MAO, MARX & THE MARKET

Capitalist Adventures in Russia and China

Dean LeBaron

with Donna Carpenter

JOHN WILEY & SONS, INC.

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To my mother Irene,
my daughter Stacy,
and my granddaughters
Rachel, Glennie, Hannah, and Leah
. . . modern women
—D. L.

It is more pleasant and more useful to live
through the experience of a revolution
than to write about it.
—Vladimir Lenin

There is a serious tendency towards
capitalism among the well-to-do peasants.
—Mao Zedong

Acknowledgments

FRIENDS WHO KNOW MY WRITING will notice greater clarity than I am normally able to achieve. Neither recent writing classes nor new organizational abilities are responsible for this. The deliverance was provided by Donna Carpenter, who crafted much of the writing. She and I have worked together during the past 10 years, traveling to Russia and China several times and driving hard at the desk as well as on the road. Pushing for the details and the whys, Donna forced me to remember and to explain. Her admirers know her as a highly skilled business ghost, with many best-sellers to her silent credit. This admirer also knows her as a partner who helped me understand what I experienced and who encouraged me to follow my instinct to share it with others. The authorship now reads DL with DC, and there are good arguments for reversing that order.

I also want to thank the participants in the experiences this book describes. Doing business in foreign lands requires tenacity, courage, and intelligence in the best of circumstances, and current circumstances in Russia and China are not the best. Paul R. Rugo, my friend and longtime lawyer and counselor, took a six-month sabbatical from Goodwin, Procter & Hoar to head Batterymarch's Moscow office near the end of our time there and, sadly, near the end of his life. Paul's efforts in deciphering the legal complexities in Russia and China were ably supplemented by his partner, John LeClaire. Others in Moscow—Jeff Braemer, Vladimir Sidorovich, Joel Barber, Svetlana Kolupaeva, Richard Sobel, Kim Malone, Oksana Kozhina, and Vera Zudina—deserve and have my gratitude. Two American advisers, Graham Allison and Vernon Alden, gave freely of their time and reputations to our Russian venture. The Russians who formed a kind of informal council to advise us risked their reputations on Western involvement early in the process. Among the many who gave unqualified support, some appearing in the chapters to follow, are: Vladimir Koblov, Evgeny Vitkovsky, Anatoly Kiselev, Oleg and Natalia Gapanovich, Anatoly Turchak, Dmitry Sergeyev, and Alexander and Vera Kuznetsov. They remain friends whose minds were torn by the massive changes they experienced. I continue to see them and cherish their friendships.

Among the many clients who visited Russia and China with me, several were notable stalwarts. Perhaps David Feldman, then at AT&T, and Gordon Binns, then of General Motors, will not mind if I identify them, violating the rule of anonymity and recognizing their full commitment in the quest for investment return from the less-than-obvious places and as role models for our new friends in these countries.

I was fortunate to have a number of friends who gave me their counsel, time, and, at times, sharp critique. Two stand out in this group. Charles Ellis, founder of Greenwich Research, is a lifelong friend who has shared many adventures with me, none greater than this and none where I needed him more. Charley blurted out in a crowded dacha, "Golly, Dean, they really think you can solve the problems." And William Wirth, then head of asset management at Credit Suisse, also shares adventures with me—which often means he initiates and I tag along. He joined me for a historic joint Russian-Japanese cosmonaut launch at the Baikonur (now Khrunichev) Space Center. We noticed the first space billboard—the large letters "SONY" on the side of the rocket. Commercial consequences were starting. And William and I have gone to China together to monitor the continuation of that miracle, with its fits and starts. Charley's and William's advice, especially in this early period, was on the mark.

Counterparts in our China effort include Ms. Yin Yafei and Mr. Lawrence Speidell, as well as Mr. Steven Fang from China Merchants Holding Company and Mr. Ma Xuesong from the diplomatic service in Beijing, who both interned with us in Boston. Other Chinese friends who gave us their early blessings include Mr. Lou Jiwei, who recommended me to leading people in Shanghai, and Ms. Chen Yu, who was extremely helpful in the same city.

The conversations recounted in this book were often facilitated by our translators and bilingual staff—the more skillful the translation, the less visible the translator. They skillfully translated not only spoken dialogue, but also written correspondence and documents from or to the Russian Cyrillic or Chinese character alphabets. You will also note that some words are transliterated to the Roman alphabet so they can be pronounced as they sound in the original Russian or Chinese. Our translators removed the language barrier and made the process fluid. My thanks to these participants whose very good work renders them invisible.

For both countries, I utilized the advice of friends and clients, some of whom accompanied me on visits to Russia, Ukraine, and China when I hardly knew what to tell them the program would be. They bravely extended their help, which landed some of them in the middle of the attempted coup in Moscow. None complained. They made me the beneficiary of invaluable advice.

Finally, I offer deep appreciation to my Batterymarch colleagues, who understood what I wanted to do and who assumed extra burdens and took extra heat while I was on the road trying to do it. My special thanks go to Marilyn Pitchford, who was much more than Batterymarch's chief financial officer at the time. Displaying uncommon devotion, she not only traveled to Russia and China, but also acted as chief of staff to the support troops as they soldiered on in trying conditions. Her tasks, which often required interminable hours, ranged from preparing our monthly flight, a mini-Berlin Airlift, to making Russian and Chinese business plans resemble something worthy of the name. If I had the impossible task of pointing to the one person who made Batterymarch's efforts work, Marilyn would get my nod. She continues to be my closest associate in every venture I undertake and makes me look better than I deserve.

D. L.

Preface

If, as the Chinese say, a journey of a thousand miles starts with a single step, then this book began with a trip to the People's Republic of China in 1980. That spring, I joined one of the first U.S. tour groups to visit since October 1949, when Mao Zedong's Communist Party seized control and effectively closed the country to Westerners. Among the stops on our trip was a trade exposition in Shanghai, a city of about 12 million people on the Huangpu River in eastern China.

We drove along the famous Bund, a wide boulevard that follows the Huangpu and is flanked by nineteenth-century European-style buildings that once housed international banks and trading companies, before they were taken over by the government and used for offices. From the windows of our dilapidated bus, we could see the old names chiseled into stonework and painted on peeling plaster. The Shanghai Exhibition Center, a large hall built in the ornate architectural style favored in Stalin's Soviet Union, contained a large exhibit of Chinese products. At a booth displaying woven textiles, a member of our group asked, through an interpreter, if he could buy one of the samples.

"Buy?" responded the man in the booth, appearing puzzled. Then, a light suddenly dawned. Within minutes, he was producing sample after sample for our inspection, accompanying each with patter about its quality, beauty, and value. I watched him scan our faces for reactions to his suggested, then quickly revised, prices. Thirty years of communism had not destroyed his instinct for trade.

Nearly 10 years later, in the fall of 1990, I had a similar experience in what was then the Union of Soviet Socialist Republics (U.S.S.R.), where I was the guest of government officials. One of them drove me to Moscow's Red Square and parked his car, but instead of taking me into the huge plaza, he guided me down a street leading away from it.

"I thought you were going to show me Red Square," I said.

"Not the square, not exactly," he replied. "This is what I want you to see."

He pointed down Kuibyshev Street to a small, stout, three-story building with enormous Ionic columns and a gabled end fronting the street. The once-grand building badly needed sprucing up, but the lions carved into the massive wooden door were intact.

"That," my guide confided, "was the Birzha, the Russian stock exchange."

Tucked in a passage between warehouses, Kuibyshev Street, formerly Ilinka, had been tsarist Russia's Wall Street, its buildings adorned with advertisements for banks, financial exchanges, and other commercial institutions. The Bolsheviks abolished those enterprises, whose once ornate signs yielded to claret-colored metal plates naming the offices of the new tenants: high party and government officials. My friend did not need to explain why he had brought me there. The message was clear. Still, he dotted the "i." "Look," he said, "we Russians may have made a mess of it for a time, but I wanted you to see that you're not the first capitalist to conduct business in Red Square."

I had noticed that boldness characterized the Soviet leaders we met. Often faced with a complete lack of either resources or strategic position, the Soviet ministers and enterprise directors displayed confidence, even bravado. And they usually got away with it.

So did I in a small but memorable incident in the fall of 1990 during my first visit to Leningrad, a historic city founded by Peter the Great in 1703. Rising from the swamps on the shores of the Baltic and site of the horrendous 900-day Nazi siege during World War II, Leningrad is a proud city, beautiful and cosmopolitan. We were to visit its largest enterprises: Leninetz, the "General Electric" of the Soviet Union; and Kirov Works, a manufacturer of tanks, tractors, and other vehicles—the Soviet equivalent of Ford Motor's Benton Harbor works where coke and iron ore are deposited in one side of the plant and completed vehicles are driven out the other.

Our group was rather large: six Americans from Batterymarch forming the advance team developing our Soviet Companies Fund and a dozen Soviet ministers, translators, and, most likely, a KGB agent or two. Because of our VIP status, we traveled in a parade of vehicles with the status of the occupant determining the style of car and level of luxury. Traffic was halted to let us pass as we sped through the city following our white police car escort.

The night of our arrival, we checked into our hotel and were assigned an entire floor, complete with a floor matron stationed between the rickety elevators and the hall for bedrooms—Americans on one side of the hall and Russians on the other. Rooms were assigned according to rank, and mine was at the far end directly opposite that of Evgeny Vitkovsky, the senior minister accompanying us. In case I needed a translator, Batterymarch's newest employee, a young woman fluent in Russian and an accountant by training, was assigned the room next to mine.

In the middle of the night I stirred and headed to the bathroom in my room. Bleary-eyed, I opened the door; it seemed odd that the light was on, but, thinking nothing more about it, I closed the door behind me. I heard a click that suggested a lock was being set. It was. I was standing in the hall, my door was locked, and I was naked.

My drowsiness cleared immediately. I was in trouble. Characteristically, I travel with as little clothing and accessories as possible. If one can do without pajamas, it is that much less weight to carry. This was an occasion, though, when I would have preferred the burdens of extra baggage.

I first needed cover, but there was nothing in sight. Even the floor matron was not at her station at the end of the corridor. Thinking I might get a towel to wrap around my waist, I rapped very softly on the door of the Batterymarch employee in the room next to mine, not wanting to awaken Vitkovsky across the hall. Whether she heard me or not, I don't know. Quite possibly a new employee on her first company assignment, looking through the peephole and seeing her boss standing naked in the hall, would reasonably have concluded that her wisest decision would be not to respond.

There was nothing for me to do but adopt the attitude of a Soviet leader—brazen it out. Shoulders back, I headed to the elevator and rode down to the lobby. I walked to the front desk where several lady bookkeepers where working on the bills and asked for a key, apologizing for my lack of identification. I was told: "It happens all the time." Taking the key, I strode back to the elevator—acutely conscious of maintaining my best posture—and returned to my room. No harm done . . . not counting a slight wound to my dignity.

It was a personal parable worthy of the Soviets: When you are stuck without cover, pretend you don't need it.

☆ ☆ ☆

I DID NOT TRAVEL to China or Russia intending to write about either one. Curiosity about a culture that had been closed to Westerners for 30 years first drew me to China as a tourist, and a serendipitous invitation from the Gorbachev government spurred me to visit Russia. But it was my fascination with the tremendous force of the changes underway in both countries that compelled me to return and eventually to participate in their economic revolutions. As an American, a capitalist, an institutional money manager, and an optimist, I wanted them to succeed. The interests of the United States are optimally served in a world that is stable and at peace. Capitalism thrives most vigorously when it is not constrained by political boundaries.

The company I founded in 1969 (and sold in 1995), Batterymarch Financial Management, handled at the time more than $10 billion for institutional clients, primarily corporate and state pension funds. Then, as now, it operated best when that capital was free to seek opportunity wherever it might exist. Batterymarch invested in Western Europe and the United States, as well as in Argentina, Brazil, Chile, India, Mexico, Venezuela, and other developing markets. As a rule, those countries are not the rich economic markets featured in the financial press. Batterymarch was there because I am a contrarian investor, and contrarians' actions are not dictated by conventional wisdom. When most investors are buying real estate, contrarians buy something else. They believe, as Humphrey Neill noted in his seminal book, *The Art of Contrary Thinking*, that when "everyone thinks alike, everyone is likely to be wrong."

My interest in contrarian thinking germinated more than 40 years ago while I was studying at the Harvard Business School, which pioneered the case-study method of teaching. Groups of students analyzed a case and reached an often-incorrect conclusion because they missed the subtle point on which the case turned. I was struck by how often the majority managed to be wrong—a condition, I soon observed, as prevalent in the real world as at Harvard. People are often lured to the majority view, even when doing so requires them to ignore what they clearly observe or to abandon their ethical and moral principles.

Contrarianism is unique because it doesn't attempt to tell people what they should do, only what they should not. If everyone is buying biotechnology stocks, contrarians know to leave those stocks alone—or to sell them, if they own any, and buy something else. Buy *what*? Contrarian thought will not supply the alternative. It teaches only that following the crowd isn't good; you must think for yourself.

At Batterymarch we looked for techniques that the markets had not yet applied—indexing and computerized trading in the 1970s, for example—and investment regions that were not yet favorites, such as Brazil and India in the 1980s. For example, several years ago our research discovered that public companies operating in emerging nations, such as Argentina, Chile, and India, were collectively producing 12 percent of the world's gross domestic product (GDP), but were accorded by global equity markets less than 5 percent of the world's total corporate valuation. To a contrarian, such disparity represents opportunity. We knew that eventually, when other investors discovered the discrepancy and bid up the market prices of the undervalued companies, early investors would be rewarded. What I saw in China and Russia suggested that similar opportunities existed in both countries.

☆ ☆ ☆

THIS BOOK IS A CHRONICLE, a handbook, an encouraging warning about doing business with Russia and China as they leap perilously toward capitalism. My ideology is straightforward: It is imperative that the West engage Russia and China in a compact for mutual higher living standards.

The alternatives seem, at best, unpleasant for all. Still, as I discovered, the course of East-West business is rarely smooth. I hope this account of events that are crucial to the transformation of socialist command economies can serve as a practical guide for investors attracted to Russia or China. I intend it as a partial map of the snares, pitfalls, and rewards of investing in these two giants whose futures will long remain uncertain. Few serious investors have approached both of these opening markets simultaneously; fewer have committed their experiences to paper.

China remains on the same path, with the Western nations grudgingly acceding to its growing importance in the world, on its own terms. Russia, on the other hand, seems to have started a new a program to restore its pride if not its economic power and standing in the world. But in both cases the engagement issues we confront today are, for the most part, the same ones we faced in the early 1990s.

I leave this record of success and failure to be viewed as more than investment advice, if only because economics has largely replaced ideology as history's driver and shaper. My adventures might also serve to caution statesmen and stateswomen about the hazards of "foreign entanglements" and the painful consequences of missed opportunity. Russia and China know they need us; we have yet to realize how much we need them.

Nothing is ever quite as contrary as reality.

DEAN LEBARON

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November 2001

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MAO, MARX & THE MARKET

Introduction

CHINA AND RUSSIA NEEDED FOREIGN CAPITAL to help them privatize and modernize state-owned industrial plants. At Batterymarch Financial Management, our contrarian thinking motivated us to become involved early in the exhilarating process of helping individual enterprises in China and Russia. Thus we played a role in assisting these huge economies to make the wrenching transition from central planning to free market trade.

We proposed to create two investment funds to channel Western capital into promising enterprises in the two countries. Those pioneering funds, we thought, would serve as models for the future privatization of other state-owned enterprises there. Working in several Chinese and Russian cities, we listened to factory and office workers, as well as managers, who told us about the depressing consequences of years of communist rule, state ownership, and central management—evidence of which we could see for ourselves. We also glimpsed the tentative optimism of people who hoped that economic change was possible for their incredibly rich, yet impoverished, countries.

I believed that freeing these countries from the chains of central planning would prove the most significant economic event of the century, benefiting not just their own populations, but people everywhere.

The United States, Japan, and the countries of Western Europe, who have been trading primarily among themselves for the past decade or more, were playing a zero-sum game in which one country's gain has been another country's loss. It was much the same with European trading rivals in the sixteenth century, before trade routes to the New World and Asia opened. The new access to markets, natural resources, and production capacities expanded economic opportunities for everyone. I believed that bringing China and Russia into the modern global economy would have a similar effect. Yoking their underused human and natural resources to the West's dynamic production and trading systems could potentially enable those countries to produce the world's next economic miracle. As I saw it, they would not merely join the community of free-trading nations; their size, resources, and potential would enable them to transform the world.

However, my view has changed dramatically during the past 10 years. The conversion of the Chinese and Russian economies from communism to some form of capitalism still promises to reshape the world economy, but not necessarily in the ways I envisioned.

China's shift toward capitalism and the demise of communism in Russia have not transformed them into Western-style capitalist societies. For the foreseeable future, the West must learn to live with the unpredictability of ongoing change instead of the permanent, definitive reformation that many expected.

What does this mean for the people of the West, in particular for businesspeople and investors? The once tentative and suspect notion that the two great Communist powers could transform themselves into free nations, politically and economically, was slowly accepted, then respected, and finally became a part of the West's conventional wisdom. I watched a parade of business delegations, economists, and technical experts make pilgrimages to Moscow and Beijing. I saw some of the great corporations commit themselves to joint ventures with former state enterprises in China and Russia. And all the while, my contrarian side was flashing a warning.

Experience as well as intuition sent the current to that flashing sign. Doing business in China and Russia proved to be full of surprises, ironies, paradoxes, and contradictions. In the end, some of my natural sympathies and assumptions had to be jettisoned when they proved inconsistent with my interests and those of the investors whose money I managed. While some of my expectations were thwarted, others were realized more fully than I could have hoped.

PART ONE

Russia

CHAPTER ONE

The Russians Are Coming

I MIGHT NEVER HAVE GONE to Russia had it not been for two phone calls, one fax, and a submarine.

The first call, in the summer of 1990, was from a friend who led a Boston-based research group called Defense and Disarmament. Together with the Soviet Academy of Sciences, his organization was sponsoring "Swords into Plowshares," a conference at Harvard University focused on production conversion, military to civilian, in both the United States and the Soviet Union. Would I be interested in addressing that unusual assembly? I would indeed.

Harvard's venerable red brick buildings and the placid Charles River seemed an appropriate setting for the subject. But I noticed an important disparity. The Soviets sent high-ranking government officials and senior managers of the factories that produced military hardware. The United States was represented by a sprinkling of middle-level managers from military-industrial companies like General Electric and Raytheon. That the American companies attached little importance or urgency to converting from military to civilian production was evidenced by the ranks of their representatives.

In their choice of delegation leader, the Soviets sent a very different signal. Vladimir Koblov was first deputy chairman, and soon to be chairman, of the State Commission on Military Industrial Production of the Council of Ministers of the Union of Soviet Socialist Republics (U.S.S.R.) (the "State Commission"). The United States has no equivalent rank or job, but imagine that all of its defense contractors, from giants Boeing and McDonnell Douglas to the smallest independent contractor, were combined into a single organization supplemented by the Pentagon's procurement bureaucracy. Someone equivalent to Koblov would be in charge, overseeing thousands of plants and offices, and millions of workers.

At the conference, some American speakers argued against converting military plants, maintaining that it could not be done for several rea-

SOVIET MILITARY INDUSTRIAL COMMISSION AND MINISTRIES

EXECUTIVE

President
Mikhail Gorbachev

Council of Ministers
Valentin Pavlov, Prime Minister

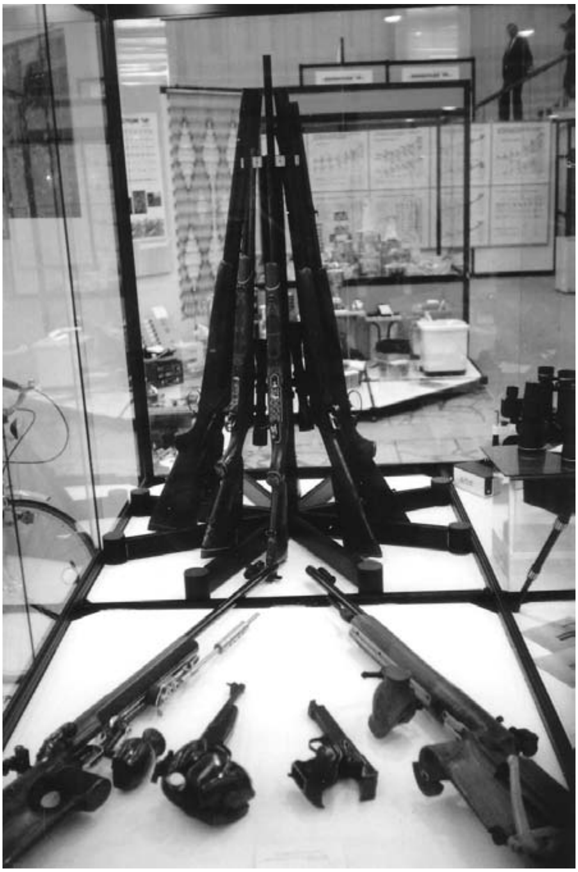
Military Industrial Commission
Yuri Maslyukov, Deputy Prime Minister and Chairman
Vladimir Koblov, First Deputy Chairman

MINISTRY OF	MINISTER	DEPUTY MINISTER
❑ Atomic Energy	Vitali Konovalov	Yuri Tychkov
❑ General Engineering	Oleg Shishkin	Rudolf Kirushin
❑ Aviation	Apolon Systsov	Vladimir Ivanov
❑ Radio	Vladimir Shimko	Mikhail Vyunsh
❑ Defense Industry	Boris Belousov	Evgeny Vitkovsky
❑ Electronics	Vladislav Kolesnikov	Yuri Kozlov
❑ Shipbuilding	Igor Koksanov	Gennady Voronin
❑ Communication	Gennady Kudryavtsev	Kaljeu Kukk

All Ministries reported directly to both the Council of Ministers and the Military Industrial Commission

5,000 Defense Enterprises and Research Institutes sons, one of which was that unions would not agree to the necessary changes in job descriptions and pay scales. The Soviet speakers, by contrast, tended to ask: "Why not? If the world wants fewer weapons and more consumer goods, let's oblige."

