsB, a market watchdog based on the U.S. Securities and Exchange Commission (SEC). Chubais first headed the commission in 1994 but then passed it on to Vasilyev.

The commission was created with the U.S.-influenced idea that the stock market and banking should be separate areas regulated by separate federal entities. The stock market would work on a U.S. model, with a wide range of mutual funds, brokers, and depositories competing for investors small and large.

Vasilyev, with Hay's and Shleifer's backing, fought doggedly for this vision, gaining himself many enemies: the Central Bank, which considers itself better equipped to regulate the market; commercial banks, which the commission has tried to keep out of the market; and some market participants, who feel that the commission has distanced itself from the people whom it regulates.

"Both Jonathan Hay and Vasilyev have a lot of enemies because they have taken a firm stance," said Ueslund.

In the battle for the stock market, Chubais was faced with divided loyalties: on one side the commission that he brought into existence, and on the other the bankers who had become his key political allies.

The GAO suggested in its report that in any case, the commission might not be up to the task at hand.

"It is unclear whether the Russian SEC has the resources to fulfill its responsibilities," the report said. "Market participants told us that fulfilling the Russian SEC's considerable responsibilities will require a significant enlargement of its staff and budget."

Just as a bureaucratic turf war between the commission, the Central Bank and powerful commercial banks was coming to a head in recent months, USAID launched its investigation into wrongdoing by Shleifer, Hay and Vasilyev.

In an April 14 letter to Janet Ballentyne, head of the USAID mission in Moscow, Vasilyev suggests that the USAID investigators were being fed information by a disgruntled former employee of the Resource Secretariat, a USAID-funded entity set up to support the commission and run by Harvard institute employees.

"Around this employee there has formed in Russia and abroad opposition to the policies of the Federal Commission in the securities market in Russia, and there is an attempt to discredit those specialists, including foreign specialists, who support the policies of the Federal Commission," Vasilyev wrote.

In a separate letter to the U.S. State Department, Vasilyev expresses concern that investigators had been questioning market participants about his possible personal financial interests in the First Russian Specialized Depository and in Pallada Asset Management, a U.S.-backed Russian mutual fund company run by Hay's girlfriend, Beth Hebert.

Then, on May 19, Chubais sent a short letter to USAID head Brian Atwood asking that the latter terminate all economic reform contracts with the Harvard institute. "Because of changing conditions, continuation of these agreements is not consistent with Russian interests," Chubais wrote.

In a few lines, Chubais had not only pulled the rug out from under his onetime foreign allies, but had deprived the commission of much of the meager resources it had. The letter also came at a difficult time for USAID, just as the U.S. House International Relations Committee was considering \$900 million in new funding for the agency's activities in the New Independent States.

The next day, USAID moved to portray the scandal as internal house-cleaning, publicly announcing that it had suspended the remaining \$14 million of Harvard's contracts and accusing Hay and Shleifer of using their positions for personal gain. The agency's inspector general alleged that Hay ordered USAID-paid employees to provide investment services for Shleifer's wife, Nancy Zimmerman.

Harvard subsequently fired Hay and Shleifer, though the latter retains his position as an economics professor. Hay and Zimmerman say that they made investments in Russian securities, but deny any wrongdoing.

Last week, Chubais made the securities commission's defeat official, announcing after a long meeting with Vasilyev and top Central Bank officials that the Russian stock market would develop according to the German model, in which commercial banks play a leading role.

"This gives incredible power to the banks," said Joel Bismuth, vice president at Unibest bank in Moscow. "They will hold the reins of the securities market and will have a strong influence on the pricing of shares. An oligarchy of banks will gain predominance."

At the same press conference, which took place after an article concerning his letter to Atwood had appeared in The Moscow Times, Chubais made the first public announcement that he was severing relations with the Harvard institute, once and for all demonstrating who runs the show in Russia.

"The investigation which was made against the Harvard researchers has some kind of political roots and I guess that these roots are produced by those in the United States who do not support the ideas of the Russian radical reforms," The Associated Press quoted Chubais as saying. "That's why I decided it is not convenient for me to have business with this kind of institution."

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