The contrast surprised and appalled me. We Americans were supposedly responsive to markets, but here it was the Soviets showing flexibility. We argued for the status quo; they, for change. The Soviets had not come to Harvard to discuss long-term gross domestic product (GDP) growth; they wanted to know how to turn rifle factories into refrigerator



During later visits to the ministries and enterprises that reported to the State Commission, we would see weapons—powerful and plentiful—on exhibit, from rifles and handguns to tanks and Proton rockets. The importance of conversion seemed obvious.

plants *now*. Perhaps the difference in authority between the two delegations accounted for some of the difference in spirit. As the conference progressed, it became even clearer that the Soviets were top decision makers for their enterprises, whereas the middle-level Americans unquestioningly expressed their companies' policies.

My own speech suggested two simultaneous initiatives: privatization of Soviet enterprises and the creation of an investment fund that would allow aggressive American, European, and Japanese corporations to buy stakes in the privatized companies. Privatization would give the Soviet economy a shot in the arm, while the fund could pioneer new areas of profit and serve as a model for future investment in the Soviet Union.

Privatization is an old and simple concept, based on the conviction that private investors, rather than the state, should own a country's factories and farms. Just a few years before, this would have been dangerous even to hint at in the Soviet Union. But thanks to the new rules of Mikhail Gorbachev's administration, it was suddenly possible. Under privatization, Soviet workers who became part owners of enterprises would have a stake in their own productivity. In this way they would gain something tangible from the abandonment of communism. They would see that the transformation to free market capitalism would benefit the great majority of people, unlike the old system that primarily served the Communist Party and the state.

However, I cautioned, while the concept of privatization was simple, its execution would be devilishly difficult. A few precedents existed for privatizing an entire state-owned economy, but none large enough to be a model for the Soviet Union. When East Germany privatized its much smaller economy in 1990, it was able to adopt West Germany's laws and economic structures. Even so, it was—and remains—a Herculean task for the Germans. By contrast, the Soviet Union would be privatizing almost from scratch, and without an established economic power like West Germany to act as a parent in times of crisis.

Privatization would involve far more than declaring that workers are now plant owners. They might have all the job skills in the world, but Soviet workers had no financial capital. If enterprises were to modernize and expand, if their managers were to learn the techniques of marketing and international trade, the country would need to enact laws permitting enterprise ownership by other investors, too. Only foreign investors could contribute both the hard currency that privatization demanded and the business expertise necessary for recently emancipated companies to stand on their own and compete in a free market. The country needed to create a legal framework in which foreign investors, individual and corporate, could feel comfortable.

The next morning my office telephone rang. It was Vladimir Koblov, who asked if I could meet individually with each member of the Soviet delegation later that day. My plan had apparently struck a responsive chord. They said it offered a more focused, specific vision than any other they had heard, and they wanted to hear more.

Desperate to stave off an economic free fall, the Soviets wanted all the help I could provide. I cleared my calendar and spent the afternoon in individual 15-minute sessions, answering questions on my investment fund proposal, about Batterymarch, and about how to create an environment attractive to foreign capital.

The next evening the entire Soviet delegation met at my home for further discussion. One of my guests, a burly, square-faced, dark-haired Russian, informed me that he had been in Boston before.

"Oh," I replied, assuming he had been on a trade mission or something similar. "When was that?"

"About five years ago," he allowed.

"Where did you stay?" I asked, anticipating the name of a downtown hotel.

"Nowhere," he answered.

This was not the first time I was puzzled when talking to Soviets, and it would certainly not be the last. My guest grinned. He had "seen the city," he said, from Boston Harbor—through the periscope of a submarine. "Swords into plowshares" hit close to home at that moment. Soviet submarines, whose nuclear weapons no Star Wars technology could stop, had been lurking in the waters near my home.

The Russians involved in the Plowshares project continued moving fast. Days later, I received a fax from the Soviet government inviting me to the U.S.S.R. to explain my ideas in detail. Before accepting, I again asked myself the hard question: Did I really believe Russia was a place where interesting profits could soon be made? I remembered some remarks by Graham Allison, former dean of Harvard's John F. Kennedy School of Government and, later, a deputy secretary of defense in the Clinton administration. Given the wealth of natural and human resources in the Soviet Union, Graham told me, it had taken a truly evil genius, Joseph Stalin, to bring the country to its knees economically. For more than 70 years, that huge nation—three times the size of the United States—had experimented with a questionable economic system and failed miserably, squandering its wealth and misusing its human and material resources. Still, that failure, bitter as it was for the Russians, held the promise of a new and better life—where Western capital and experience could be crucial.

I believed the potential of a free market Soviet economy was enormous, if only because of the nation's size. The country was simply too big to ignore. After China and India, it ranked third in world population, with almost 300 million citizens. Those millions wanted cars, appliances, well-made clothing, and decent housing, which Western companies could supply at affordable prices. If and when the free market revolution took place, the U.S.S.R. would provide a vital market for Western producers, and it offered a rich opportunity for Western investors.

The chronic shortage and shoddiness of Soviet consumer goods did not indicate ineptitude as much as it pointed to a lack of emphasis in these areas. For seven decades, the economy had been driven by concerns of national security, not by the demands of the marketplace. Influencing every economic decision was the Communists' determination to control all aspects of society. What the Soviets knew how to do, they often did very well. While their advanced weapons represented their exper-

By special invitation, I traveled to the Baikonur Cosmodrome in Kazakhstan and witnessed the December 2, 1990, launch of the Soyuz TM-11 mission, a historic joint mission with a private Japanese company. In this picture (*not* taken with a telephoto lens), the cosmonauts begin boarding for their mission to Mir.

tise in research, technology, and production, precious little of that knowledge and proficiency was used to stock retail shelves.

Likewise, political failure, as opposed to a lack of resources, accounted for the difficulty in feeding Soviet citizens. Prior to its breakup at the end of 1991, arable land composed 11 percent of the country, the same percentage as in China, but the Soviet Union was comprised of more than twice the land mass of China and only a quarter of the population.

Yes, there were spot shortages of fuel and other natural resources, but these, too, can be attributed to organizational shortcomings. The Soviet Union held 40 percent of the world's reserves of natural gas and almost 6 percent of the oil. (Its annual oil production in the early 1980s had been about one-sixth of the world's total.) The natural wealth was staggering. The country also had more timber, coal, iron ore, copper, zinc, nickel, lead, gold, and other precious metals than any other nation in the world.

The human talent was also extremely impressive. By any standard, the Soviet labor force was well-educated and highly trained. If early in the century only 10 percent of the population attended high school, by 1959 90 percent of Soviet workers had some high school training, and when Gorbachev came to power, nearly 100 percent had a high school education. By that time, high school attendance and the literacy rate in the Soviet Union were nearly identical to America's. The drive for educational achievement was growing because, coupled with Party membership, it was the principal route to upward social mobility. Higher education was also expanding. In 1990, 9 percent of the population had college degrees, compared to 2 percent in 1960. The technologically sophisticated defense systems were designed and perfected by one of the world's largest pools of 1.5 million basic-research scientists and engineers.

I concluded that a partnership with the West could involve many of those scientists and engineers in socially useful research and economically profitable development projects. The task was to identify the technologically advanced parts of the Soviet military establishment that could, after privatization and conversion, compete successfully in the world market. And, furthermore, this had to be done in a society immersed in the process of making the treacherous and unprecedented transition from communism to capitalism. I couldn't let a challenge of this magnitude slip by.

And so I left for Moscow in September 1990, thanks to two telephone calls, one fax, and a submarine.

CHAPTER TWO

From Marx to McDonald's

As my plane flew east through the European night, I read and thought about the enormous, enigmatic country whose rivalry with my own had shaped the course of so much history during the past half century. The Soviet Union had been for me, as for most Americans of my generation (I was then 57), an inexplicably malevolent place, called the Evil Empire by President Ronald Reagan as recently as the mid-1980s. Yet, there I was, the consummate capitalist, on my way to pursue business in the Soviet Union. And, I told myself, if Mikhail Gorbachev's reforms took firm root, Western businesspeople would follow the pioneers in droves.

A more prescient, or pessimistic, explorer might have embarked on his or her first visit with more skepticism and less enthusiasm about the business opportunities in a reformed Soviet Union. But I'm an optimist by nature, who couldn't help marveling at how quickly and thoroughly the world had changed. I wasn't alone in my optimism, though close to it. Shortly before the flight, unsettling news had emerged from the U.S.S.R., which for so long had kept its problems secret. The country was evidently facing economic and ecologic disaster.

Food shortages were exacerbated by poor food quality: A 1990 Soviet study found that one in three samples collected by inspectors was unfit to eat. Consumer products and services were also scarce and vastly

This well-stocked produce market in Moscow was not a typical scene.

inferior to Western counterparts. Barely one in 25 Soviets owned a car, compared to two of every three Americans. (A black South African was more likely to own an automobile than a Soviet citizen.) What was then called Leningrad had one gas station for every 201,000 people. Despite recent expansion, the Soviet telephone system was years, if not decades, behind. The country had one-seventh the number of telephones per capita as the United States. It was common for a visitor to spend half an hour or more trying to call abroad, only to be put on hold or disconnected.

The World Bank estimated that as much as half of the Soviet Union's so-called industrial production assets—plants and equipment—were so old and antiquated that their worth barely exceeded their salvage value. The worst were in the civilian sector, where most of the machinery predated World War II. Reports indicated that after seven decades of Communist administration, Soviet health care was deplorable. The life expectancy of a boy born in the Soviet Union was 65 years, three years shorter than that of a child born in third-world Mexico. As a sign of how calamitous the country's decline would become, by 1995, only five years later, average male life expectancy in Russia would drop to 57. (As Boris Kurdimon, a Russian bibliophile and bon vivant now living in Manhattan, remarked on turning 58: "I'm legally dead!") The Soviet Ministry of Health reported in 1988 that only 25 percent of the 35 million children aged seven or younger could be considered healthy. Health-related problems limited the career choices of more than half of Soviet high school graduates.

In 1988, the Gorbachev government issued the nation's very first report on the state of the Soviet environment, in which 290 "ecological disaster zones," most of them in Russia, were identified. The 3.7 million square kilometers covered by those disaster zones represented 16 percent of the Soviet Union's total territory, about 10 times the size of unified Germany, or more than a third of the area of the United States. Soviet citizens, the report continued, were regularly exposed to far more air and water pollutants, and a far greater range of them, than were their Western counterparts. An estimated 20 percent of the Soviet population, or 60 million people, lived in environmentally unhealthy areas. In 1988, Ukraine alone sent 10 times as many toxic chemicals into the air as did the entire United States, which is about five times its size. In the most highly polluted areas of the Soviet Union, such as Siberia, male life expectancy was 20 years less than in the industrial nations of the West. Respiratory disease killed Soviet men at a rate nearly three times greater than German, French, British, and American men.

This grim picture showed no signs of improving. In the absence of a free market, the government made economic decisions. The Soviet economy could have delivered more and better medical care, consumer goods, and food, as well as a cleaner natural environment, but only if the government gave these goals a high priority. Before Gorbachev it did not. Instead, it chose to pursue an arms race with the West, which could far more easily afford the race. The Soviet people paid a terrible price.

At the same time, I knew the country was not an unmitigated economic disaster. Its defense technology alone showed that it had impressive research and production capabilities, and its achievements in the Cold War era suggested the Soviets knew how to apply them. They had, after all, exploded their first atomic bomb in 1949, a feat that astounded Western experts. That they launched Sputnik, the first space satellite, in 1957, humiliated the United States and touched off the decades-long space race.

Defense interests also inspired other technological developments. In the mid-1980s, the Soviets masterfully bugged the new U.S. embassy building under construction in Moscow. Invalidating the designers' best intentions, Soviet espionage experts used highly advanced sensor technology to implant hundreds of ceramic devices, invisible to conventional X-ray scanners, inside the embassy walls. So sophisticated was the technology that Soviet spies could reportedly pick up what embassy staffers were pecking on their IBM Selectric typewriters. The building remains vacant to this day.

In fact, some inventions migrated from Soviet laboratories to U.S. markets during the time of open hostility between the superpowers. One was a surgical stapler, a substitute for traditional suturing techniques, that New Yorker Leon Hirsch parlayed into the multimillion-dollar United States Surgical Corporation. Industry giant Kaiser Aluminum & Chemical Corporation bought rights to a Soviet casting technique that lifts molten aluminum in pulsed magnetic fields. The Holland Company uses advanced Soviet welding technologies to make railroad cars, while Perkin-Elmer Corporation, a leader in atomic absorption spectrometry (which measures the trace elements in parts per billion), acquired from the Soviet Union specialized sample preparation accessories that boost equipment performance. For the basic cost of translation (usage fees are another matter), information on Soviet innovations had actually been available for years in the West. Soviet engineers and scientists published openly in books, journals, and author's certificates, their equivalent of U.S. patents. Thanks to those publications, American missile manufacturers now added the metal beryllium to rocket propellants, while E. I. du Pont de Nemours & Company, Inc. (DuPont) altered its production techniques for making vinyl acetate after learning the Soviets had devised a superior process.

Perhaps it took an optimist to believe that the U.S.S.R. had companies and products sufficiently advanced to attract Western trading partners immediately, and to believe that cutting-edge Soviet technologies had value in the international marketplace. I was such an optimist. However, I was also aware that the real dangers for investors were not only economic but historic as well. If history does not necessarily repeat itself, its patterns are always recurring, and maybe more in Russia than in countries exposed to outside influences. The Russia of the late twentieth century paralleled the country of the previous century. "An empire," wrote Richard Lourie in *Predicting Russia's Future* (Whittle Direct Books, 1991), a book that condenses a thousand years of Russian history into less than a hundred pages, "fails to solve social and political problems, and its structure collapses under its own weight." Lourie was referring to Russia under the tsars as well as under the commissars. Both tsarist and communist Russia collapsed for essentially the same reason: The rulers refused to sacrifice any of their power to address their societies' ills. This had changed little through the centuries.

Still, many Russians themselves wanted a strong state headed by a powerful leader. In 1240 the country was overrun by the Mongols, who ruled for the next 250 years. A vast plain open to invasion from every side, Russia needed protection above all else. Every city was built around a kremlin, or fortress, and a psychological focus on the fortress evolved. While Western Europe was experiencing the Renaissance and the Enlightenment, and Europeans were landing in the New World, Russia, cut off from the rest of Christendom, was a servant to Mongol lords. Russia again formed a strong and unified state under the reign of Ivan the Terri-

Moscow's Red Square borders one side of the Kremlin, the seat of Soviet government.

ble, whose name, 500 years later, still stands as a symbol of pathological cruelty. Ivan was Stalin's hero and role model.

Another powerful and cruel figure who shaped Russia was Peter the Great, founder of St. Petersburg. Having traveled and studied widely in the West, he was determined to drag his backward land into the new world of science and technology, but without the social progress for which Europeans were clamoring. In particular, he was unwilling to grant any freedom to the serfs who made up 90 percent of the Russian population.

After several bloody rebellions, Russian serfs were finally granted their freedom by Alexander II in 1861, two years before Abraham Lincoln freed the American slaves. Oddly, both emancipators were assassinated—Lincoln by a bullet, Alexander by a bomb. The timing could not have been worse for Russia: On Alexander's desk sat an unsigned edict proclaiming limited representative government in Russia. Even today, Russians don't quite know how to remember the "tsar-liberator." On one of my tours of St. Petersburg, I would be shown the spot where he was assassinated. "This," said a Russian friend, "is where Tsar Alexander II was murdered by terrorists in 1881." "Well, comrade," another Russian observed, "some of us would call those terrorists heroes of the Revolution." Embarrassed, my friend's face turned scarlet.

The period between 1881 and 1917, the year of the Bolshevik Revolution, was a time of fierce struggle between the forces of the ruling tyranny and the increasingly confident and violent revolutionaries. Those wishing for a more liberal, gradual solution to the country's problems were becoming a minority. The situation grew extreme.

The last tsar, Nicholas II, was a weak man, influenced greatly by his wife. She, in turn, was under the spell of the Russian mystic Rasputin, who claimed the power to heal their hemophiliac child. Nicholas granted some freedom, but it was too little, too late. Worse, he led his country into two disastrous wars, one that ended with the humiliating defeat in 1905 by Japan, whose army had gone from samurai swords to battleships in a mere 50 years; the other was World War I, for which Russia was so ill prepared that one soldier in four went into battle unarmed, with instructions to pick up rifles from the dead. The system collapsed. Waiting to pick up the pieces were Vladimir Lenin and his Bolshevik party.

Lenin was a Marxist revolutionary who drew his principal support, thin as it was, from the industrial working class, which had been sorely abused as Russia surged toward capitalism in the late nineteenth and early twentieth centuries. Hardened by the execution of his brother, who was hanged for terrorism, Lenin became a masterful organizer without

Vladimir Ilich Lenin, head of the Bolshevik ("majority") party, was 47 years old at the time of the 1917 Revolution.

pity for his enemies. Overthrowing the monarchy in 1917 proved fairly easy, and only six people were killed when the Winter Palace, the seat of imperial power in St. Petersburg, was seized. But the civil war that followed took some 20 million lives between 1918 and 1920. The Bolsheviks, now calling themselves communists, abolished private property, nationalized banks, and redistributed land to the peasants. Private capital and profits were prohibited. The Russian Orthodox Church was persecuted and placed under state control.

Yet after the civil war, which reduced industry to 20 percent of its pre–World War I level, Lenin was forced to compromise. In 1921, he launched his New Economic Policy (NEP), which permitted the reintroduction of some capitalist practices. Peasants were allowed to sell their produce; private trade flourished; and private banks, closed since 1917, reopened. The state retained control of heavy industry, transportation, and foreign trade, but the NEP recognized limited personal property rights and small inheritances. In introducing his economic reforms 70 years later, President Gorbachev cited Lenin's NEP. He seemed to believe that if a little bit of capitalism was all right for Lenin, it was all right for today's Russians.

By the middle of the 1920s most sectors of the Soviet economy had,

Lenin is remembered not only as a revolutionary but also as a political theoretician. This statue on the grounds of the Kremlin portrays a more statesmanlike Lenin.

as a result of NEP, regained their prewar operating levels. But, while capitalism in Russia was enjoying a brief rebirth, the single-party Communist regime was consolidating its hold on government. Lenin died in 1924, and by the time Joseph Stalin succeeded him, after a bitter four-year struggle with rival Leon Trotsky, the Communist Party had a stranglehold on all power within Soviet society.

Few in the West remember Stalin as anything but one of the century's most heinous despots. Still, it is Stalin, not Lenin, who deserves credit for industrializing the country. Like Mao Tse-tung (Mao Zedong) in China, Stalin inspired a fiercely loyal, cultlike following, which permitted him behavior that no constitution would have. Under Stalin the totalitarian era in the U.S.S.R. began in earnest. He abolished NEP and imposed his own economic scheme to place the Soviets on an equal footing with the West.

Central planning replaced state capitalism. Government goals destroyed nascent market mechanisms. Two major crash programs, planned industrialization and agricultural collectivism, underlay a series of six five-year plans that set goals in all economic areas, including agriculture and consumer goods. Heavy industry—the production of electricity, steel, oil, and coal—claimed first priority on Soviet capital and labor. By 1934, less than six years after Stalin had taken ironfisted control of the economy, the country ranked second only to the United States in industrial output. Yet the quality of life for the average Soviet citizen hardly improved, and for some it deteriorated.

The agricultural peasants lost the most, as Stalin stole their land rights and forcibly relocated them onto collective farms, exiling or executing the well-to-do (the ownership of a cow was enough to denote a person as such). The collectivized farms were supposed to produce the food to feed an expanding industrial workforce, but collectivization failed from the start. Many peasants slaughtered their animals rather than surrender them to the state, and the country's livestock population dropped by half. Drought struck the grain-growing regions in the early 1930s, but the real starvation was caused by Stalin, who devised a simple way of ridding his country of peasants with capitalist tendencies: confiscate their grain at the beginning of winter, forcibly confine them to their villages, and clear out the bodies in the spring. As many as 10 million peasants perished. Unmoved, Stalin remarked, "One death is a tragedy. A million is a statistic."

During the 1930s, Stalin purged (exiled or murdered) millions more, especially fellow communists, in order to remove any threat to his power. And in World War II another 27 million died.

One may assume that Stalin stood unchallenged in the ranks of Soviet villainy, but such an assumption, like so many concerning contemporary Russia, would be simplistic. In January 1991, I visited a grave site behind Lenin's tomb, in Moscow, along the foot of the Kremlin wall. My guide was the young son of a Central Committee member. Walking slowly from tomb to tomb, he quietly told me something about each revolutionary buried there. We finally came to the last grave, Stalin's. A simple marble slab bore his name and dates (1879 to 1953), beneath which were a dozen or so fresh flowers.

Not a petal decorated any of the other graves.

I was puzzled. "Why Stalin?" I asked, pointing to the flowers.

"Because he was a great leader," came the reply.

But, I pressed on, as tactfully as I could. "Do the Soviet people know how many millions of their fellow citizens perished at this man's command?"

"Oh, yes," my guide answered. "But Stalin was a strong leader. Many of my countrymen wish Gorbachev were as strong a leader. We need another great man like Stalin."

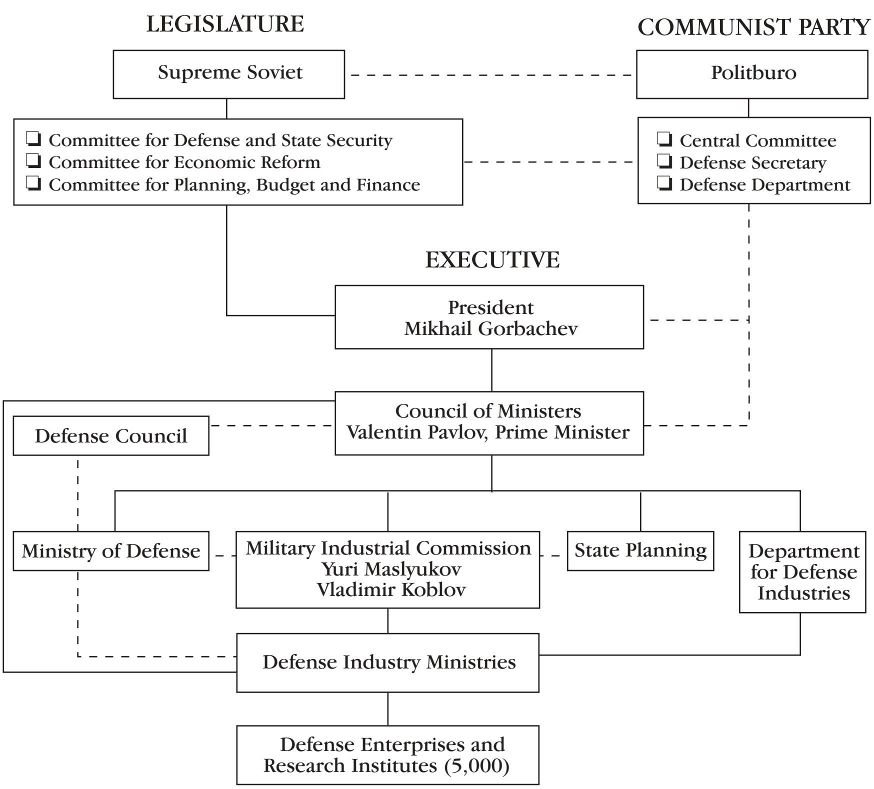
When Stalin died in 1953, the Soviet Union was officially very rigidly structured, and under this structure a mass of informal, often illegal,

Visitors to Lenin's mausoleum in Red Square, between the Spassky and Nikolsky Towers of the Kremlin's walls, can see his embalmed body.

arrangements flourished. His successor, Nikita Khrushchev, attempted some reforms, but they were opposed by a large segment of the powerful apparatchiks who sat at the top and lived very well under the old ways. Reforms were less significant than massive corruption under Khrushchev's successor, Leonid Brezhnev. The Russians say that the Soviet system has been ruled by bald reformers and hairy reactionaries—bald Lenin, hairy Stalin, bald Khrushchev, hairy Brezhnev, and finally the greatest and baldest reformer of them all, Mikhail Gorbachev, who discovered that the house that Stalin built could not be repaired, but had to come crashing down.

Our plane descended upon a Russia in crisis. In a highly unusual departure from protocol, the Soviets granted us permission to fly into Moscow in Batterymarch's private plane. From the air a visitor can view things not apparent from the ground—the layout of city streets, for ex-

ORGANIZATION OF THE SOVIET GOVERNMENT



ample—which was why tourists were forbidden to photograph from Soviet airspace until the late 1980s. A few years earlier an attendant on Aeroflot, the Soviet airline, reported a friend of mine who ignored the prohibition. On the ground, his camera was confiscated, and he was detained for several hours by security police, who continued to tail him, he was convinced, during the rest of his stay. Not until the late 1980s did the Soviets stop deliberately publishing inaccurate street maps of Moscow and other major cities. In addition, no private flights, on which photography could not be controlled, were allowed to cross Soviet territory until approximately the same time. We interpreted our authorization to land at Moscow's Sheremetyevo 2 airport as a hopeful sign.

I arrived with some Batterymarch colleagues. Although we agreed to avoid politics entirely and confine our activities to business, we wondered if that would be possible for U.S. businesspeople, especially since our visit was itself an act of some political significance. Still, we were determined that our Soviet hosts understand that our interests lay solely in conducting business for our mutual benefit. Months later, when CIA and FBI agents solicited information about the Soviets associated with our project, I declined to offer any, and they did not insist. I did offer to introduce the agents to those Soviet officials, but the Americans demurred. "We're not ready yet for that kind of openness," one said.

Our plane touched down at 2 A.M. My first glimpse of what the Russians call "Soviet reality"—referring to the mix of grandiosity and shoddiness—was properly discouraging. The bumpy runway was overgrown with grass at its edges. I wasn't yet seasoned enough to appreciate Sheremetyevo 2's superiority over smaller airports, where potholes large enough to blow out tires and damage landing gear were common.

Dozens of Aeroflot aircraft were parked far from the main terminal. Many were missing an engine or two due to the chronic shortage of spare parts. One of Aeroflot's greatest problems—or, from my perspective, its greatest opportunities—was a failure to meet the demand from potential customers. In 1990, the Soviet Ministry of Aviation reported that the enormous country's sole airline turned down between 30 million and 40 million requests for domestic flights every year. Even so, Aeroflot operated the world's largest air transportation network, flying 100 million people 660 million miles annually. It placed first in the common measure of revenue passenger miles: 244 billion. Its share of the total world market was an impressive 17.42 percent, more than double that of then second-ranked American Airlines.

As we taxied toward the gate, it struck me that Aeroflot, operating as a monopoly, would be a prime candidate for privatization, since it could

One of the many aircraft of Aeroflot on an unkempt runway.

be logically broken up into a number of competing regional carriers. The Soviets had yet to express any interest in taking that step, but maybe we could convince them.

As instructed, our plane passed the ordinary international terminal and taxied to a VIP building. The vaunted "workers' state" clearly accorded certain people privileged treatment, and we were among them, even if the bus that ferried us to the terminal was shabby and dirty. We were met by Jeff Braemer, a Batterymarch staffer who had arrived a day earlier to arrange our itinerary, along with several Soviets. They included Evgeny Vitkovsky, a delegate to the "Swords into Plowshares" conference and deputy head of the Ministry of Defense Industry; Vitali Komarov of the State Commission on Military Industrial Production; and Anatoli Rosenzweig, an interpreter.

Inside, the wood-paneled terminal with its Oriental carpets on parquet floors was more elegantly appointed than many airport VIP lounges outside the Soviet bloc. A huge bust of Lenin, which, as we would discover, was identical to countless others in offices and factories, observed us sternly from a place of prominence. After perfunctory document checking that took less than 10 minutes, we walked down a stairway to four automobiles waiting at the sidewalk.

In the Soviet Union, even more than in most other countries, the statuses of foreigners (and government officials) are indicated by the makes and models of the cars in which they are driven. President Gorbachev rode in a Zil limousine, the top of the Soviet line. Bulbous Chaikas were for those deemed slightly less important. Volgas were the next step down. By the winter of 1993, Gorbachev was reduced to a Volga, and Yeltsin rode in a Zil. The small fleet awaiting us consisted of one Chaika, two Volgas, and a BMW police car—all of which were black, except the white police car dispatched by what the Soviets called the special police force, a euphemism for the KGB. Led by that KGB car, its siren blaring, our motorcade sped toward Moscow, ignoring red lights and taking the center lane reserved for Communist Party officials so they could avoid Moscow's traffic problems as they were zipped from homes to offices.

Even later, after the collapse of communism, we were driven in this fashion, although our "police" escort had been abandoned. While on a practical level we covered much more ground than would have been possible otherwise, it certainly evidenced the disparity between Communist Party officials and their guests and ordinary citizens. We felt discomforted as we passed people standing in long lines for basic necessities, which happened often.

Like the architecture and elegance of ancient Moscow, and the gold spires and swelling domes of Orthodox churches, everything Stalin touched was transformed into a vehicle for impressing the individual with the supreme power of the state. Built in the style he favored, seven bizarre Gothic skyscrapers continue to dominate the city skyline. The largest, Moscow State University's main building, overlooks the city from the summit of the neighborhood where we stayed, a section known as Lenin Hills. The ornate wings and capricious spires of the nearly 800-foot tower remind one of an enormous stone wedding cake. But now, driving through the city streets, we passed the most obvious symbol of the new capitalism, a McDonald's restaurant near Red Square, scheduled to open in two months. The opening of the fast-food establishment would actually represent the closing of an old circle. When the Mongols, otherwise known as Tartars, conquered Russia in 1240, they brought with them a favorite dish of raw beef mixed with onions and spices. That dish traveled west to Germany, where it became popular as steak tartare. In the 1880s, a citizen of Hamburg tried a cooked variation; thus the hamburger. The hamburger that became an American classic was about to enjoy a homecoming in Moscow.

By the time I visited Moscow's McDonald's on my third trip, in March 1991, some problems, very predictable within that culture but completely unforeseen by the American managers, had been solved. One was the customers' tendency to line up behind the *longest* queue at the cash registers, although 27 of them were normally open for service. "After

Not only McDonald's, but Pizza Hut would open to a thriving market in Moscow.

years of experience," the economist Marshall Goldman explained, "Soviet consumers have come to expect that the longest line forms in front of the most desirable goods. McDonald's had to station special ushers to reassure customers that all the lines offered the same food."

Still, the lines remained long in 1991. Standing in line for more than an hour, I performed some market research through an interpreter. Why were people eating there? Their reasons surprised me. It wasn't the food, they said, but the courteous service. McDonald's, it seemed, was Moscow's only restaurant where the prices were affordable and customers were sure to be greeted with a smile and a friendly "May I take your order, please?" People also admired how McDonald's was run, like a finely tuned machine. A single person took an order, filled it, received payment, made change, and handed over the purchase, a procedure that bore no resemblance to that in most Soviet stores, where buying something required three steps: A clerk hands the customer a ticket to buy the product; another clerk fills the customer's order (assuming goods are available); and a third takes the customer's money and makes change. And no one smiles.

A 45-minute drive delivered us to Lenin Hills, which Tolstoy readers may recall as Sparrow Hills. (And Sparrow Hills it would soon be again, when thousands of streets and sections of Moscow and other cities were

Cars assigned for our use wait outside the dacha, Batterymarch's elegant home in Sparrow Hills.

The beautiful grounds surrounding the dacha.

restored to their prerevolutionary names.) An armed soldier of the State Militia, roughly equivalent to our National Guard, protected the gated entrance to an estate of superb government houses, built during the Stalin era for the exclusive use of very privileged visitors. The sentry waved us through. Our dacha, or country house, was an enormous two-story structure on two acres of beautifully landscaped grounds, completely walled off from the street. This is where President Reagan stayed in 1988, when he and Gorbachev took their famous stroll in Red Square. Eleven other dachas, similar in size and design, all with small, private parks, were scattered around the neighborhood.

Each person in our party of six was given a separate bedroom with

My bedroom at the dacha.

Office adjoining the bedroom in my suite at the dacha. The importance attached to our work was underscored by the facilities provided to us.

bath. The house also contained a large foyer, living room, dining room, kitchen, and billiard room. My suite, which consisted of a bedroom with twin beds and a large office with a chair and a sofa covered in ornate gold brocade, was stocked with a huge box of chocolates, bottled mineral water, fruit, and other delicacies—which surprised me, given the acute shortage of food.

Although it was 4 A.M. and we were exhausted, our hosts proposed a toast to the success of our venture, the first of countless toasts Soviet people would offer during the coming days. (Visitors quickly learn that what is said over drinks in Russia is often as important as what is said at meetings.) Nothing seemed quite real. We were in the capital of the world's largest empire, now in its death throes, for the purpose of helping Russia through its metamorphosis. And if the past was a guide, it would be a grandiose future. What else could be expected from that land of tsars, Rasputins, and Stalins?

The bite of the vodka was very real. So was my thirst for sleep. I drank up fast. The workday would begin in five hours.

CHAPTER THREE

Soviet-Style Fish Chowder

REFRESHED MORE BY EXCITEMENT than by sleep, I registered my first daylight impressions. Moscow was mighty, vast, and ugly. Every once in a great while, however, crumbling brick tenements and stained concrete-slab apartments parted to reveal a church from a Russian fairy tale with blue, white, and orange cupolas, their gold crosses flashing. Then it was gone, and I was back in the heavy, lumbering traffic with its drab trucks and mud-streaked buses. Although military vehicles and civilian trucks built on military models composed much of the traffic, plenty of private cars—mostly small, boxy Zhigulis, without options, sold abroad as Ladas—had recently become popular.

Like Paris, Moscow was built in expanding concentric rings, but its boulevards are broader, some wide enough to accommodate 20 cars abreast. Those boulevards are intersected by avenues radiating spokelike from the Kremlin, originally a fortress constructed in the twelfth century and still the city's heart. Although there is much greenery, I noticed few large trees and was told that as World War II approached Soviet scientists believed leaves and other foliage would retain poisonous fumes if the Nazi armies resorted to gas attacks. Not waiting for this theory to be proven, the Soviets chopped down most of Moscow's large trees.

For me, the Russian experience would be a study of contrasts. While huge concrete boxes house its bureaucracy, these beautiful churches seem to embody its soul.

Facing the entrance to the Kremlin, good friends Vladimir Sidorovich, Gordon Binns, and David Feldman stand in front of the Cathedral of St. Basil the Blessed. Built in the mid-1500s, it is the oldest building in Red Square, other than the Kremlin.

Within the walls of the Kremlin.

Replanting began in 1947, but it went slowly, like so much other non-defense work, and was given a lower priority with each passing year.

In contrast to vertical New York, Moscow is more like Los Angeles—sprawling, horizontal, endless. Russians themselves say it isn't really a city, just a gigantic village. Among the crowds thronging the sidewalks, I saw few people moving with the purposeful stride of American urbanites. Instead I saw either lethargy or panicky haste. On a side street, I noticed a Russian man attaching his windshield wipers, which he had locked in his glove compartment for safekeeping overnight. He did this in the same automatic motions with which he opened the door and switched on the ignition. It was just one more task before driving off, just as many Americans automatically remove their radios and attach antitheft devices to their steering wheels. I had read the explanation in newspapers. Wipers left out overnight are stolen and traded on the black market. The state was the sole manufacturer of windshield wipers and didn't produce nearly enough to satisfy demand. Here the consumer was not king, but beggar or thief.

We were streaking down the VIP lane on our way to an appointment at the Ministry of Defense Industry. I was about to meet the infamous central planning system in the person of Boris Sergeevich Belousov, the minister himself. In the Soviet Union, government bureaus made each and every legal, business, and economic decision. Not a ship or even a rivet was produced unless ordered by a Kremlin office. Not a car, a gasket, or a windshield wiper was made unless approved by some government plan. Those plans covered every aspect of the Soviet economy, not just the manufacturing sector. Restaurants were mandated to serve so many meals, painters to cover so many square meters, taxi drivers to make so many trips, hospitals to care for so many patients. Even writers had to produce a certain number of pages. Sometimes Soviet trains ran without a single passenger, making extra, unscheduled trips around the tracks just to satisfy a plan's mileage requirement. In the mid-1980s, the central government controlled the production, pricing, and distribution of roughly 30 million products manufactured by nearly 50,000 plants, and this in a country with very few computers available to track the data. Estimates put the number of personal computers in the Soviet Union at 350,000, about 1 percent of those in the United States at that time.

Government control of the relationships among those thousands of plants had been in place since the early 1920s. It was not efficient or even effective in producing and distributing the right amount and combination of products, but the system seemed to work, at least in its own terms. The enterprises depended on the bureaucracy to do what markets do elsewhere: decide what goods should be made and services offered, in what quantities, and at what price. An immense bureaucracy called Gosplan ("Stateplan") prepared the annual and the five-year plans for every ministry and every enterprise. The five-year plans, beginning with the first, issued by Stalin in 1928, and (except for a gap during World War II) continuing through the twelfth, presented by Gorbachev in 1988, reflected broad policy set by the party. After the plans were officially issued by Gosplan and approved by the presidium of the Supreme Soviet, the country's rubber-stamp legislature, they carried the force of law. Failure to reach the prescribed production targets was potentially punishable.

Consequently, a production problem was viewed less as a mishap than as a crime. Plant managers were less interested in fixing problems than in affixing blame. No matter how long it took, someone had to be found guilty.

The contrast between our system and theirs would strike me even more forcefully months later, when I took a group of Soviet managers to visit General Motors' truck manufacturing plant in Pontiac, Michigan. While we were touring, a computer failure stopped the assembly line. "Hmmm, broken, just like ours," quipped one of the Soviets. But when the group talked to the plant manager, the conversation turned more serious. They did not ask what it took to get the line moving again but wanted to know who had been responsible for the glitch. Clearly, the Soviet system emphasized the stick more than the carrot.

Although the higher-ranking managers had access to special food stores, better health care, and finer vacations, they were probably more motivated by fear of losing their jobs and the precious privileges than by the desire to succeed, rise higher, and enjoy more perks. On the whole, bonuses and other positive reinforcements were rare in the Soviet system. Virtually the only feedback was negative: usually docked wages for quotas not met or instructions not followed.

In a Soviet aircraft factory, I saw a board displaying various incorrectly made parts, with the name of the worker responsible next to each. I realized that if a disaster befell this economy in its difficult transition from communism to capitalism, people conditioned to seek a culprit would do so. During my subsequent trips to the Soviet Union, it became apparent, as overall economic conditions deteriorated, that Mikhail Gorbachev would bear the brunt of the blame.

Central planning did more than generate fear and stifle initiative. It also left the Soviets focused entirely on gross production, and with a peculiar attitude toward quality control, at least regarding the production of civilian goods. Quality was no concern of the producer whose performance was measured only by the number of units produced. It was solely the consumer's problem.

I knew from the outset that the emphasis on gross production was an obstacle we would have to address if our mission was going to succeed, and I also knew that it would be an uphill battle. The yardstick of achievement for Soviet enterprises was purely quantitative: the number of tiles laid; the boxes of soap produced; the weight of nails manufactured. No one was deceived. The workers made endless sarcastic jokes about manufacturing the "world's fastest watches and largest microchips." *Krokodil*, the premier satiric magazine, summed up the situation in a cartoon that showed a nail factory proudly displaying its "record output": a single gigantic nail suspended from an immense crane. In the oil industry, rewards went to those exploration workers who exceeded a target number of feet drilled in the ground. Because it was easier to drill the first hundred feet than the second or third, the countryside was pockmarked by hundreds of thousands of 100-foot holes that yielded no crude oil.

Since the target for textile mills was specified in yards of cloth, managers routinely instructed their workers to weave as loosely as possible in order to get the most yardage from a given amount of thread. And it didn't matter to coal mine managers, who were required to produce a specified tonnage of coal, that their miners uncovered a variety of other minerals that could have been sold in the world marketplace. Told to produce coal, that was all they produced, simply discarding the other minerals, no matter how precious. (The alternative was to sell the unscheduled items illegally. This, together with the associated corruption that plagued the centrally planned economy, was another massive problem.)

Soviet enterprises produced opaque sunglasses, shoes that only the barefoot would don, and appliances so faulty when they left the assembly line that they could never be repaired. Exploding television sets, long known to be a major cause of catastrophic fires, continued to be manufactured. Enterprise managers were told what to make, and their enterprises hewed to the numbers on the production plan with only the slightest, if any, concern as to whether their products were useful or safe. The quality of the products made virtually no difference to them, at least in terms of how they were rewarded.

Pollution, which ranked high among various problems, was much exacerbated by the gross production mentality. Factory managers and their supervisors in trusts and ministries were so obsessed with meeting the production plan that they avoided anything that they considered an obstacle to production, such as installing pollution control equipment. Obviously, this worked to the severe detriment of the environment. The levels of air and water contamination grew even more alarming because most Soviet industrial plants were built before World War II and, as in the rest of Eastern Europe, used highly inefficient, highly polluting production processes.

Some Soviet research institutes did fine work developing cleaner, more efficient technologies, but research often remained theoretical. Hardly ever was it applied, because the researchers who developed the new processes had no contact with the enterprises that might use them. And since the ministries that operated the enterprises were responsible for monitoring pollution there, the government was, simultaneously, violator and regulator. Ministries were supposed to police themselves, but the system provided no incentives for them to do so.

Most local and regional authorities complied because their bread was buttered in the same way. The few brave ones who tried to warn of the health hazards and environmental damage of industrial projects were usually ignored or overruled. Massive hydro projects undertaken during the Brezhnev years, despite local opposition, resulted in environmental disaster. Those projects, designed to reverse the flow of rivers in order to irrigate the southern republics, were ultimately stopped under Gorbachev, but the damage could not be undone.

As if all this were not enough, the central planning system rewarded weakness rather than strength. For example, if the manager of a plant that made tires reported that equipment problems were preventing him from meeting his quota, the appropriate ministry would allocate additional capital to the facility so it could get the job done. Enterprises that met their quotas received no capital infusion for modernization or improvements until they fell behind in production. In other words, the Soviet system spent money on losers, not winners: another feature inimical to efficiency and growth. The Soviet government itself estimated—very conservatively, as it turned out—that 3,087 enterprises, employing about 2.3 million people, were operating at a loss.

It was absolutely clear that many policies, practices, and attitudes would have to change before Soviet enterprises could function in a market economy. Still, some progress had been made, at least on paper; otherwise our group would not have made this visit. Gorbachev recognized that the country could not maintain its status as a superpower without fundamental shifts in the planning system. The centerpiece of his reform was the Law on the State Enterprise, which took effect at the beginning of 1988 as part of the new five-year plan. The idea was that planners would concentrate on long-term strategy, leaving day-to-day decisions to enterprise managers. Following only broad guidelines from Moscow, the latter would draw up their own plans instead of having them imposed from above. Part of their output would fill so-called state orders that satisfied the country's most basic or strategic needs. For the rest, they would be free to negotiate their supplies and sales themselves through direct contracts with other factories and customers.

In Gorbachev's vision, the share of state orders would gradually decrease. However, increased responsibility would accompany increased freedom to maneuver and operate. Factories would have to cover their own costs and finance their own enterprises.

Several major changes were necessary to make the new system work. For one thing, free market pricing of raw materials, goods, and services had to replace state-set prices. Everyone knew the distortions inherent in the current government-decreed prices. Enterprises now purchased raw materials, such as coal and iron ore, for as little as 20 percent of Western prices, an arrangement that encouraged vast waste. The Soviet Union consumed more than twice as much energy per unit of gross domestic product than in the West, largely because enterprise managers had no incentive to conserve energy when their energy cost was only a fraction of its real cost on the world market.

In short (although it is difficult to be brief about a system so massively inefficient in so many ways), the immense waste and the seemingly incurable shortages of quality consumer goods were linked. More than that, the insufficient quantity and quality of products were an inevitable result of bizarre daily bureaucratic errors and careless work, common when there are no incentives to do well; the lazy and the diligent are paid exactly the same. But the deeper cause of the colossal economic madness was a political decision: the Communist Party's determination to maintain total power, total control. In my appointment with Boris Sergeevich Belousov, head of the Ministry of Defense Industry, I was about to encounter that very different world.

Enterprises subordinate to the Ministry produced an enormous array of products: microscopes, motorcycles, oil rigs, tractors, and even ships and power stations. As an investment manager who lives by the market, I was intrigued and impressed by the communist attempt, however unsuccessful, to replace the market's capacity to absorb the countless bits of disparate information that it considers in setting a price. I was eager to talk to a man who had tried to keep such an ambitious system on track.

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WITH THE SOVIET PENCHANT for acronym, the Ministry of Defense Industry was called *Minoboronprom*, "MinDefInd." It was housed in the generic Moscow office building, a boxy, concrete structure that surely looked old on the day that it was first occupied. Inside, no one seemed troubled by the scattering of burned-out lightbulbs. As we walked down ill-lit corridors, people with the unmistakable posture of having nothing to do but sit at their desks stared at us through their open office doors.

Our escort, Evgeny Vitkovsky, a deputy to Minister Belousov, had driven with us from the dacha in Lenin Hills. Our group included my friend and attorney, Paul Rugo, and my colleagues, Rich Gula and Jeff Braemer. Well over six feet tall, Vitkovsky, whose close-cropped, gray-flecked hair went well with his strong jaw line, carried himself much like the Soviet army general he used to be. With 10 minutes to spare before our appointment with his boss, he ushered us into his own office, whose desk was festooned with a rainbow of eight rotary telephones. I would soon learn that you could judge a Soviet official's importance by the number of phones on his desk, which conveyed prestige to Soviet visitors. However, they were a source of increasing embarrassment when the visitors were Westerners, since they were evidence that push-button and multiline telephones were not yet in use in the Soviet Union.

I must offer a few more words about telephones, which reveal a good deal about a country's condition and attitudes. Since glasnost, it was

With former general Evgeny Vitkovsky on the steps of the dacha.

perfectly legal to call abroad. However, exasperating delays highlighted the burden of the Soviet Union's long isolation: No more than 91 lines connected Moscow to the rest of the world. To be fair to the Soviets, East-West trade politics also contributed to the scarcity of international connections. Western and Japanese communications companies were forbidden, by an agreement between their own governments, to rent time on Soviet orbiters. Though these orbiters had plenty of excess capacity, the agreement was in place to promote their own use of Western- and Japanese-owned satellites. It seems we don't always practice the free market capitalism we preach. Only Soviet planners were to blame, though, for the 15 million Soviet citizens on waiting lists for telephones.

Our Russian hosts accompany Paul Rugo (second left), Rich Gula (second right, carrying a bag), and me (left) for a short walking tour in central Moscow.

Although this situation would improve, at the time the Soviet Union had no city phone directories, and only difficult, cumbersome directory assistance was available. High party members used an entirely separate system for their important communications with each other and had directories that listed all members. Vitkovsky showed us Gorbachev's entry, which included both his office and home numbers.

Vitkovsky's spacious office, typical of upper-level ministry offices we would see on this and later trips, was wood-paneled and attractively furnished. Leather-upholstered armchairs surrounded a large conference table that sat perpendicular to the end of his desk, forming a T. Two portraits, one of Lenin and the other of Gorbachev, hung on the wall. In Gorbachev's, which was taken when the president was much younger, the birthmark on his head had been airbrushed away. In conversation during this and subsequent visits, Soviet officials sometimes referred to him as "Gorby," a familiarity an American does not expect from members of such an inflexible hierarchy. This was a useful reminder to me that Soviet officials, despite how we once imagined them, can be regular people, too.

Strangely, we saw no portrait of Karl Marx in any office at all. No likeness of communism's philosophical founder graced a wall, and no one

We were mindful of the irony—Lenin, the revolutionary, often present at these meetings of capitalists.

mentioned his name, perhaps because Marxism seemed to be disappearing from the Soviet Union in late 1990 although the country was still governed by the Communists, Lenin's party. Though I never asked, I always assumed that all of the officials we met were party members. Since government and managerial appointments in state enterprises were, in fact, made by the party, which seemed to envelop the government, it seemed a safe assumption. At that time, the Communist Party had about 19 million members, roughly the same number of people estimated to have comprised Russia's ruling class when the Bolsheviks took power in 1917. In

A lighter moment with Evgeny Vitkovsky.

one way, although not in all ways, the Revolution exchanged one ruling class for another.

Membership in the party offered substantial privileges. In the old Soviet Union, one of those privileges was "access." Only a party card could open doors to "closed" stores that supplied special foods, imported medications, Western clothes and cosmetics, and modern appliances. Likewise, permission for foreign travel was granted only to a select few.

When our 10 minutes had passed, Vitkovsky led us down a long hall, through a large wooden door, and into an even more expansive office. He introduced us to his boss, Minister Boris Belousov, a large, square-faced man in his mid-50s who wore an ill-fitting dark suit. We shook hands all around. Belousov, who did not smile easily, was obviously used to giving orders, and we sat where he indicated: Americans on one side of the conference table, Russians on the other. The setting seemed more appropriate for arms negotiations than for a business meeting.

"Would you like to say something?" asked Belousov through an interpreter.

Thanking him and his colleagues for inviting us to their country, I said we had come to see for ourselves the economic transformation about which we had heard in Cambridge. We wondered what role, if any, we could play. Then it was Belousov's turn. Unlike the direct communication at Western-style business meetings, he read a prepared text about the problems of converting plants from military to civilian production. Maybe he had never attended a business meeting and seen its informality; perhaps he felt the formal approach was more appropriate; or he was uncomfortable in the presence of foreigners. In any case, we felt awkward.

Most of our first meetings with government officials and enterprise leaders were conducted with self-consciousness on the part of the bureaucrats. Within Soviet culture, the degree of formality was directly proportional to the official's rank in the government hierarchy. Surprisingly, Soviet businesspeople and industrialists were far more conscious of their ranks than people in equivalent positions in other countries tend to be. Our experience found bureaucrats, not businesspeople, most concerned with their status. Then I remembered that in the Soviet Union, under the Communist Party, an industrialist and a bureaucrat were one and the same. This explained why the cumbersome central planning system made itself felt on every level, from the man reattaching his windshield wipers to discussions taking place in the highest government offices. I did find the formality useful, however, in that it gave us an opportunity to assess each other before anything substantive was said.

With an interpreter translating, Belousov continued reading in Russian. Despite a possibility of "temporary economic instability" in his country, he predicted an annual growth of 34 percent in the consumer-goods business sector. With some bluster, he declared that Soviet production targets were consistently met, but we all knew better than that. Stressing that the Soviet Union needed Western investment to convert its military plants, the Minister conceded that the country was in dire need of hard currency. He concluded by saying that he hoped we would discover all we wanted to know about Soviet enterprises during our short visit and offered to do everything he could to assist us. He also warned that he did not think the country had much time. About this, he was right. A little more than a year later, at the end of December 1991, following an armed attempt to oust Gorbachev—a bumbling coup attempt that ended in arrest and suicide—the Union of Soviet Socialist Republics ceased to exist.

Belousov and other officials with whom I talked recognized a need for major change even though they had attained their powerful positions under the old system. If for no other reason, they were motivated by their profound embarrassment when they encountered Westerners. Their humiliation sometimes expressed itself in arrogance: a notion that we were somehow obliged to invest in the Soviet Union. Their dire need for relief made me feel that I could trust them. I thought that if we made a deal they would stick to it, whether or not we had a contract. Those men, I thought, and continue to think, would not forget people who had helped them when they were in so much need. My hunch was that early investors in the Soviet Union would have a special relationship, unattainable by those who would come later.

The naïveté I detected in Belousov that day, his lack of familiarity with how the capitalist game really works, appeared again that evening in fresher, purer form. In the dacha's dining room, Paul Rugo and I found ourselves explaining the rudiments of capitalism to members of the State Commission on Military Industrial Production. We explained, for example, how companies issue stock for sale on a public exchange. Our new

We roll up our sleeves for Economics 101 at the dacha.

students had a hard time grasping the difference between an equity investment and a loan. "I don't understand," said one Russian after another. "You mean that people would lend money to an enterprise by buying its shares and the enterprise wouldn't have to pay them interest?"

However, the members of the State Commission picked up the fundamentals of capitalist theory quickly, although how that theory would be enacted remained to be seen. Nothing in our first encounters suggested that the Soviet changeover would be easier than we had imagined. Indeed, there was a real question as to whether it was possible at all. The swift, deep currents of history in Russia are often the final arbiters of success and failure in any venture. Twice in this century—in the years before the Revolution and again during Lenin's New Economic Policy immediately following the civil war of 1918 to 1920—capitalism had flourished only to be curtailed, the first time by World War I and the second by Stalin. The current wave of unrest, characterized by political chaos and civil wars, could capsize the still fragile vessel of emergent Russian capitalism.

Of course, Russians themselves shared that anxiety, but over the centuries they learned to allay their misgivings in fatalism and humor. Jokes on every subject, from sex to central planning, were as plentiful as the work ethic was scarce. Nearly every Russian I met had a joke to tell, some

Meeting with key executives of the military complex, including Anatoly Kiselev (center) and, to his left (second from right), Evgeny Vitkovsky.

about shortages or even the KGB. One joke I heard combined both: A visitor to Moscow was going around asking the prices of various goods in different stores. Everywhere he went, the clerks told him, "We're out." As he left each store, the man wrote down in a notebook what that store was supposed to carry but did not. A KGB agent, suspecting Western espionage, approached the man and asked politely what he was doing.

"I've been coming here for 30 years," the man said, "and never before have I found prices so high and goods so scarce. No sugar, no meat, no soap, no socks, no razor blades, no salt, no butter, no nothing."

"Well, comrade," the KGB agent replied, "thirty years ago we would have shot you for being so curious."

"So," the visitor asked, "why don't you?"

The KGB agent shrugged. "No bullets."

This epoch was legendary for its lack of consumer goods and lines waiting for anything. Lightbulbs would be cycled forward from fixtures where visitors had been toward ones in their new destination. Soap would be put in washrooms just before visitors came and removed very quickly when they left. Food would be hoarded to put on a hospitable spread for guests.

One Russian declared that going from capitalism to a planned economy was simple, like making fish chowder. You catch some fish, chop them up, and cook them in broth. There's your chowder. Going from central planning to a free market was even simpler, he assured me. Just turn the chowder back to broth and bring the fish back to life.

CHAPTER FOUR

Swords into Plowshares, Inc.

I LIKED VLADIMIR KOBLOV from our first meeting at Harvard, when, as first deputy chairman of the State Commission overseeing millions of workers in the military sector, he led the Soviet delegation to the "Swords into Plowshares" conference. His request for my one-on-one meetings with his team showed admirable initiative, which he repeated by securing us the government invitation when he returned home. Having breakfast with us at the dacha was a third display of initiative.

Understanding gestures in your own country becomes instinctive. You know what it means when someone sees you to his or her own door, to the office door, or to the elevator. Although some gestures were similar in the Soviet Union, assessing them was more difficult. Still, Koblov's arrival for breakfast seemed a clear signal that he really wanted to talk, which would be done best first thing in the day. It was respect of the highest sort from close to the highest level: Koblov was number two at the gigantic State Commission on Military Industrial Production, which controlled the most sophisticated segments of the Soviet economy. In those early days, we never imagined how much significance was attached to our dacha or to what sinister and destructive use it could be put. But we did infer, from the stream of limousines coming and going, that some Soviets were intimidated by its location and importance. But not Koblov.

Koblov had a shock of white hair, a grandfather's benevolent portliness (although he was only in his early 60s), and a warm smile. Informal and informed, he was Belousov's opposite. Perhaps their difference in styles represented a not uncommon distinction between a chief executive officer and an executive vice president. Still, I had no illusions that a person could rise to such a position in so vital a field without being realistic, not to say tough. He reminded me of what Andrei Gromyko, the long-serving foreign minister, said when he nominated Gorbachev to lead the country: "This man has a nice smile, but he has iron teeth."

We feasted on meat, fish, cheese, bread, jam, juice, and coffee in the dacha's sun-filled dining room. While most of the population stood in line for bread, the Soviets provided lavish rations for foreign visitors. I wondered if and how Koblov would deal with such disparities, although I had no intention of bringing them up. This trip was theirs to orchestrate. I wanted to see what they wanted to show me, listen to what they wanted me to hear, learn what they wanted me to know. If they wanted us to take a closer look at specific enterprises, we would do so on a separate trip.

Koblov was frank. In 1987, as he reminded us, Soviet leaders, including of course Gorbachev himself, publicly acknowledged the Soviet economy's

With Vladimir Koblov, "godfather" of our project, in Moscow.

desperate condition. Growth rates were declining steeply, and the chronic shortage of consumer products was being felt acutely. Basic industries were using obsolete equipment to produce shoddy goods. Farm production was low and the distribution system woeful. To complicate the situation, Soviet managers and bureaucrats were resisting all attempts at reform.

The information age had dawned in the West, but Soviet goods were still being produced the old-fashioned way, with techniques pioneered in the heyday of mass production before the advent of the computer. Koblov declared that the old ways no longer worked in a world being transformed by the global economy and the technological revolution. The Soviet leadership tried to comprehend this reality, albeit belatedly. He said that in addition to Gorbachev a host of other politicians, scientists, economists, and even military leaders had begun to see that the Soviet Union was wobbling on its superpower pedestal. That was when, Koblov continued, the Soviet press first began using the term *konversiya*, "conversion," although then it was more of an idea than a plan. More than 30 percent of the workforce labored in the 5,000 enterprises producing military equipment under the control of Koblov's State Commission. Of the nearly 47,000 national enterprises, he said, those 5,000 were the best: the most modern and productive and best managed.

During the 1980s, military spending accounted for as much as 25 percent of the Soviets' annual gross domestic product (GDP), compared to 7 percent in the United States. As the arms race slowed, those industrial plants downshifted accordingly. Rather than see their best plants idled, the Gorbachev government endorsed the concept of transforming some military enterprises into ones that produced commercial and consumer goods. Conversion was taking four forms, said Koblov. In the first form, there was complete conversion, meaning military production would cease entirely. As of 1990, no plant had done this. The second form was conversion through diversification: Military enterprises would shift a limited percentage of production to civilian goods. A number of such projects were underway when we arrived, some of which made sense to us upon closer inspection. Many, however, seemed plain foolish.

Central planning dictated to defense plants exactly what they could make. We ran across dozens of military-industrial mismatches during our visits. For example, the Soviet Ministry of Aviation, which controlled a number of manufacturing facilities, was producing equipment for processing fruit, vegetables, sugar, and macaroni. The Ministry of Defense Industry controlled meat, poultry, and ice cream processing units, in addition to manufacturing metal containers. And, prior to reorganization and merger into other ministries, the Ministry of Machine Building, traditionally responsible for arms production, controlled the manufacture of equipment for baking, sugar refining, brewing, and butterfat production. In an earlier era, the Ministry of Medium Machine Building oversaw the Soviet nuclear weapons industry; later it churned out dairy products.

The country's premier producer of space rockets was making children's sleds. At that factory, I saw workers attaching runners made of titanium to the sleds. The plant, which still manufactured rockets, had titanium but no steel. Its choice was either to halt sled production until more steel arrived or make the runners from titanium; it opted for the latter because its costs of titanium and steel were the same. Military design engineers at one plant created a sausage machine. That was the good news. The bad was their failure to age the sausage, which came out a stomach-turning green. Other military engineers produced a household washing machine with 37 separate cycles, some 30 more than any consumer, given the choice, would ever use.

The central planners seemed to have made their assignments by throwing darts blindfolded. My view, which I emphatically advanced to government officials, was that military plants should manufacture civilian goods similar to the products they had been making previously. Examples could include aircraft, medical equipment, electronic gear, or high-precision machine tools. Arguing what I thought was obvious, I explained that those plants would then also have an advantage in the export market. That was the export-friendly strategy employed by the Japanese after World War II, and by the Chinese after the death of Mao Zedong. Like them, the Soviets might earn more of the hard foreign currency they badly needed to capitalize additional commercial plants.

The immediacy of the problems contributed to the government's failure to plan more carefully. By the late 1980s, the top priority was stocking retail shelves. That the average family was having trouble finding food, clothing, and personal hygiene products made it seem reasonable for defense plants to make toothpaste, even if they were better at building satellites. Westerners who feel smug about Soviet manufacturing blunders might do well to remember some whoppers of our own. After the Vietnam war, for example, Boeing-Vertol Inc., a subsidiary of The Boeing Company, which specialized in military electronics, tried to diversify by building a fleet of trolley cars for Boston. While it made excellent guidance systems, Boeing-Vertol built terrible trolleys. The cars proved chronically unreliable and cost more to repair than the antiques they were designed to replace. Not to be outdone, Grumman Corporation, one of America's defense giants, landed a huge contract to build buses for New York City. The vehicles had to be taken out of service when they began to snap in half, as did Big Apple tempers.

In contrast to public transportation in many Western cities, we would find a model metro system in Moscow—clean and well run.

Waiting on the metro platform with Dr. William Wirth.

Many U.S. companies didn't even attempt to convert, and, as a result, programs like the Sea Wolf nuclear submarine exist for no purpose other than to provide employment. I believed that the Soviets, attempting more with fewer resources, deserved our sympathy and support. In retrospect, their goal of shifting 60 percent of defense production to the production of civilian goods by 1993 was not as ambitious as it had initially appeared. When we first visited the U.S.S.R., defense plants already produced an impressive variety of consumer goods, including all of the country's televisions, radios, videocassette recorders, cameras, and sewing machines. Ninety-eight percent of Soviet tape recorders and most of its vacuum cleaners, washing machines, motorcycles, and scooters also came from converted defense facilities, as did nearly half of the bicycles and a quarter of the wristwatches.

The third Soviet form of conversion, Koblov explained, was known as absorption: transferring responsibility for entire civilian industrial sectors to Soviet defense ministries. Although absorption, which reverses the normal flow from military to civilian, might be interpreted as the opposite of conversion, it can be particularly effective in bringing poorly managed enterprises under the superior experience and expertise of military-industrial managers. In 1988, for example, the Ministry of Machine

Defense conversion had already begun at some of the enterprises—swords into plowshares ... and bicycles ...

. . . and radios and other consumer products.

Being an enthusiast, I was intrigued by this motorcycle produced at one defense plant; less so by the neighboring baby stroller.

Building for the Light and Food Industries was dissolved. Many of its 110 design bureaus—the Soviet equivalent of corporate engineering departments—and 220 factories and plants were absorbed into eight other ministries organized under the State Commission. Shortly thereafter, the defense ministries found that roughly 60 percent of their inherited equipment was worn out, useless, and fit only for spare parts. Ministry officials scrambled to bring the rest of the plants' equipment into a semblance of working order.

In 1990, the Ministry of Fisheries was similarly dissolved on short notice, and its plants and factories were also absorbed into the network of defense ministries. That particular ministry proved to be a living, breathing (if only barely) case study in Soviet waste and ineptitude. To cite just one example, the bureaucracy had built for 40 million rubles—about U.S. $40 million, before the hyperinflation the country would soon experience—a state-of-the-art oyster farm, but failed, forgot, or otherwise found reason not to construct a processing plant; the oysters' transportation from the farm facility was, likewise, not arranged. More than 100 tons of harvested oysters languished in open-air storage bins, where they eventually spoiled. In a similar case of bewilderingly poor planning, tons of salmon were buried or dumped in the woods of Sakhalin Island, off the coast of eastern Siberia, because the ministry's processing plants were located a great distance away on the mainland. Since the available cargo ships were insufficient, much of the catch rotted. Needless to say, placing these industries under quasi-military administration could not make matters worse.

A fourth conversion method didn't qualify as conversion at all, despite the government label saying that it did. An old-fashioned auction was held for selling existing military equipment to both domestic and foreign enterprises for civilian use only. In 1989, PepsiCo, Inc. reportedly paid $150,000 for each of 17 Soviet submarines. No, the corporation was not planning to sail this fleet through a sea of Pepsi-Cola in a stupendous promotional gimmick, or to launch it in battle against Coca-Cola. PepsiCo's idea was solely to salvage the subs' scrap metal and reprocess it in the form of aluminum cans.

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KOBLOV'S MISSION WAS TO MARKET the conversion concept to Westerners like me, who might help raise the necessary capital. We knew that conversion would be an extremely complex process for which new machinery had to be acquired, plants had to be redesigned—in some cases radically—and hundreds of thousands of Soviet workers needed to be retrained. All of this would require massive amounts of money. Koblov had to persuade potential providers of capital that Soviet conversion would work. A superficial political plan with little chance of succeeding in the marketplace would be worth neither our serious attention nor our money.

If slightly indirect and sometimes obscure, Koblov was quite sophisticated for someone with little experience in this area. After breakfast, he launched the second stage of his marketing strategy. With Evgeny Vitkovsky, one of his handpicked associates, our team set off in our motorcade, still a mixed fleet of Chaikas and Volgas with a KGB escort in a white BMW.

Beyond Moscow's outermost road circle, a ring highway of relatively recent construction, the capital is surrounded by fields and forests. In moments, you're deep in the old Russian countryside of ramshackle peasant villages. We were headed for Zagorsk, about an hour's drive to the northeast. The road out of Moscow was potholed and dusty until it abruptly turned into one that rivaled any U.S. interstate. "Oh, yes, it's quite nice from here to the border," explained one of the Soviets. "The roads we build start falling apart in six months. When we want something good, we bring in the Germans." Sure enough, the work crews beyond that point were German, and they were using German-built equipment, which raised doubts about the Soviets' capabilities in this manufacturing category, rather like seeing foreign-made tools in U.S. machine shops.

In Zagorsk, we drove not to a factory, but to the city's famous cluster of chapels, cathedrals, and monasteries. Our astonishment, which did not surprise Vitkovsky, was clearly part of Koblov's strategy, though we had no idea what he was aiming for. We forgot about business as we approached the white walls, over which towered dozens of cupolas, some pure gold, others blue with gold stars. Their beauty was almost unreal, and the cathedral interiors, aglow with hundreds of candles lighting hundreds of icons, were even more striking. People of all ages had come to pray and drink from the springs of Zagorsk's well of holy water.

An old Russian chronicle has it that in 988 A.D. Grand Prince Vladimir of Kiev, the ruler of Russia, decided that he and his people should give up their pagan gods, the greatest of whom was Perun, god of thunder. So Vladimir sent emissaries to the Middle East to study the world's three great religions: Judaism, Islam, and Christianity. Islam appealed to the prince until he discovered that the Koran prohibits the consumption of alcohol. Abandoning their pagan gods was one thing, but Vladimir knew that his people were unlikely to give up drink. He even wrote a couplet on the topic: "The Russian cannot bear to think / Of life devoid of all strong drink." Vladimir opted for Christianity over

The monastery of Trinity-St. Sergius at Zagorsk, about one hour's drive from Moscow.

Judaism, supposedly because of Greek Orthodoxy's structures of great beauty, which I was seeing now for myself. But, as always, there was an economic reason; his natural trading partners, the Greeks of Byzantium, were Christians. Grand Prince Vladimir ordered "that the idols should be overthrown and that some should be cut to pieces and others burned with fire; . . . that the god Perun should be bound to a horse's tail and dragged . . . to the river." He appointed 12 men to beat the idols with sticks.

Thus Vladimir began a tradition that lives to this day: The images of the old gods must be destroyed when the image of a new god is raised up. The communists burned religious and symbolic icons. Stalin was originally buried within Lenin's tomb, but after Khrushchev denounced him his body was removed in the dead of night and buried outside the tomb, though right beside it. And in our day, we have seen crowds watch the toppling of statues of Lenin.

Why had Koblov delivered us there while cathedral services were being held? I guessed he had several reasons. The Soviets understood Americans to be a religious people. Perhaps they were trying to communicate that the importance of religion was a value we all shared. Seventy

The monastery at Zagorsk, with its complex of buildings, is an important center of pilgrimage in Russia.

years of communist ideology did not eradicate the church as the embodiment of enduring religious faith, or as a repository for Russian art, music, and architecture. Koblov was making the point that in the new Soviet Union religion could flourish once more.

Yet the experience itself, combined with remarks by Vitkovsky, made it clear that they were sending a larger message also. More than anything else, potential investors in Russia feared turmoil. And this was a demonstration of Russia's continuity, the great enduring forces that have outlasted all political convulsions and tyrannies. I heard the unspoken argument that was something like this: The church that was sorely op-

Religious services are, once again, held in almost all of the churches at Zagorsk. Religion is an enduring part of Russian culture.

pressed for more than 70 years has come back to life. Despite the spoiling effects of communism, this will also be true of Russian workers and managers whose appreciation of the value of enterprise and hard work will be rejuvenated. Religion has regenerated; so will capitalism.

It was an important point, and nicely made. My subsequent experience confirmed that Koblov was right about Russia's essential continuity. I felt this as we passed through every Russian village. It was present at the Bolshoi Theater, where the last tsar watched ballets and operas, and in the ironic jokes Russians love to tell, a habit acquired long before 1917. Still, it is one thing to retain religious convictions and a sense of humor, while it is quite another to assume that Soviet managers and workers have retained even a slight working knowledge of conducting business in a capitalist system after more than seven decades of communism. Yet Gorbachev had only to crack open the door to limited free enterprise for the trading instincts of many Soviet citizens to emerge full-blown.

Psychologists, anthropologists, and political scientists will long debate how the trading instinct survived the prolonged period of sometimes savage suppression. In his book *More Like Us* (Houghton Mifflin, 1989), journalist James Fallows offered what seems to me a reasonable working explanation. In the long run, wrote Fallows, a society's strength depends on ordinary people's voluntary behavior.

> Ordinary people matter because there are so many of them. Voluntary behavior matters because it is too hard to supervise everyone all the time. . . . [C]ertain brute-force accomplishments are possible under centrally controlled, involuntary systems. But societies are more likely to be successful over the years, more likely to satisfy their people's physical and spiritual needs, if they can entice rather than force people to act in useful ways.

There was no shortage of commercial instinct on Moscow's Arbat Street. (While prices were stated in rubles, the market-savvy vendors often asked to be paid in dollars.)

In a bow to the more relaxed political atmosphere of the early 1990s, even the traditional *matryoshka* (nesting) dolls sold on Arbat Street reflected the times—we now saw "Gorby" dolls and, later, coup dolls.

This suggests to me that capitalism, broadly defined, is the condition to which people naturally revert when freed from the constraints of an imposed ideology.

But Fallows' idea was aimed toward the long term. What interested us right then was to locate possible investment targets among the existing high-tech enterprises that were converting to civilian production. From the monastery at Zagorsk, our convoy made a short trip to a plant that manufactured reinforced plastic items: casings for water desalinization filters, springs, and satellite radio dishes. We were not given a tour but were shown some of the plant's products. They looked good, and the articulate general manager, an engineer, was well informed about them. However, he was notably uninformed regarding various circumstances that would arise if his plant sought foreign investors or tried to compete in world markets. He was unable to answer questions about his manufacturing costs, the real price of raw materials, energy, or labor. Furthermore, he did not know how the plant's products compared in price or reliability to others already on the market. His ignorance of all but the production aspects of his business surprised me, but more visits to more enterprises would show me that he was not unusual in this respect, and why he was not.

The plant manager did, however, know how to do lunch. Three women served an elegant four-course meal at a long wooden table flanked by benches. The conversation, lubricated by ample amounts of vodka, was easy. Ordinarily, the plant manager confessed, it would be illegal to serve vodka at lunch in Soviet workplaces because of problems with alcoholism. “But this a special occasion,” he announced. Not too special, I soon concluded, for vodka would be poured at nearly every meeting and meal. Lasting more than two and a half hours, “Russian lunches have a way of turning into dinners,” one of our hosts explained. In many ways, that day set a pattern for the rest of the trip, which took us to Leningrad and to Kiev, capital of Soviet Ukraine. At nearly every stop, we encountered a similar mix of national pride and salesmanship, competence and ignorance. There was no shortage of business instincts among Russians, Ukrainians, and other Soviets. What they lacked, often sorely, was a command of technique, practiced skills, and knowledge of modern business methods.

All our visits to factories and plants were brief. First impressions had to count because they were all we had. Some locations were revoltingly filthy, others admirably hygienic. Staff at some plants tried to be efficient, but most had no idea of the kind of efficiency that competing internationally would demand. For example, at a semiconductor plant named Almaz, managers bragged about their products’ reliability, but the factory’s test facility, located miles away, fell far short of Western standards. When a component failed the quality test, the examiners tossed it into the rubbish. No procedures were in place for feeding test results back to the factory so that managers there could correct or improve faulty processes. In spite of this, I saw that frequently the workers had a high degree of technological expertise and a passion for learning.

I met the officials and saw a smattering of the goods. Now it was time to decide whether to form a team to investigate selected enterprises in greater detail, or to say thank you and *dosvidanya*.

At the Harvard conference four weeks earlier, I had roughed out a proposal for attracting Western capital to the Soviet Union. My idea was to create a fund, sponsored jointly by the Soviet government and Batterymarch, and sell shares to American, Japanese, and European corporations and pension funds. We would use the money to buy equity stakes in up to 20 Soviet enterprises that showed promise for competing in world markets. We might also offer corporate investors the opportunity to form strategic partnerships with those enterprises. My principal goal, so far, had been to see if those ideas had any merit. The Soviets were savvy enough to know, and candid enough to admit, that most of their enterprises with a chance of success in international markets were in military production. (Soviet oil producers were among the exceptions.) Since World War II, the military industries had been favored with first priorities in supplies, services, and talent.

Gorbachev had a grand scheme that implicitly underlay the idea that military plants be the first to receive Western investment. Although I had neither read nor even heard it discussed as policy, every Soviet assumption about Western business involvement rested on that scheme. Its logic went something like this: If the United States spends more than $250 billion a year to protect itself from a Soviet threat that no longer exists, it should make available a portion of those saved defense dollars for investment in Soviet enterprises. Gorbachev didn't understand that U.S. defense spending, despite all of its patriotic rhetoric, was as responsive to domestic employment needs as to security concerns. In any case, I knew that I had to sell my investment plan in the West, as well as in the East, and on several levels. Agreement with the Soviets would mean nothing without convincing foreign investors, who had to feel their capital was relatively safe and that they would receive a return commensurate with the risk. Many people asked me why anyone would invest when Gorbachev's power base looked so shaky and no one could predict who or what might follow him. But I believed there were good reasons to defy conventional wisdom.

I listed the reasons on a legal pad. If the West did not invest, the Soviet economy would stagnate, maybe even collapse. Either way, everyone would suffer, perhaps disastrously, since economic collapse is often an invitation to despotism, as in post–World War I Germany. If the West did nothing, we could hardly wring our hands later if political tyranny were reborn in the Soviet Union.

Second, creating a healthy, growing Soviet economy would open new markets for Western enterprises, which were needy in their own way. In that sense, helping the Soviets meant helping ourselves, which is the kind of altruism that appeals to any capitalist. Clearly, the catch was that we could not export much to the Soviets until they could export to us. Therefore, the faster they produced goods for their own markets, the faster workers and companies would accumulate the cash and credit to buy from us.

Third, a Soviet Union with an operative market economy could become a reliable, stable source of crude oil for Europe, the United States, and Japan. Already the world's largest oil producer, the U.S.S.R. was pumping nearly 20 percent of the world's petroleum, more than double the amount coming from oil-rich Saudi Arabia. With Western capital and technology, the Soviet petroleum industry was likely to become even more productive, which, again, could only be to the advantage of Western trading partners.

Fourth, the smoother the transition from communism to capitalism, the smaller the risk of nuclear weapons falling into the wrong hands. And the risk of terrorists targeting any of the 50 Soviet civilian nuclear power plants was also greatly diminished. Reducing that risk would, in turn, allow Western allies to cut their own weapons production. U.S. and European taxpayers justifiably wanted a peace dividend, and this was one way to give it to them.

My fifth reason was moral. For 70 years, Westerners have been trying to persuade Soviets that our system was superior. We told them that it worked better, did more for the average citizen, and raised the standard of living for all. Now that the Soviets seemed to agree and accepted that Marxism had failed, did we not have a responsibility to help them establish a workable alternative? I believed we did.

I closed my eyes and pondered the situation. Then I looked again at my list and was immediately struck by its major shortcoming. Each of my reasons offered a good argument as to why U.S., European, and Japanese governments should encourage investment in the Soviet Union. None, however, addressed the individual investor's needs and concerns. What kind of fund would investors prefer—one that, like a conventional mutual fund, bought shares in a portfolio of companies, then waited for the share value to rise, or a more active fund for direct investment that would include provisions for involvement at the board and, possibly, management levels, allowing investors a hand in making strategic decisions themselves? Could we combine the two?

Those questions were premature until a simpler one had been posed and resolved: Had we seen enough real promise to merit creating a team that would take a closer look? I believed we had. Swords *could* be beaten into plowshares, and at a profit.

Paul Rugo, my friend and attorney who accompanied our delegation on this first trip, helped me compose a letter of intent to establish and develop the Soviet Companies Fund, an equity fund of up to $1 billion that would provide investment in Soviet joint stock companies. Under the terms of our letter, Batterymarch and the State Commission on Military Industrial Production agreed to work to attract "investments of industrial enterprises from different countries to be invested in the reallocated Soviet defense production industry" (in particular, in the areas

Flanking our translator, Paul Rugo and I negotiate the terms of the letter of intent with Vladimir Koblov.

After working out the details, we are committed; we sign the letter of intent. Now the real work would begin.

of high technology, space technology, and so on). The Soviet side would compose a list of a hundred military enterprises that could be fully or partially privatized to compete in the world market. Batterymarch would subject those enterprises to close scrutiny while simultaneously working to create a fund for subsidizing their conversion and privatization. The Soviets would pay our expenses in their country. They would supply us with a dacha, drivers, and vehicles, and make all the necessary logistical arrangements.

All Russians and Americans involved attended our final grand evening in the dacha. Koblov presided for his side, I for ours. We sealed the deal with signatures, a handshake, and the clink of glasses icy with vodka.

CHAPTER FIVE

The Right Stuff

TWO MONTHS AFTER THE TOASTS, I was back in Moscow, ready to take a large step toward a more serious commitment of interest and capital. In accordance with the agreement between Batterymarch and the State Commission, we now had an office near Red Square, as well as transportation and a regular liaison. We were to provide the office staff of eight, pay all legal expenses, and cover transportation of all potential investors: in short, everything requiring hard currency. This made sense. If the Soviets had enough foreign currency, they would not have needed us in the first place.

One of my more obvious hunches was proven correct. The 5,000-odd enterprises controlled by the State Commission were, indeed, the cream of the Soviet crop. The next task was to work with the Soviets to select the top 100 of the 5,000; we wanted the best overall, as well as the best for our purposes. To that end, we visited the Minister of General Engineering, Oleg Shishkin. His office was in yet another drab concrete building, as gloomy inside as out; but important work was done there. Shishkin's ministry was the overseer of space-related enterprises, such as the Khrunichev Proton rocket factory near Moscow and the Baikonur launch facility in Kazakhstan.

This time we tried to arrange the seating to avoid the confrontational

Batterymarch's office at Merzlyakovsky Pereulok No. 8, across the street from the USA–Canada Institute, a well-regarded think tank that some said had KGB roots.

With a laptop and modem—if somewhat iffy phone lines—Jeff Braemer was our first American analyst on-site. (Thank you, Jeff.)

At the Baikonur Cosmodrome, I was honored to see the Soviet space program firsthand. Before the launch of the Soyuz TM-11 mission to the Mir space station, we were "up close and personal" with the cosmonauts.

feeling that occurred when we sat on opposite sides of the table. But Soviet protocol again prevailed. Politely, yet firmly, Shishkin insisted that we sit on our side and they on theirs. His monologue assured us that as many as 15 of the enterprises under his ministry's control were operating on the cutting edge of their industries' technologies, and he felt that their products would fare well in the international marketplace once their managers learned the fundamentals of trading. With cheering confidence, he said we could go straight from his office to one of the leading space-industry plants and see its excellence for ourselves.

For decades, the U.S.S.R. had spent whatever amount the Communist Party commanded for defense; the consumer side of the economy received what was left over. The importance and high-tech nature of defense industries, on which were lavished the majority of resources, elevated the social status of scientists working in the field. They were honored and privileged. Their welfare was a matter of state concern. For example, those assigned to the H-bomb crash program traveled to the distant laboratories and test sites by train, since they were considered too precious to risk air travel.

The highest Soviet honorary society is the Academy of Science, an organization with significant clout whose past members include many brilliant scientists. The current 1,250 members, among the highest-paid Soviet citizens, were known by the prestigious title of "academician." Their rewards, less in rubles than in status and perquisites, included country dachas, relatively fine apartments, the use of cars and drivers, foreign travel, and, until recently, shopping in special stores. Sometimes academicians invented a product or process that precipitated an enterprise's creation. Since many then headed these enterprises, which were likely possibilities for Western investment, we were about to meet several of those very privileged people.

The criteria I planned to use for investment analysis were similar to those I use in any other emerging industrial country—Brazil, India, or China, for example. In the Soviet Union, however, I would be looking first for what I call diamonds in the mud: enterprises with unexpected competence in a high-tech area. I wanted to identify technology-based products that would have immediate appeal to Western buyers. Any potential investment target needed the capacity to generate hard currency quickly; first it had to continue to acquire the necessary equipment for modernizing its production, and then it had to pay off its Western investors in something besides rubles.

As always in such exploration, I had to rely on intangible signs for gauging management competence; I call this evaluative process "face investing." Did the managers seem resourceful in obtaining raw materials? Did they have a global viewpoint? Face investing would have to play an even greater role in the Soviet Union than in China. Before opening themselves up to Western investment, the Chinese spent 10 years calculating how to conduct business and deal with foreigners. The Soviets, by contrast, were coming under investor scrutiny without time even to study capitalist business procedures, much less practice any.

Half an hour after leaving the Ministry of General Engineering, our cars delivered us to Khrunichev, the country's principal manufacturer of launch rockets. If the generic Soviet ministry building is concrete, squat, and ugly, the generic Soviet manufacturing plant is huge, sprawling, and surrounded by thick walls topped with barbed wire. Khrunichev fit that description. After our visit, it would become a regular stop for Western officials and businesspeople, but we were among the first foreigners to tour the plant in its current incarnation. Built for automobile manufacture in 1916, a year before the Revolution, it switched to airplanes in the 1920s, and produced some of the best-known Soviet aircraft over the next four decades: the Tu-2 and Il-4 fighters of the 1940s, the 3M and M-4

The best testimony I can give to my impressions is that, if I had a chance to ride into space, I would want to do it in a Soviet launch.

high-speed strategic bombers of the 1950s, and the Mi-6 helicopter of the early 1960s. In 1961, the enterprise was renamed for Mikhail Khrunichev, a Minister of Aviation. In 1962 it shifted to rocket production. I was particularly eager to visit here because I was an analyst of aerospace stocks before founding Batterymarch. My interest in the industry and in rocket and satellite technology remained keen.

Our greeting, which combined elements of a military parade and a chamber of commerce presentation, was typical. Four men in business suits stood at near attention when we pulled up to Khrunichev's single-story office headquarters. One was the managing director, Anatoly Kiselev, whom I would later consider a friend. Kiselev is an intense, heavyset man with a round face and thick, dark hair. After shaking hands with our hosts, my colleagues and I made our way down the line to exchange greetings with the others.

Kiselev then led us into a very large conference room and gestured for us to sit around its wooden table, indicating that Russians and Americans should face one another from opposite sides. After the pleasantries, I pointed to a long row of photographs of Soviet rocket launches. “Please ask Director Kiselev to explain what is taking place in these,” I said to the interpreter. Actually, the photographs interested me less than our host’s candor.

Russians are notorious for a strutting display called *pokazukha*, a show for deceiving, impressing, or both. The most famous instance occurred in 1787, when Catherine the Great wanted to see how well her subjects were living in her newly won southern territories. She had placed those lands under the governorship of her former lover, Prince Grigory Potemkin. At every stop, Catherine was greeted by happy crowds of neatly dressed peasants standing outside well-kept houses. What she didn’t know was that only the facades of the houses had been freshly painted, and as soon as the royal coach had passed the fine clothing was

Anatoly Kiselev, managing director of Khrunichev, details the history of Soviet space launches.

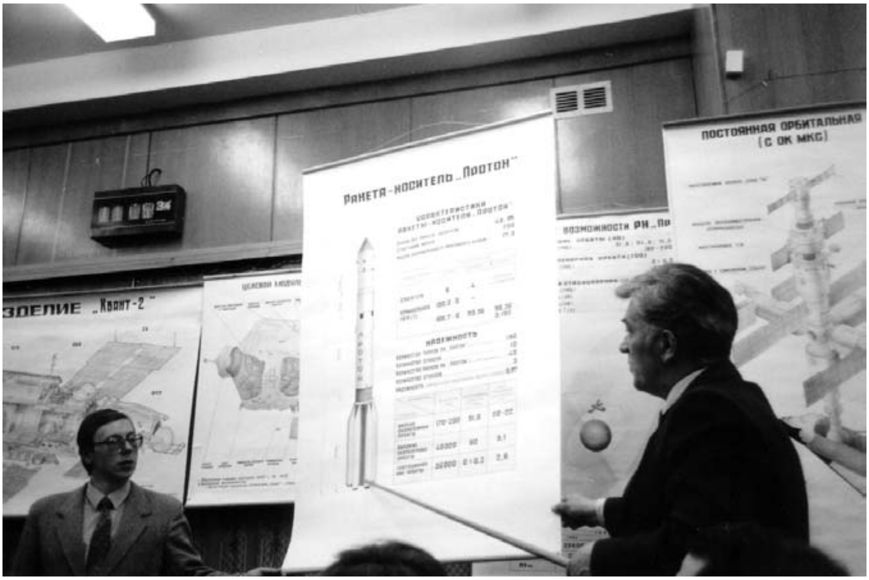
torn from the peasants and rushed by swift horse to the next village. Thus the expression "Potemkin village," a catchphrase for energetic, sometimes inventive deception, came into use. While I did not expect anything of that magnitude at Khrunichev, I did wonder if a show would be staged.

Kiselev seemed above that. Moving from one photograph to the next, he quietly explained the type of rocket launched, the launch date, and the rocket's capabilities. In 1957 (the year Ford Motor Company introduced the Edsel), the Soviet Union launched Sputnik, the first man-made satellite, which set off a 30-year superpower space race that put the Soviet and American governments directly into the aerospace technology business. Rocket development took different paths in the two countries. The Soviets favored larger and more powerful single-use rockets, or expendable launch vehicles (ELVs); the U.S. route led to the development of the reusable space shuttle. The Soviet launch rockets were big in part because the country lacked the miniaturizing technology that allowed Western firms to build lighter electronic components for their satellites. Khrunichev built a launch vehicle that was capable of hefting 24 tons into earth orbit, twice the lift capacity of the largest American rockets.

Khrunichev's first rocket, the type D Proton booster, was developed in 1961 as an intercontinental ballistic missile (ICBM) and designed to carry a 100-megaton nuclear warhead, which could destroy a large city. Later, the Soviets converted the type D Proton booster to a launch vehicle for unmanned lunar and planetary missions, as well as for manned spacecraft. When we visited, Khrunichev was building the D-1h, which would be used to launch all space station modules through the 1990s. These are the parts that lock together to form the space station. They would use the smaller D-1e to launch payloads into high earth orbit.

Kiselev thought the principal target of any plan for converting Khrunichev to civilian production should focus on the commercial space-launch business. He was correct; that was a huge and growing market. Estimates were that at least 119 satellites—81 for telecommunications, 20 for observation and weather, and 18 for scientific exploration—would be launched by private companies between 1991 and 1995. Launch costs typically ranged between $50 million and $100 million, depending largely on the weight of the satellites. The average was approximately $60 million.

Based on what we were seeing, it seemed that the Soviets would have advantages as a competitor in that market. The U.S. National Aeronautics and Space Administration (NASA) stopped launching commercial satellites after the 1986 *Challenger* accident that killed six astronauts and



A schematic of the Proton rocket at Khrunichev near Moscow.

Christa McAuliffe, the New Hampshire high school teacher. U.S. rocket makers, who thought that the shuttle fleet would fill most of the launch demand, had not developed affordable one-shot rockets. At that time, the largest competitor was the French consortium Arianespace, with 50 percent of the market. Arianespace charged about $60 million per launch, using a rocket that could lift a maximum of about five tons, the weight of an average commercial satellite. U.S. competitors included Martin Marietta, whose Titan rocket cost about $100 million per launch; McDonnell Douglas, which charged $65 million per launch for its Delta rocket; and General Dynamics, whose Atlas rocket cost $50 million per launch. (The Titan was most expensive because it was more powerful and could launch larger payloads than the others.) Although all three U.S. manufacturers professed interest in the market, they appeared content with their government contracts and did not actively pursue commercial opportunities.

The Soviets would face heavy competition from China, which had already entered the commercial launch business. In April 1990, its Long March rocket propelled into space AsiaSat I, a commercial satellite owned by Asia Satellite. China charged between $20 million and $30 million to lift a load, which is roughly what Kiselev indicated Khrunichev would charge. However, even if they were ready, the Soviets could not join the competition immediately, because the Coordinating Committee for Multilateral Export Controls (COCOM) forbade shipping satellites from signatory countries—Japan and all North Atlantic Treaty Organization (NATO) countries, except Iceland—to unfriendly nations, including the Soviet Union. The Soviets could not attract launch customers unless COCOM's restrictions were lifted. The largest pool of potential customers was also excluded by U.S. export controls that barred the shipment of American high-tech commercial satellites to the Soviet Union. (I felt strongly that American export controls should have been lifted. Free-market capitalists who deny their markets to others are hypocrites.)

COCOM was obstructing the Soviets on several commercial fronts. The Soviet Ministry of Communication, the American telephone company U S West, as well as French, German, Dutch, and Italian companies were jointly planning a fiber-optic communication line that would stretch 14,400 kilometers across Soviet territory, connecting Western Europe with Japan, Southeast Asia, Australia, Oceania, and the United States. COCOM prohibitions on some crucial components halted work on the project. Similar trouble stymied a $20 million joint venture of the Ministry of Communication and Alcatel, the French telecommunications giant, for a high-speed fiber-optic communications line across Siberia's Lake Baikal. But some progress had been made in lifting COCOM restrictions. In July 1990, the Paris-based organization permitted the export of personal computers with 80386 chips, personal computer network hardware, and some minicomputers and mainframes to the Soviet Union. This offered hope that the satellite prohibitions might be rescinded before it was too late for Khrunichev.

Having completed the preliminaries of our visit, we left the conference room and crossed the street to a huge building with a cement floor and a rounded metal roof: a rocket assembly facility, where several giant ELVs were under construction. The full Khrunichev plant consisted of about a dozen similar buildings, at least two of which, including the one we were in, were as long as several football fields. None was messy, but they were not as well painted and clean as one might expect of an aerospace factory. Signs in Russian on the interior walls—"Your Work Is Important for the Country!"—exhorted workers. Our hosts said we could wander at will through this once-supersecret installation and freely question anyone.

"May we take pictures?" I asked.

"Of course," Kiselev replied with a smile. "The CIA already has photographs of everything you see here."

We crawled beneath the rockets and filmed their production processes, testing the limits in every possible way. I was not disap-

Khrunichev's Proton rockets near Moscow. The Baikonur Cosmodrome in Kazakhstan includes six major launch complexes, one of which is the Proton launch complex. With its 30-year history of over 200 successful launches and a total program reliability rate greater than 96 percent, it is the only Russian site capable of launching the Proton rocket.

pointed. Since they decided to open their doors to Westerners, the Soviets were far less guarded with us than certain U.S. companies would be with Soviet visitors.

On the subject of intelligence-related matters, my work with the Soviets provoked unwanted inquiries from both sides. A businessman I knew in Cambridge, Massachusetts, telephoned me to say that "people in the building," a sobriquet for the Pentagon, "would consider it a favor if you could persuade the Soviets to reduce their production of army battle tanks and invest in plants that could be converted to civilian production." I said I wasn't in the business of making investments as favors for the "people in the building."

I also fended off Soviet requests. After Batterymarch had become engaged in the U.S.S.R., one of my assistants visited the New York offices of the Soviet Trade Council. He was handed a slip of paper with a name, "Nikolai," and a phone number. "Have Mr. LeBaron call him," a Soviet official said. I did call, and we arranged to meet at the Trade Council offices. Nikolai arrived wearing an expensive Italian suit. Through an interpreter, he told me that people "at the highest levels" of the Soviet government wanted to change the terms of the agreement we had just signed. Instead of all cash, Batterymarch was to provide a portion of its investment capital in the form of consumer goods. "You must understand," he said, "that the people you're dealing with now may not be in power in six months. The situation in our country is highly unstable. You Americans are so naive; you think that the Cold War is over, but our missiles are still pointed at your cities. If the central government doesn't hold, no one can guarantee that our colonels sitting beside silos all over the country won't fire those missiles. No one. Winter is almost here. We must have consumer goods. We need lots of things for our people. If we don't get them . . ."

The threat was no less clear for being left unspoken. I refused, however, explaining that I was a financial person, not a trader dealing in shampoo and such. From all accounts, it would have been unlikely that, if I had imported any consumer goods to the Soviet Union, they would have reached the public without most being stolen with official aid; then the goods would be sold on the black market at a huge profit. I never heard from Nikolai again. I assumed he worked for the KGB. In fact, I came to assume that almost anyone I dealt with on the Soviet side could work for, or with, the KGB. But I decided that it made no difference, since I was not colluding with them.

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THE KHRUNICHEV WORKERS WE SAW as we walked through several of the buildings wore clean white lab coats. That small sign was a good one, because people who care about their professional appearance usually care about the quality of their products. Another good sign was that Kiselev answered all of my questions with apparent candor. When I asked about the defect rate of his rockets, his answer astounded me: He said that 14 rockets were assembled for every one that was eventually used. "That is," he elaborated, "we make 14 rockets, test them, then shoot only one, because only one passes all our tests." That approach to quality control was common in Soviet plants making all sorts of products. "If we produce something in large enough numbers," the thinking went, "some are bound to come out right."

I asked about competition, less to hear his answer than to learn whether he had considered the issue. I took it as a sign of initiative when enterprise leaders were concerned about this. Kiselev focused not on the French, despite their leading position in the commercial launch business, but on the Japanese, who, he said through the translator, were out to "grab" technology wherever they could. Like many Soviets with whom we spoke, he was cautious about Japanese investment in his enterprise.

Considering the political history, the openly anti-Japanese bias I found in the Soviet Union did not surprise me. Early in the century, Russia's eastward expansion brought it into a collision with Japan. Tsar Nicholas thought he could solve the problem, and divert his restive population, with a "short, victorious" war. Short it was. Japan destroyed the Russian fleet in two major engagements, and Russians never forgot the severe humiliation of the Russo-Japanese War of 1904–1905. Likewise, the Japanese have not forgotten the northern Kurile Islands, seized by the Soviet Union in the final days of World War II and retained by the Soviets under agreement with the United States. This remains so heated an issue in Japan that Tokyo repeatedly insists that its improved relations with Russia, including economic and technological aid, are dependent upon negotiations on the islands' sovereignty.

Next, I tried to learn whether Kiselev was familiar with some common Western business practices. Did he know, for example, that Western companies typically purchase launch insurance to cover losses caused by rocket failure? Although aware of the practice, he hadn't considered two points on which seasoned Western businesspeople would have seized: Khrunichev would pay lower rates than its Western counterparts because the success rate of its launches was so high, and he could pass along the savings to his customers by dropping his prices.

Another cavernous cement structure displayed a model of the 20-person Mir space station, which was launched in 1986. (The Mir continued in orbit until March 2001, when Moscow brought it down. Most of Mir burned up on reentry, but five or six large chunks landed in deep water in the middle of the Pacific.) The name Mir, or "peace," was itself a bit of *pokazukha* for disguising the structure's partially military purpose. When we visited, the Soviets were still working on a shuttle fleet to supply the station, which they hoped to use as the major staging arena for missions to Mars and the moon. Batterymarch analysts had already determined that any investment potential in the Mir space station would depend on the market for materials manufactured in the microgravity and vacuum of space; that is, on the demand for perfect crystals, pure alloys, and certain pharmaceuticals. The Minnesota Mining and Manufacturing Corporation (3M) had already contracted with NASA to conduct a number of microgravity processing projects, but market demand remained questionable.

The Mir model, elevated above the floor by a platform, was the exact size of the space station itself, 43 feet long and 14 feet wide. We walked

At Khrunichev, a schematic of the Mir ("Peace") space station.

Full-size model of the Mir space station at Khrunichev. At the time of this picture, the Mir had been in orbit for about five years.

up a short flight of steps into the spacecraft. Each sleeping compartment had a folding chair, mirror, porthole, and sleeping bag. The bathroom, with its stainless-steel sink and toilet, was all the more impressive in light of the lavatories at most of the plants we visited, sometimes cell-like rooms with a hole in the floor. The Soviets were clearly more concerned about the care of their cosmonauts than the comfort of ordinary earth-bound citizens. Cosmonauts' complaints that they got on each other's nerves after long weeks of very close confinement led space engineers to design a closet-sized room to which Mir voyagers could retire to read, watch television, or simply have privacy. Many ordinary Soviet citizens, about a third of whom occupied communal apartments shared by several families, lacked that luxury.

If not for Khrunichev's ELVs and a space station that potentially made economic and competitive sense, we would not have considered the plant as a possible investment target, despite its advanced technology and small army of skilled engineers and workers. The Ministry, however, had a different idea. A large room in the next building displayed its idea of the conversion projects Khrunichev should be working on: camping equipment, folding bicycles, sleds, milk pumpers for cows, four sizes of saucepans (three, four, five, and six liters), and ski poles.

"Why are you making these things?" I asked Kiselev.

"The Ministry told us to," he replied with a shrug.

"But you're Khrunichev," I protested. "You build fantastic rockets. Someone out there will be interested in your product."

That, he said, was his hope, too. But his second shrug conveyed a strong sense of Soviet fatalism and Slavic rue.

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Driving to Machinostroyenia, our next stop, I pondered the likelihood that a serious brain drain would imperil Soviet conversion projects. What the United States is to lawyers, the Soviet Union is to scientists and engineers, of which it has more per capita than any other nation, and their skills, unlike those of many Soviet citizens, can be easily marketed internationally. In 1989, 50 members of the Academy of Sciences went abroad on long-term contracts. In 1990, some 250 academicians left: roughly one-fifth the membership. Since then, the number of scientists of all types emigrating or working abroad has sharply increased.

Machinostroyenia, a half hour's drive from Khrunichev, is a scientific research facility for space experimentation, something like a combination of Bell Laboratories, the Rand Corporation, and General

Dynamics. It is as good as any company in the West, or in the East, for that matter.

Its general manager, Gerbert A. Yefremov, was a tall, strong, healthy man in his late 50s. "Will we be allowed to videotape our tour?" I asked. "Certainly," Yefremov said, smiling. "If anything happens, they'll just arrest us both."

One product of the huge facility, which employs some 10,000 highly skilled engineers and scientists, was already in strong demand in the West. This was information collected by what Yefremov called Almaz (the diamond), an earth-sensing satellite. In 1972, NASA launched the first of a generation of earth-sensing satellites called Landsat 1. Like its successors, it surveyed the continents and adjacent coastal waters to gather data for a variety of practical purposes. Congress privatized Landsat in 1985, awarding it to the Earth Observation Satellite Company, based in Houston. Remote-sensing satellites have proven invaluable in weather and crop forecasting, oil and mineral exploration, mapping, and monitoring air and water pollution.

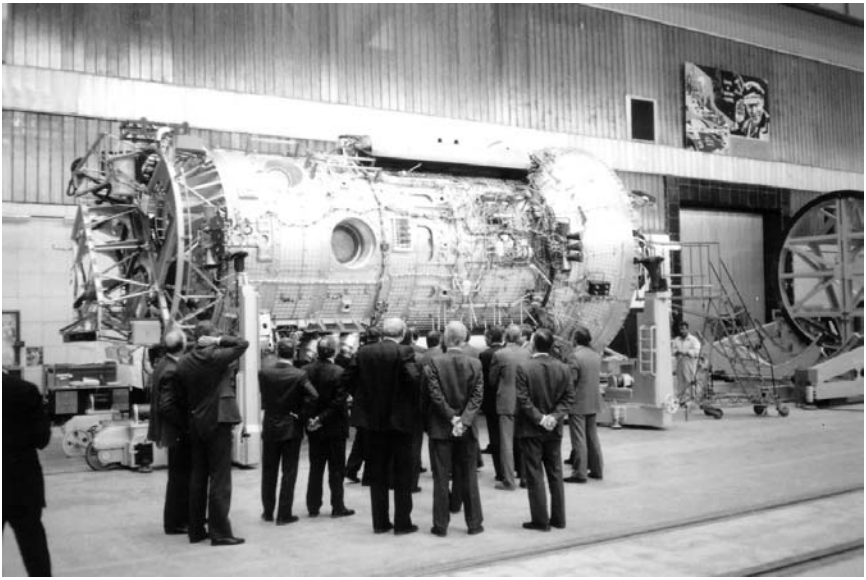
Yefremov boasted that the Almaz was competitive with, and in many ways superior to, its Western counterparts, since it was capable of higher

A technical discussion with Gerbert Yefremov, general manager of Machinostroyenia near Moscow.

Gerbert Yefremov describes some of the technical components at Machinostroyenia. (Notice, behind us, the hull of a boat.)

resolutions, recognizing surface features as small as 15 meters. It also gathered radiometric data by temperature; that is, maps of the earth are graded by temperature rather than, say, elevation. He said that Machinostroyenia had already formed a partnership with the Houston-based Space Commerce Corporation, and that selling Almaz data could generate as much as $125 million annually.

Only several years earlier, such a joint venture involving American and Soviet space-related firms would have been unthinkable. The Soviet space industry operated in total secrecy, and the Almaz satellite was then known as the supersecret Cosmos 1870. But a 1989 resolution of the



One of the satellites at Machinostroyenia.

Machinostroyenia's Almaz earth-sensing satellite.

Central Committee of the Communist Party and the Council of Ministers finally allowed glasnost to touch down on the Soviet space program.

The jovial Yefremov was an accomplished aerospace engineer, a Hero of Socialist Labor, a laureate of Lenin and other state prizes, and an academician. Also active in politics as a representative in the Russian Republic's Congress of People's Deputies, he proudly sported his deputy pin. Yefremov's only child, holder of the Soviet equivalent of a Ph.D. in economics, later told us: "You're the first capitalists I've ever met." The bright young woman recounted some of the difficulties in teaching economics in a country with socialist textbooks. Words like "manager" and "marketing" were nowhere to be found; concepts such as "supply" and "demand" went unexplained. From a well-known Soviet reference book, *The Dictionary of Foreign Words*, she translated the definition of "businessman"—"a capitalist, smart dealer, a fat cat intent on making profits out of everything, stopping short of nothing to fill his pockets."

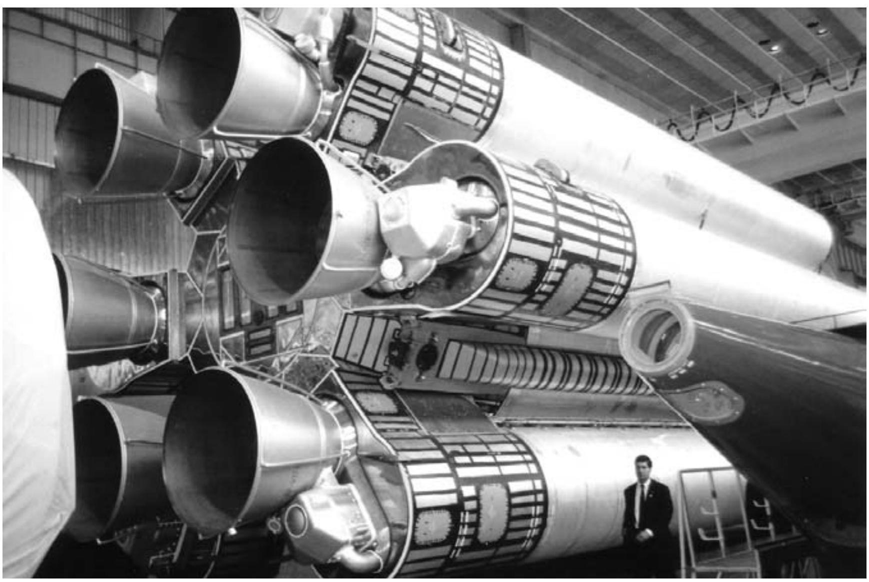
Yefremov was also proud of a young team of Machinostroyenia astroscientists who were competing in an international competition to put a satellite into orbit, "Columbus 1992," in honor of the 500th anniversary of Columbus' voyage to the New World. Eager for Batterymarch funding, the

We would experience a high degree of candor and openness as we toured the labs at Machinostroyenia.

young scientists had asked Yefremov for permission to make a presentation to us. He had agreed. In addition to formally arguing their case, young team members periodically appeared to brief us on their activities as we toured the plant. Although Yefremov found their often unexpected presence slightly annoying, I was impressed by their Western-style initiative.

Yefremov also exhibited results of other research, including devices for manufacturing pharmaceuticals in space, specialty space optics, and satellite agricultural maps of the organic content of soil. Judged by those and other products, Machinostroyenia could clearly be a world leader in the coming industrialization of space.

I was interested to see that Yefremov's enterprise was entirely self-contained, much like turn-of-the-century American mining and mill company towns. Reutuv, a little Machinostroyenia city for workers built on a 250-acre site near Moscow, had apartments, a health club, and a movie theater. We would soon see other enterprises that similarly tried to cater to all of their workers' needs. Under communism, many leading plants spent large sums on employee benefits, providing medical and health care, education, and leisure facilities. Some seemed almost Japanese in the amenities they afforded their workers: comfortably furnished



Products of a wide range of space research at Machinostroyenia were available for inspection.

relaxation rooms, nurseries and kindergartens, large reception halls for weddings and parties, and health clinics with special baths and massage rooms. Salaries were not high, though, averaging about 218 rubles a month, which was less than the amount paid to many assembly-line workers. (Two hundred rubles was worth about $8 in 1990—less than 4 percent of its international exchange value 10 years earlier—but such comparisons are not useful in conveying the actual standard of living, because of the different costs of living in the two countries. Also, the salary doesn't take into consideration the substantial free benefits given to Soviet workers.) Machinostroyenia workers put in 41 hours a week over five days and got three to six weeks' annual vacation, depending on their length of service.

Our visits to Khrunichev and Machinostroyenia prompted new thoughts regarding our criteria for selecting enterprises for possible investment by the Soviet Companies Fund. As we were driven back to our dacha late that afternoon, I decided we should add two more points. First, I wanted to see a close link between any new products and services and that same enterprise's past capabilities and achievements. Second, we should avoid any conversion project that promised to take an enterprise dominant in one industry into a new industry where it had no advantage. Moreover, I wanted to limit ourselves to enterprises that could win the commitment of a Western strategic partner. The Soviet need for Western management skills, marketing expertise, personnel, and equipment was clearer than ever. The Soviet Companies Fund would need investors who also wanted to function as partners with Soviet enterprises.

Beyond that, I was positively buoyant. The trips to Khrunichev and Machinostroyenia suggested that we would find plenty of Soviet enterprises suitable for the Fund. Fortunately, I didn't have the slightest idea of how a subsequent trip to Leningrad would bring us crashing back to earth, slamming us into "Soviet reality."

CHAPTER SIX

Russia's Wrong Stuff

THE KIROV WORKS IN LENINGRAD was not a candidate for the Soviet Companies Fund. Why, then, a member of our party wondered aloud to one of the officials accompanying us, was it included in our tour? "Kirov," the official replied, "is like the general you must invite to the wedding." In other words, the venerable plant was too big and important to be slighted. Besides, getting there was half the fun.

We took an early morning flight from Sheremetyevo 1, one of Moscow's four airports for domestic flights. Like our interstate highway system, the Soviet air transportation network was part of the country's defense infrastructure. Consequently, everything related to air travel inside the country—airplanes, airports, air traffic control (ATC), air safety—fell within the purview of the Ministry of Aviation, which reported to our sponsor, the State Commission on Military Industrial Production.

Primitive would be a good description of Soviet air traffic control. In the United States, ATC radar tracks every commercial flight aloft, anywhere in the country. In the U.S.S.R., radar tracked only the aircraft in the vicinity of its major airports. For the rest, air traffic controllers relied on pilots to radio their positions. Therefore, Soviet ATC was useless in avoiding collisions over much of the country. This was hardly a comforting thought.

However long the lines at Western airports, their computerized ticketing and baggage handling systems were a dream compared to the Soviet systems then in place. Tickets were usually written by hand. Travelers arriving at the airport in Kiev, the capital of Ukraine and the third largest Soviet city, retrieved their luggage from haphazard piles inside a small cinderblock building. Aeroflot's fleet of 16,000 aircraft, more planes than are owned by all U.S. airlines combined, was so huge because the airline transported cargo as well as people. In addition, it had to be large since Aeroflot planes spent much of their time broken down. Many were technological dinosaurs, requiring longer and more frequent maintenance than Western planes, and the Soviets had not learned how to keep spare parts in stock. French air carriers keep their American-made, long-haul Boeing 747s and DC-10s flying between 4,000 and 5,000 hours a year. Aeroflot's equivalent, the Il-62, averaged less than 2,000 hours.

Canceled flights were common, often because airports ran out of fuel. Fuel shortages occurred partly because Soviet aircraft burned enormous quantities—two to three times as much per flight hour for the Il-86, for example, than for the equivalent European-made Airbus. Soviet planes weighed more, partly because they needed stronger, heavier landing gear to cope with the country's badly maintained runways. Proper repair of potholes would have enabled a smaller number of lighter, more fuel-efficient planes to be flown, with fewer flight cancellations. But potholes couldn't explain all of Aeroflot's problems. On a later flight, I asked a Soviet official with whom I was traveling whether I could see the cockpit. We opened the door unannounced. One of the two pilots on duty was asleep in his seat, a bottle of beer in his hand. After that, it seemed almost superfluous to learn that not every seat on a Soviet airliner was equipped with a seat belt.

Soviet aircraft, it occurred to me as we approached Leningrad, could be retrofitted with fuel- and maintenance-efficient engines from Western manufacturers. Of course, that would require a lot of capital, which the Soviets did not have. Alternatively, I thought that strategic business alliances between Soviet and Western aircraft manufacturers could be valuable to the Soviets, while giving the Western firms entry into this potentially huge market. It might even be possible to fuse partnership agreements between Aeroflot and one or more Western air carriers, and—a triple-bump landing interrupted my thoughts.

We boarded a Hungarian-made Icarus bus and were driven 30 minutes along badly potholed roads to Leningrad, which is an hour's flight from Moscow but centuries away in its look and feel. Moscow is much older, dating to the eleventh century. Peter the Great started constructing Leningrad (once Petrograd, then Leningrad, and now again

The Bronze Horseman . . . Tsar Peter the Great.

Originally named after Tsar Peter's patron saint, the city's name was changed to Petrograd; later to Leningrad; then, in late 1991, back to St. Petersburg.

named St. Petersburg) in 1703. Whereas the Soviets had "modernized" Moscow, filling the capital with blocks of uninspiring concrete buildings in the postwar utilitarian style, central Leningrad had been left delightfully frothy, although in some disrepair.

The Winter Palace, built 250 years ago, is still painted the blue-green of crushed avocado. The Admiralty Building, under its slim spire, is a sharp lemon yellow. Like Venice, Stockholm, and Amsterdam, Leningrad is veined by canals, hundreds of miles of them. Four hundred bridges link the islands that comprise a good portion of the city. The enchanted effect was dimmed only by abundant smog from the emissions of nearby industrial plants, such as Leninetz, Russia's General Electric.

The Kirov Works (Kirovsky Zavod) was named after Sergei Kirov, the Leningrad Communist Party boss, who was assassinated in 1934. If Joseph Stalin did not actually order that murder, he used it as the pretext for initiating the Great Terror of the 1930s. Either to conceal his purges or because it suited his malevolent sense of humor, Stalin also ordered that a number of important institutions be renamed in honor of Kirov, including the theater that was home to the world-famous Kirov opera and ballet.

The Winter Palace, Tsar Peter's residence at Dvortsovaya Ploshchad—Palace Square.

Emissions notwithstanding, with executives from Leninetz we explore the formation of a joint stock company to design and produce absorption refrigerators for sale in the U.S.S.R. and abroad.

With Anatoly Turchak, general director of Leninetz, the second largest enterprise in Leningrad.

Of the more than 100 proposals reviewed, Leninetz's was one of the more promising. In early 1991, we formalized our intent.

The best-known product of the Kirov plant was World War II's T-34 tank, roughly equivalent to the U.S. Army's Sherman. The tank's designer, M. I. Koshkin, kept the machine elegantly simple. His goal was to create a combat vehicle that was inexpensive to manufacture, simple to operate, easy to repair, and effective in battle, and he succeeded. A product of applied common sense rather than inspirational genius, it was crudely constructed with rough castings that were precision machined only where absolutely necessary. Its crew was cramped and uncomfortable. Still, the T-34 consistently outperformed the more sophisticated German Mark III in battle, often because it could negotiate mud and snow, which immobilized the German machines. In the Battle of the Kursk Bulge in the summer of 1943, 3,000 Nazi tanks clashed with the same number of T-34s. The result was the destruction of much of Hitler's war machine. Perhaps national pride, in this case justified, also played a role in our command visit to the Kirov Works. Intensely proud of their contribution in World War II, Russians considered themselves the true victors in the European theater, and with good reason, since they turned the tide almost a year before the Allied landing at Normandy. Tens of millions of Soviet people were killed during that war compared to 500,000 U.S. deaths in both the European and Pacific theaters.

The Kirov Works was a unit of Kirov Production Amalgamation, the Soviet version of a conglomerate, a single enterprise that controlled a variety of smaller enterprises from its central headquarters in Leningrad. (In 1990, amalgamations accounted for about 55 percent of Soviet industrial output.) The Kirov Amalgamation had also formed strategic partnerships, called associations, with several other enterprises, among them KamAZ, a diesel engine manufacturer and truck maker near Leningrad, and the Karl Leibknecht Mechanical Plant, a nearby gear maker.

Currently, the Kirov Works assembled more tractors than tanks. Even by Soviet standards, the Works were immense. Some 60,000 people worked in the 12-building complex, which was guarded by high stone walls topped with an iron railing. This reflected a general condition: Soviet enterprises now employed an average of 830 people per factory compared to 64 on the average U.S. payroll. Moreover, the American number was declining and the Soviet number was growing, at least in 1990. Total employment in Soviet manufacturing industries in 1990 was about 35 million, or a little more than a quarter of the labor force, substantially more than the 12 percent of the U.S. workforce similarly engaged.

This disparity was significant. Soviet enterprises typically employed more workers to produce the same amount of goods as their counterparts in other industrialized nations. A 1990 survey by the World Bank showed that manufacturing plants built in the U.S.S.R. by Western corporations employed 50 to 150 percent more workers than comparable facilities in the West. A 1989 study by the Soviet government revealed that enterprise managers usually hired two workers for every one they needed. Overstaffing was among the biggest problems facing Soviet managers, and one of the primary reasons for poor productivity—only reaching about 40 percent of U.S. levels—in most industries.

Overstaffing did, however, serve several purposes, including providing jobs. Since 1936, the Soviet Constitution guaranteed every Soviet citizen work in accordance with his or her education, vocational training, and capabilities, although not every worker had a job, despite Soviet propaganda. Full employment was a primary party goal; for this reason, among others, Soviet enterprises tended to have more personnel, including managers and professionals, than they needed. People were rarely laid off or fired, and it was *very* rare that someone was dismissed for inefficiency.

Overstaffing also enabled managers to compensate for miscalculations in production scheduling and for employees' chronic tardiness and absenteeism. Uncounted thousands of workers were late and absent because they were "shopping," which meant chasing scarce products around the city and standing in long lines to get them. Many joined lines without knowing what was being sold. Whatever it was, it would come in handy later, or it could be swapped for something else. Not surprisingly, this frantic pursuit of basic items often left employees exhausted and ill-tempered. Millions of work hours were lost. During past labor shortages, many managers competed for workers by offering them shorter work schedules with no pay reduction to accommodate their need for queue time.

Tardiness and absenteeism had not always been so bad. Riding a bus shortly after we opened our Moscow office, a Batterymarch analyst overheard the following conversation, which his interpreter translated for him: "Look at him," one old woman said to another, pointing to a young man. "It's 10 o'clock, and he's late for work. In Stalin's day, they shot people for being late. The government ought to do that again. Then you'd see people get to work on time." In fact, the government was considering dismissal as a cure for tardiness and chronic absenteeism. This would be especially effective if managers had the autonomy to hire and fire on the basis of their labor needs and the competence of their employees.

Well aware that overstaffing had long reduced their productivity, Russians were attempting to cut the swollen ranks of workers, but with little success. The 1987 Law on State Enterprise required enterprises to adopt wage policies that linked pay with productivity and that ultimately would slash their workforces. Four years later, only some 3.3 million workers, a small fraction of the swollen workforce, had been laid off, and a third of that number found new jobs in the same enterprises. To be fair, some Soviet managers hesitated to fire workers because there was no unemployment insurance (which was enacted into law well after our first visit). Workers were given up to three months' separation pay, during which time they were expected to look for another job and register with one of the 2,000 labor offices that concentrated on finding personnel for state-owned enterprises.

Everyone knew that the transition to a free market economy would put millions of Russians out of work. Government planners had estimated that a slow transition, 8 to 10 years, would displace approximately 4.5 million workers, and that a speedy two-year transition would nearly triple that figure, raising it to 11.6 million, about 8 percent of the labor force. If the experiences of Poland and other Eastern European countries that chose rapid transitions are a guide, even the latter figure is low. By late 1990, some experts had drastically revised their estimates to 30 percent, or 45 million people.

Overstaffing, however, was only one of Kirov's problems, but the problems could all be traced back to the structure endemic to Soviet enterprises. The director, Pyotr Semenenko, did not resemble the soft-spoken scientists and engineers we had met previously in either his appearance or his manner. Semenenko, a tank and tractor builder, was a big, burly man with thick, dark hair, dark eyes, and a booming voice, who had worked his way up from the assembly line. He offered to lead us through the production lines personally. Filth and litter covered the floor, which was also soaked with oil that had apparently spilled and leaked over decades. Without thinking, I reached down to pick up a piece of paper. Since American and Japanese managers often pick up litter to demonstrate care about their employees' work environment, my own movement was instinctive, and certainly not intended as a rebuke. But Russians of rank apparently do not stoop to perform such chores. Semenenko and his minions looked aghast.

Safety was no higher a priority at Kirov than was cleanliness. Forklifts raced through the plant at astonishing speeds. Workers cutting metal with acetylene torches wore no protective glasses. There was no Soviet equivalent of the U.S. Occupational Safety and Health Administration (OSHA), and it was obvious that most enterprise managers cared little, if at all, for their workers' protection. In none of the enterprises we visited would we see workers taking even the most elementary safety precautions, such as wearing steel-toed shoes. At the mill that made steel for Kirov, we crossed a catwalk over a huge vat of molten steel. There was no guard rail. Not surprisingly, a 1989 study commissioned by the leaders of the world's seven largest industrial nations found that industrial accidents were the leading cause of death for Soviets under the age of 45, and that 3.5 million Soviets worked under conditions that violated customary Western labor safety codes.

I read the lack of concern for safety and cleanliness and the chronic overstaffing as signs of the perilous state of the Soviet central planning system, now under exaggerated stress; as enterprises began switching to free market economics, many were failing. Floundering, too, was the ability of central planners to match the needs of industrial customers with those of suppliers. Semenenko complained that his plant was having trouble finding a small diesel engine for one of its tractor models. Months later, we came across an enterprise in Ukraine that had developed just such an engine. Both enterprises reported to the same ministry, yet neither knew of the other's existence!

At least a hundred huge, 325-horsepower tractors stood at the end of Kirov's production line. This is a tremendous inventory for finished goods for any plant. "Half are waiting to be shipped," Semenenko explained, "and the other half are complete except for batteries." As we would discover, the unshipped inventory worried him no more than similar inventories bothered other Soviet managers. Stockpiles of finished or nearly finished goods piled up in almost every enterprise we visited over

Part of the rolling stock at Kirov Works (Kirovsky Zavod).

the coming years. A finished tractor, Semenenko reasoned, and rightly so in terms of the centrally planned system, was a good tractor because it meant that the factory was one number closer to meeting its quota. Putting tractors to use was someone else's job. Surely, many millions of rubles were tied up in inventory in this factory alone, and billions more in the hundred or so Soviet plants I would see.

The obsession with meeting quotas accounted for the fact that most Soviet plants were vertically integrated. Kirov had traditionally forged its own steel so that it could continue producing even if supply lines were cut during a war. And in peacetime the plant had so much difficulty getting steel of the right grade, in the right quantities, and at the right time that it continued making its own. The same was true of tires. Kirov did not make its own rubber, but after once running out of tires, management bought a 15-year supply. Under the rules by which Soviet managers operated, the tires, stacked everywhere imaginable, indicated foresight and good planning. In fact, Kirov was organized much like Henry Ford's early automobile plant at Benton Harbor, Michigan, where iron and coal came in one end and Model Ts out the other. But the method of vertical integration that made sense in the heyday of mass production could be inefficient, perhaps disastrous, in the age of specialization.

Having said this, I should add that Kirov was not an example of extreme Soviet vertical integration. An aircraft plant we visited took bauxite in at one end and sent a completed airplane out the other. Compare that to Boeing, who may build wings in Seattle, the fuselage in Japan, and the horizontal stabilizers in Dallas, then assemble those and other components in Seattle. A Russian enterprise of similar size had less than 10 percent of Boeing's 5,000 to 6,000 suppliers, but 10 times the problems in procuring its supplies. The Soviet distribution system was a Rube Goldberg contrivance. Yet Semenenko was one of the men who had mastered the crazy system and, despite all odds, actually produced tractors.

How did the final product stack up? Semenenko was eager to show us the K-20, a 35-horsepower diesel minitractor that he and his colleagues believed would reap big export sales. Developing the K-20, Kirov had already spent 51 million rubles on research and development, 5 million for "preparations for mass production," 6 million to produce 300 prototypes, 4 million for testing, and 460 million for plant modifications. Now the minitractor was ready to go.

Semenenko kept rattling off statistics. Some 2,451 pieces of equipment, 60 painting lines, and 7 conveyor lines were dedicated to the K-20's production. The operation covered 140,000 square meters of production space, including 9,720 square meters for welding facilities, 63,800 for mechanical assembly, 6,100 for painting, and 4,200 for aluminum casting. Each minitractor would require 283 worker hours to build. If we were not impressed by those numbers, it was because we did not know how to interpret them. We had no immediate way of comparing Kirov with tractor makers in other parts of the world. How would John Deere's manufacturing operations differ from theirs? How did Kirov's products compare in quality? Semenenko couldn't tell us, nor could any of his managers. In fact, they had never considered how their operation fared against its competition. In a market economy, having accurate current data on the competition is an essential first step for contending on product and price. Since Soviet enterprises never operated in a market economy, they had no system for gathering and analyzing such data. Certainly, we could not fault Semenenko for this. He had no reason to keep tabs on his competitors because, until recently, Soviet enterprises had none.

A Soviet consumer wishing to buy a sewing machine did not choose among a variety of brands. Every sewing machine sold there was made by a single enterprise—Shveinaia Association—at a single plant in Podolsk. Although this was not true of every consumer item, and East European imports did supply a sliver of competition in a few areas, 30 to 40 percent of Soviet industrial output in 1990 was, according to official estimates, composed of goods produced at single sites. Another large percentage was manufactured by single enterprises. For example, every freezer in the country was manufactured by a single association at one of its two plants. Single enterprises, according to the Cabinet of Ministers, produced 100 percent of the tram rails, 97 percent of trolley buses, 100 percent of all electrolytic tinplate, and 100 percent of all the equipment used to turn coal into coke.

Single-sourcing led to tremendous disruptions in the supply stream, which partially explained the Soviet managers' passion for vertical integration. A single factory shut down for a mechanical failure could have consequences for the entire economy; it would, at the least, lead to severe shortages. Indeed, during one of my later trips, there was a massive shortage of cigarettes because one of the very few plants that made them was having problems.

Semenenko invited me to test-drive the K-20. The tiny tractor ran roughly, jerking forward every time I tried to let the clutch out smoothly. But it had an unusual and appealing feature: articulated wheels. All four wheels steered together, which made the machine very maneuverable on tiny plots of land, which would be useful in many third-world countries. Semenenko estimated the domestic demand for the compact tractors would grow to 100,000 and 200,000 a year as agricultural reforms facilitated the establishment of more and more small farms. In addition to tractors, the plant manufactured basic, universal-style weight-training equipment. "Why weight-training equipment?" I asked. "Ministry orders," came the answer. I suggested that Kirov hire a group of former Soviet Olympic weight lifters to appear in advertising for its products. Semenenko nodded unenthusiastically. As with other Soviet managers, marketing was foreign, even alien to him.

So, apparently was quality control, for we saw none at Kirov or at most of the other enterprises we visited. Gospriemka, the state organization that tested and approved products, fell under the auspices of Gosstandart, the State Committee for Standards, created in 1987 to monitor quality in consumer goods, as well as in some producer goods enterprises. In 1988, its first full year of operation, 8 percent of the total output of industrial enterprises subject to inspection was rejected. Rejection rates ran considerably higher for products like washing machines (27 percent), television sets (19.6 percent), and furniture (16 percent). While the rejected goods were not always scrapped, some were sent back for repairs. These figures were high compared with those of Western manufacturers, whose rejection rates rarely top 5 percent. Moreover, many of the products acceptable to Gospriemka did not meet world standards.

The quality of most Soviet textiles was poor, particularly in design

The K-20 with its articulated wheels.

and finish. Soviet shoes were a fiasco, and stories abounded of footwear boxed in sets of two right or two left shoes. Large quantities arrived at stores unfit to wear; for example, an entire load of women's shoes without soles was shipped to a department store.

Trucks were based on outdated designs and equipped with inefficient gasoline engines, although conversion to diesel had begun. Gears, made in Leningrad, suffered from poorly manufactured parts and sloppy assembly. While Soviet manual and automatic machine tools compared reasonably well with their Western counterparts, computerized, numerically controlled machine tools were not up to par, technologically. Computers that were produced by the domestic industry, which was a spinoff from military activity, frequently experienced hard-disk and diskette-drive failures.

Above all others, two factors in particular frustrated efforts to improve the quality of Soviet products. One was the managers' ingrained and sole focus on gross production; the other was the lack of any real incentives for workers. Rewarded for quantity and not quality, managers and workers received the same pay and benefits regardless of how well or, more to the point, how poorly they made their products.

As we walked out, I asked Semenenko about pay (not paychecks because the country had no checking system). He said that wages at the

Kirov plant averaged 278 rubles a month, making Soviet workers among the lowest-paid in the world. Despite this, for ideological reasons Soviet blue-collar industrial workers traditionally earned higher wages than many professionals. The average salary of scientists at the Khrunichev rocket factory, which we had visited the day before, was 60 rubles a month less than welders on the Kirov assembly line. But, as we know, this was not true in every case; the scientists whose honors included membership in the Academy of Science were exceptions.

To make matters worse, wages themselves were becoming less of an incentive to produce, because money had already started to lose its value. There were too many rubles in circulation and not enough goods to spend them on. In response, people deposited an extraordinary amount of money in savings banks, which were the only banks open to ordinary citizens. (Salaries rose 12 percent in 1990, despite falling industrial output.) The only influential wage incentives were very large ones, such as the salaries paid to attract workers to Siberia. If Karl Marx promised to create a society of values without money, his heirs were doing the opposite, creating a society with money that had no value.

Until shortly before our visit, Kirov, like other Soviet enterprises, paid its workers with cash received from the central government. But with fewer orders coming in from the government and less money coming in from the ministries, Kirov and the others had to borrow, which placed them in bad though not yet disastrous circumstances. Kirov paid an average of 2.9 percent interest on short-term notes from a Leningrad bank. During the following year, interest rates rose dramatically, nearly matching Western market rates. But managers indicated no intention of repaying their borrowed money, on the assumption that the monetary system would eventually collapse, much as the German system did after World War I.

After our tour, we reboarded the Icarus bus and were driven to a building on the outskirts of Leningrad. Semenenko had his construction crews build this vast empty structure that Kirov had no plans to use, because the crews already on the payroll might as well be building something. Now, he offered brightly, we could have it if we could find a Western company that wanted to locate here. Our encounters with such nearly pathetic naïveté were frequent. One manager showed me a huge parcel of land on which he wanted to build a new factory to produce diesel engines. "All I need," he actually said, "is some Westerners to put up $500 million to fund the venture." He had no idea that investors expect to earn a return on their investments.

The previous visits to aerospace plants were a high point; today's visits were a low. Advanced rocket and satellite design showed central

Although this structure was built without an intended use, it was still hard to fault Semenenko's logic in putting his construction crew to work—they were on the payroll and not otherwise engaged.

planning at its best. The Kirov's clunky inefficiency was more typical; if it was not the most glaring example of state-managed ineptitude, it was certainly bad enough to make us realize at a deeper level why transition had to involve more than privatization alone. Soviet enterprises would have to learn and develop all the systems and tools, not to mention the mentality, that make a market economy work. Nothing less than an entire way of life as well as ingrained cultural and psychological perspectives had to undergo radical metamorphoses.

Yet, dispiriting as the Kirov plant had been, an idea crystallized for me there. Why was it necessary to invest in entire enterprises, or even in significant portions? A discrete segment that showed genuine promise could be selected for privatization and investment. As a whole, the great Kirov plant that had contributed mightily to Hitler's defeat was a disaster, but the little K-20 tractor with the nifty turning radius might well be worth betting real money on. In true Russian style, I had been simultaneously depressed and inspired.

CHAPTER SEVEN

Eureka!

I FELT LUCKY IN LENINGRAD. Perhaps it was because I found a chance to conduct some real business, even in the legendary, antiquated Kirov plant. And Leningrad had dignity. Its atmosphere was crisper, more bracing than Moscow's, and not just from the winds blowing from the Baltic. The formerly majestic capital was confident that it would soon be great again. This was the city that saw the end of the tsars and the storming of the Winter Palace, that withstood the 900-day Nazi siege without water or heat and barely any food. Ten thousand people died daily from starvation during the worst of that blockade, and the frozen earth had to be blasted with dynamite to create their mass graves. Yet the city triumphed.

It had been a determined city from its grievously costly, stunningly ambitious inception. Unlike Moscow, which had grown up organically around its kremlin fortress, Leningrad's great collection of architecture and planning was created by one person's order. Tsar Peter the Great, driven by his obsession to make Russia part of modern Europe, willingly sacrificed several thousand peasants to the cruel work of building on the former swamp.

Now, in 1990, the city's spirit was captured in its bright-eyed mayor, Anatoly Sobchak. (Former Mayor Sobchak died in February 2000.) Trim and athletic, he struck me as a worldly, no-nonsense man. He won my admira-

Often called the "window on Europe," the character of Leningrad (St. Petersburg) is both West European and Russian.

Meeting with the forward-looking Anatoly Sobchak, mayor of Leningrad.

tion at once. Like Gorbachev, he was a lawyer, a difficult profession in a country where the important laws were made by the Communist Party, not the legislature. Yet legal studies had given both men advantages by training them in rhetorical argument, skills Russian leaders now needed.

Sobchak had a vision. Eager to free Leningrad's business enterprises from the tangled web of Moscow politics, he was lobbying the Soviet government to turn the city into a free economic zone with its own tax and credit policies and an autonomous program for attracting foreign investors. While Moscow's politicians had an entire nation to turn around, argued the mayor, his city, with its business traditions and proximity to Scandinavia and Western Europe via the Baltic Sea, could achieve economic change most efficiently by operating independently. Leningrad could attract foreign trade that would help the Soviet Union's international balance of payments. Furthermore, the city's experience in converting from communist central control to freewheeling capitalism would act as a model for the rest of the country.

Sobchak wanted the city's enterprises freed from Moscow's ministries. He expected that some could be sold to private interests, and he planned to invite foreign banks and brokerage firms to help reestablish Leningrad's stock exchange, closed since the Revolution. He had already implemented a commodities exchange—allowing enterprises to avoid the central planning system—in which unofficial buyers and sellers traded openly among themselves, buying and selling raw materials and partially finished goods at market prices. The forward-looking leader knew that converting to free market competition would cause Leningrad's heavy industries, including shipbuilding, to trim jobs severely, and he had plans to deal with unemployment in the transitional economy. Sobchak wanted to create a labor exchange to help laid-off workers find new jobs. He and others in his administration even suggested that we create a Leningrad fund, and move our headquarters there from Moscow. That was my first inkling of the fierce long-term and continuing rivalry between the two cities. The invitation to move to Leningrad was indicative of how the regions with real power had already begun to pull away from Moscow, the all-powerful center.

By our meetings in January 1991, Sobchak became an enthusiastic supporter of our efforts to privatize a number of Leningrad's enterprises. Unfortunately, his encouraging acumen and enthusiasm were hardly typical. Although some of the fundamentals of capitalism, such as buying, selling, and investing, remained intact, albeit a bit rusty after 70 years without markets and market institutions, the majority of Soviet citizens expressed little desire to swap their socialism for our capitalism. (Little markets in

Mayor Sobchak encouraged us to establish a separate fund to invest in the enterprises in Leningrad.

which peasants were allowed to sell small quantities of food and pet owners were allowed to sell kittens and puppies had existed previously.)

Needless to say, most Soviet citizens wanted more and better consumer goods, and hoped to earn living wages in jobs that they chose for themselves; they were told that economic and political reform would accomplish these goals. But the desire for the benefits of capitalism—the goods and products—should not be misread as a desire for capitalism itself. U.S. newspaper articles erroneously interpreted the Russians' hunger for, say, blue jeans as evidence of a yearning for free enterprise, but such shallow and ethnocentric reporting neglected to consider the historical events and cultural circumstances that shaped Russians quite differently from Westerners. Those critical differences resided primarily in social and philosophical attitudes. In any case, the Russians' enthusiasm, or lack of it, for economic reform was, for now, irrelevant. What capitalism would mean in everyday life—such as the availability of all kinds of consumer goods, and the necessity/opportunity of expressing one's individual initiative and responsibility—had never been explained to them. Unlike so many changes in Russia, including Christianity and glasnost, these virtues could not be decreed from above. In the land of the worker, the worker would be expected to work in different ways and for different goals.

Most Americans are practical and sanguine, evidenced in their belief in 30-day self-improvement programs, while Russians are not. Americans are optimistic, although some Russians think they would be less so if World War II had been fought in their streets. Russians tend to have majestic flights of self-confidence, then plunge into moods of apathy and gloom. The differences in national mood and outlook partly explain the American misperception of the Soviet Union's plans for economic reform. In 1989, when the Gorbachev government unveiled a 500-day program to create the foundations of a market economy, Americans accepted it at face value. A people who believe in thinner thighs in 30 days will assume that anything can happen in 500, even if it is dismantling and rebuilding an entire economy. Few Americans understood the degree to which lifelong beliefs and attitudes were required to change for the Russians to accomplish this incredible feat. However, most Russians were not optimistic; their cynicism or realism, depending on your viewpoint, remained pure and unsullied.

Despite everything I thought I knew about the difficulties of transition, not until I became more seasoned did I begin to consider or factor in the Russian state of mind—by which I mean, in part, the influence of that nation's geography and history—to anywhere near the degree it deserved. During my fifth official trip to the Soviet Union, I was struck by how deeply the suspicion, sarcasm, and fatalism ran. In Leningrad, people standing in lines to buy food assured me that the shift to a market economy would never happen; but if for some reason it did, no good could come of it. I was expecting and prepared for pessimism. I knew enough Russian history to concede that pessimism was part of the culture. Still, I was shocked by the number of ordinary people without hope. I thought that at least some of the Soviet Union's long-suffering citizens would be enjoying their new Western-style freedom and be brimming over with anticipation of things to come. But if there were any reform enthusiasts among ordinary Russian people, they stayed at home when I was out on the streets asking questions.

Reading about Russian food shortages prepared me neither emotionally nor intellectually for the sight of people running around trying to get enough to eat. But seeing helped me to understand motives and attitudes. The scenes in Leningrad and Moscow were very disturbing; I saw men and women bent double under sacks of potatoes, their basic food for the coming winter. People were obviously suffering, and the country's pride had been profoundly affected. This national humiliation had a direct impact on how Russians now conducted business, often disregarding their own self-interest to maintain what little pride was left.

Most leading political figures had accepted the fundamental need to move from collective to private ownership, although, of course, there was substantial disagreement as to how much should be privatized and how much should remain controlled by the state. Fear of the unknown may have been the greatest obstacle to private enterprise. The collective was universally understood. "Privatization" had a strange, even foreign, ring in a country whose language had no word for "privacy," and whose view of private enterprise was negative. Actually, this assumption was incorrect in that Soviet propaganda had painted a mercilessly distorted picture of life in a Western system of private enterprise; yet it was equally correct because capitalism had, in fact, been extremely difficult in prerevolutionary Russia, even without the distortions. Most people viewed privatization as a threat to their employment, rather than as an opportunity for advancement. "Me get ahead?" the average Russian seemed to think; "I'll get clobbered. I'll be exploited. Or lose my job. Who will look after me then?" The Russian instinct for security far outweighs that for opportunity.

Understandably, Russians had little comprehension of either the rights or the conditions of private ownership in a free society. I had an il-

It wasn't all business when Vladimir Koblov visited me in Weesen, the little town in Switzerland where I maintain a home.

luminating conversation on this subject with Vladimir Koblov, our "godfather" in the defense complex. Over the course of my trips to the Soviet Union we became close friends, and I invited him to visit me in Switzerland. One day we went for a walk that took us through some fields belonging to farmers near my home there.

"Why do the farmers allow us to walk across their property if it's private?" asked Koblov.

"Well, the fields *are* private property," I said. "But certain rights, such as right of way, remain with the public in perpetuity."

"I don't understand," he replied. "I understand private ownership and I understand state ownership, but I don't understand how the two get mixed up together."

Decades of state ownership and management had made most people who grew up under the Soviet system suspicious of anything else. "Won't private ownership mean exploitation of the workers?" Russian journalists were almost certain to ask me in their interviews. It may take decades of living in a free market system for the former Soviets to overcome such distrust and to understand that any exploitation under capitalism was far less than that inflicted by the old Soviet system. Although

Vladimir Koblov pauses to consider the apparent incongruity of a public right of way on private property.

that system did pay (relatively small) pensions and provided (often inadequate) health care, it abused workers by banning labor unions that could bargain collectively and by ignoring safety and health precautions. And this was in addition to paying paltry wages and charging a fortune for shoddy goods.

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HAVING BEEN AMONG THE FIRST foreigners to explore the profit possibilities in Soviet privatization, we wanted also to be first to identify and strike deals with them. Since we knew precisely what we were scouting for—the managers and enterprises whose experience and international product appeal would make them most capable of adapting to the marketplace—we knew it when we saw it: Leningrad Optical-Mechanical Enterprises, Amalgamated (LOMO). LOMO was the Soviet Union's leading designer and manufacturer of telescopic mirrors, high-quality microscopes, and other optical devices such as flexible endoscopes, used medically to see inside hollow organs like the gastrointestinal tract and vascular system. A vast enterprise employing some 20,000 people, LOMO was about a 10-minute ride from the city's historic district. As it is currently constituted, LOMO

Entrance to the Leningrad Optical-Mechanical Enterprises, Amalgamated (LOMO), the leading Soviet designer and manufacturer of optical devices.

was founded in 1962, but parts of it date back to 1914, to an enterprise that was very briefly traded on the Russian Stock Exchange.

From the outside, the beige brick headquarters building appeared no different from other Soviet enterprises. Surprises waited inside. The first, which prompted a private little "ah" of satisfaction, came in the reception room, which featured a large, abstract map of the world. It was one of the small details I always look for: telltale signs of an enterprise's guiding vision. Clearly, LOMO was thinking globally and, perhaps just as importantly, wanted to make that known.

Like the building, the conference room looked nearly identical to every other we had seen, and would see, in the Soviet Union, as if a single designer had been given the contract for them all. There we met Dmitry Sergeyev, a confident, soft-spoken man of 51 who had been LOMO's general director since 1986.

Sergeyev, known and respected in his country as a capable and effective administrator, had been at LOMO since 1963, after he graduated from the prestigious Leningrad Institute of Precise Mechanics and Optics.

Dmitry Sergeyev presents an overview of LOMO. Its six facilities manufactured not only microscopes and endoscopes, but also cameras, TV broadcast equipment, spectrometers, spectrophotometers, telescopes, and optical measuring equipment. His colleague, Alexander Kuznetsov, is seated at the right.

After introductions, we walked to another building where Sergeyev showed us to an enormous, carpeted room in which samples of LOMO's work were artfully arranged on plexiglass pedestals in display cases.

In comparison to the dangerous and filthy conditions of the Kirov Works, LOMO seemed immaculate, even more than what was required. Young, efficient-looking technicians in crisp white lab coats contributed to the world-class environment. The products, too, were impressive. LOMO's research facility had recently developed a line of sophisticated microlenses that rivaled or surpassed any produced in Germany or Japan. More surprising, and encouraging, was how well LOMO was presented. Sergeyev and a deputy, a winning 40-year-old designer named Alexander Kuznetsov, were knowledgeable, modern businessmen whose awareness of their customers made them unusual, if not unique, among Soviet enterprise managers.

In particular, Sergeyev's knowledge of his customers was exceptional. He knew who bought his products and for what price. And he had a strategy for selling his goods abroad. He would begin, he said, by aggressively pricing his small microscopes in order to gain market share. By charging less than competitors for products of similar or lesser quality,

LOMO became our model enterprise. Our earlier meetings were filled with promise.

Part of LOMO's inventory of microscopes.

LOMO would appeal to customers who needed top quality but couldn't afford high-end goods. This was a sophisticated capitalist approach for the manager of a communist enterprise. Pursuing further insights into Sergeyev's thinking, I asked if LOMO made contact lenses. "No," he said. "But it's a growing part of the optics market." I was trying to find out whether Sergeyev saw himself in the glass-grinding business or the vision business. His answer made it clear: the vision business.

I discovered something extraordinary when I noticed a 900-power student microscope modestly exhibited in the display room. I asked Sergeyev how much it sold for. He said 25 rubles—less than $1 then. Subsequent research revealed an American market for roughly 3 million such devices, a neglected jewel that LOMO could easily export. The 25-ruble microscope in the display room confirmed my belief that our Soviet Companies Fund, or any other investor for that matter, should not invest in entire enterprises, which would almost certainly produce more lemons than gems. It would be better to create an entity that dealt only with the research and production of world-class products that looked promising for overseas markets—in other words, carve out pieces of specific factories, managers, and goods.

Explaining this concept to the Soviets, I suggested that they could be

We repackaged the student microscope—in a commercial environment, both substance and presentation would count.

pioneers in economic reform. Economic authorities and enterprise managers wouldn't have to reform their entire systems at once. For example, consistent with reengineering theory and practice, they could tackle the easiest parts first; we would learn along the way and gain self-confidence as well as experience. I might have added that genuine self-confidence based on acquired knowledge and competence was something that most Russians desperately needed regarding all aspects of the world economy. Although I bit my tongue, I certainly believed that starting with winning products would offer the country emotional and educational, in addition to economic, benefits.

This would be a kind of guerrilla investing: Pick areas where you know the terrain and focus your efforts there. This would not have been my chosen strategy in the past, but I had yet to deal with enterprises developed by fiat instead of by market forces. The Russians, sensing that I wanted to take the wheat and leave the chaff, resisted intuitively. Apart from LOMO, we visited many other enterprises, including the Kiev Airplane Production Association (KAPA), which built the Ruslan, the world's largest cargo plane, and the Mriya, which carried the Buran, the Soviet space shuttle.

In Kiev, Ukraine, at the hangarlike manufacturing facility of the Kiev Airplane Production Association (KAPA).

The Kirov plant's K-20 tractor with its short turning radius, LOMO, KAPA, Leninetz—the Soviet Union clearly had some potentially choice morsels, although perhaps fewer than I had imagined.

We had to act fast. Our teams would have to make several follow-up trips in relatively rapid succession. Investors from U.S. pension funds needed to be brought over, given a tour, informed, convinced—all of which would require time. The Soviets would have to draft comprehensive business plans, something they had never done before.

But sluggishness, not speed, was the order of the day, partly because the Soviet authorities were not of one mind about privatization. This revealed more about Russian and Soviet realities and attitudes than it did about privatization itself, which was not new and, for us, not complicated. Many countries had transferred state-owned or -operated enterprises to private ownership. Since 1979, central governments around the world had sold to investors more than $300 billion worth of shares in companies those governments owned in whole or in part. While some of that privatization happened in developing countries where industrialization was fairly new, most took place recently in Western Europe.

Britain and France both sold huge nationalized enterprises to private-sector investors. Margaret Thatcher's government sold Britoil, British

Gas, British Telecom, Rolls-Royce, and Jaguar, among others. Under Premier Jacques Chirac, France privatized a number of financial institutions and public utilities, including Saint-Gobain, Crédit Commercial, French Telecom, and Banque Paribas. One may have expected the Soviets to draw upon those experiences in their own privatization efforts. But they did not. Furthermore, most proved reluctant to sell, or to transfer in any way, the entire ownership of state-owned enterprises to investors. They wanted to sell just a partial share of companies, usually no more than 30 percent initially, after which the government would remain the majority shareholder. This would have enormous ramifications for the enterprises and, of course, for potential investors as well.

When the British government sold shares in British Leyland in the 1980s, investors bought 50 percent of the stock, thereby gaining control of the company. Leyland's top management changed, and no one could doubt who was in charge: private shareholders. And there was no question about the new management's orientation, its view of the free market, or the company's ultimate objective: maximization of shareholder value. The new executives were experienced private-sector operators who knew to whom they were accountable and for what. Soviet privatization, at least in its early stages, was clearly going to be different, more along the lines of the practice in third world countries such as India, where the state retained a majority of the shares. As majority shareholder, the Indian government continued to make decisions at the board level. While this could mean a certain stability, it also introduced the potential turmoil of shifting political winds—companies would be no more stable than the government that controlled them. But for 1991 and the foreseeable future, decisions to invest in India would be well rewarded.

Initially, at least, Soviet enterprises weren't so much being privatized as "de-stateized," to use a word popular at the time. Within this concept, enterprises would be gradually weaned from central planning and made competitive, but without the state losing control. The argument was that quicker, more drastic change wouldn't work, because Soviet managers had no experience in competition or other market demands. No profit-oriented managers were ready to step in, even if the government had invited them. My protracted daily dealings made it clear to me that the Soviet government didn't want such change and was in no hurry to surrender its power to a suspect experiment. The Soviets seemed to fear that foreign buyers would take advantage of the weak ruble and snap up manufacturing assets at discount prices.

To a considerable extent, the rank and file shared this attitude. The workers were cynical: "They pretend to pay us and we pretend to work," was one of their favorite expressions. But, as the great Russian writers have been reminding us for the past 200 years, things were a bit more complicated than that. The workers also craved security and feared freedom, which they viewed as an unappealing combination of social anarchy and greater personal responsibility. Their national pride fused with a traditional distrust of foreigners to make all Russians suspicious of outside investment. Part of their xenophobia was based on years of isolation and propaganda, but some of it was rooted in real experience. Two great invasions of Russia came from the West—Napoleon's France and Hitler's Germany. And, at least since the sixteenth century, when Moscow was proclaimed the third Rome (Constantinople was the second), the Russians have believed in their historical mission as a people with a unique way of life. As a poet wrote, that life will neither be "glimpsed nor understood by the foreigner's haughty eye." If few Russians are shaped entirely by those beliefs, even fewer are entirely free of them.

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WITH A STAFF of four to six American professionals and about twice that many Russians working in our dacha and our office, we now entered actual negotiations with the government and specific enterprises. Our agreement required them to select 100 companies for us to examine. Many of their choices were floundering organizations in sore need of funds. I guessed this was rooted in the old method of pumping money into failing enterprises and ignoring independent ones.

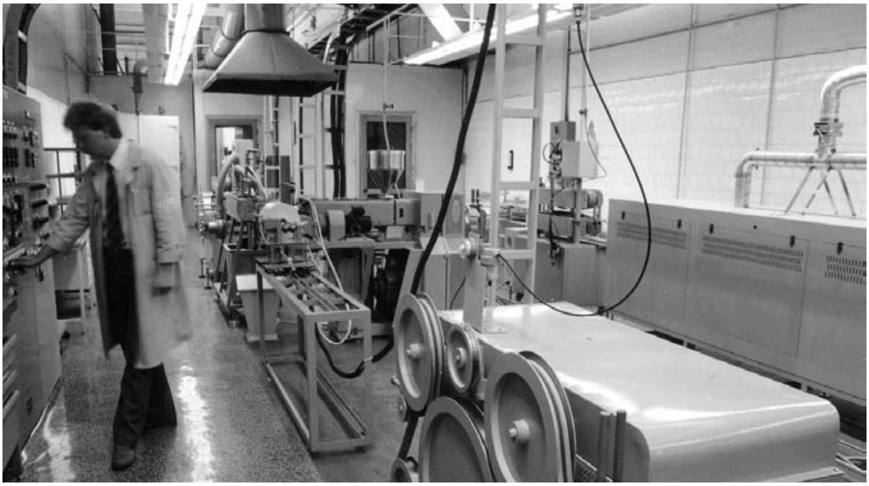
The clock was ticking, but time was on our side because we were in the running here before almost everyone else. Still, that advantage would be useless unless we could overcome the old system's inertia and strike good, solid deals. And we were responsible for delays, too. It was difficult to keep our senior staff in Moscow; the city was tumultuous and fascinating, but there was little to do except work, and people were anxious to go home. The hotels and restaurants where foreigners tended to congregate had unsavory reputations in the Soviet Union. They were frequented by pickpockets, muggers, and prostitutes, whose number and rapaciousness were growing as more foreign tourists and businesspeople visited the country. Except for a handful of hotels and restaurants, the accommodations were very spartan, and the food seemed prepared to prove the Russian proverb that hunger is the best sauce.

Still, we hadn't stopped making progress. To my great satisfaction, LOMO held up to closer scrutiny. Of its young staff, Director Sergeyev was among the oldest at 51; his deputy, Alexander Kuznetsov, who held the equivalent of a Ph.D. from Leningrad's Electro-Technical Institute, was 40. Sergeyev had been at LOMO for 28 years and Kuznetsov for 17, which was a good sign. In addition, my hunch in the reception room was proven right: LOMO was truly international in its thinking, evidenced by the staff's remarkable command of foreign languages as well as Sergeyev's knowledge of foreign markets. Many workers were fluent in English or German.

Our research indicated that roughly half of LOMO's product line had been commissioned by the military; the other half went to a wide range of medical, research, and educational institutions, and to domestic and foreign industry. A Soviet enterprise with a record of successful exporting was unusual and valuable from a prospective investor's point of view. LOMO's experience included selling in Eastern Europe, Africa, Asia, the Middle East, and, most significantly, Canada and Western Europe, which together accounted for 40 percent of the company's average export sales of $1 million a year. Moreover, there was a long history of collaboration with foreign firms, which helped maintain high quality standards. LOMO, or its antecedents, had worked with prestigious German optical concerns both before and after World War II. More recently, Olympus Optical of Japan, which sold components, technology, and equipment to LOMO, helped it to develop its endoscope line. And, until currency difficulties in the Soviet central government terminated the deal, LOMO had been talking with Switzerland-based Leica about licensing microscope technology.

However, our closer examination also revealed weak points. Much of LOMO's equipment was antiquated, and only replacements from the West could make it competitive. Their design sense was also lacking. No concern for competition meant that little, if any, attention was paid to appearance or packaging. Other little signs were also disturbing. Walking through the factory one day with Sergeyev, I noticed workers grinding glass without safety goggles. "That's terrible," I said. "I'll send over a shipment of goggles." "No, no, we have goggles," Sergeyev replied. "The workers just won't wear them." Was that true? Or was Sergeyev concealing the truth out of pride? Were the goggles too shoddy or cumbersome to wear? Had Soviet workers, like plant managers, lost the habit of safety, or never acquired it? Was it like the Soviet air passengers who disdained seat belts even when Aeroflot had them in place? There was no way of knowing, because here in Russia we were living in a different reality.

Still, despite its problems, LOMO was the best prospect. By focusing on it, we were telling the Soviets what we were really looking for, and that others would do well to emulate this relatively model enterprise. LOMO's business plan was intelligent and inspired confidence, in contrast to nearly all of the poorly constructed plans that we looked at. We



Part of LOMO's manufacturing operation at the parent facility.

Assembly workers at LOMO.

sent copies of LOMO's plan to many of those enterprises so they could see what we needed. In fact, some took our advice so literally that they whited out LOMO's name and numbers and inserted their own.

LOMO impressed the potential foreign investors who were invited to visit by the Soviet Companies Fund at Batterymarch's expense, in accordance with our agreement. The purpose of the trips was to show the investors precisely where their money would be going and, equally important, to convince LOMO and the other enterprises of our seriousness. Sensing that investment might be riskier than we had first imagined, we decided to invite corporation heads as well as the administrators of pension funds, because the former were more likely to see the value of getting in on the ground floor. But that adjustment in strategy took time, like everything else.

LOMO's people impressed many Western executives—including Gordon Binns and Charles Tschampion from General Motors, David Feldman and Robert Angelica from AT&T, John Meyer from Harvard Management, Dennis Tito from Wilshire Associates, George Russell from Frank Russell Company, Roland Machold from State of New Jersey, Nicole Harper from Atlantic Richfield Company (ARCO), Gordon Macklin from Hambrecht & Quist, Robert Jeffrey from The Jeffrey Company, Robert Burns from BellSouth, Allan Hodgson from Alcan, Kenneth MacWilliams from Prudential, Michael Clowes from *Pensions & Investments*, and others—because they were avidly interested in and eager to learn about modern international business; and they were candid about their unfamiliarity regarding many important aspects.

That ignorance included how private pension funds operated, since, in the large sense, there had been only one Soviet employer and one dispenser of pensions—the state. In an effort to educate, LOMO's company newspaper, *Spectrum*, interviewed Mike Clowes, the editor of *Pensions & Investments*. The interviewer perceptively discussed the mutual wariness between the Soviets and the Westerners: "To tell the truth, there's plenty of room for doubt here. If we're intimidated by their vast business experience, they're in turn put off by our complete lack of any such experience."

More topical obstacles hindered our progress, not the least of which was the Persian Gulf War. Significantly, for the first time since the end of World War II the Soviets supported a U.S. foreign-policy initiative, and one against Iraq, an old client state. Ironically, the war was bad for Soviet business in general and for the Soviet Companies Fund in particular. For several months international travel was discouraged by the U.S. government, because Iraqi-sponsored terrorist retaliation was expected.

Although that never occurred during our time there, many of the people I wanted to bring over weren't traveling anywhere, thank you.

Nevertheless, we pressed ahead with our deals, concentrating on LOMO, although not to the exclusion of other enterprises. We hammered out a working agreement, and a detailed, realistic strategy began to take shape. As stated in the Soviet Companies Fund's joint stock proposal, LOMO would produce "high-quality, aggressively priced light and surgical optical microscopes and flexible medical endoscopes" for sale in Soviet and Western markets. Those markets were growing, concentrated, and highly competitive. The key, of course, was LOMO's ability to produce excellent devices at very low cost.

Some consultants (from Arthur D. Little and others) were concerned that the look, finish, and packaging of the products, although not essential to their functioning, might not meet world standards and would hamper marketing. LOMO needed, and the Soviet Companies Fund would seek to provide, a strategic partner in the form of a Western corporation that would develop marketing and sales and that would also introduce Western management practices, upgrade equipment, and invest hard cur-

Alexander Kuznetsov presents LOMO's proposal for a joint stock company that would design, produce, and market LOMO's surgical microscopes and flexible medical endoscopes.

It looked top-notch, but I declined Alexander Kuznetsov's invitation to personally test LOMO's flexible medical endoscope.

rency. The leading candidates were companies already producing microscopes and endoscopes, including Leitz, Olympus, Fuji, Nikon, Eastman Kodak, and Polaroid. With substantial operational involvement of personnel from a strategic partner, the hard currency would be used to train personnel, purchase top equipment, and fund research and development.

LOMO would be competing for a share in a world optical microscope market of some $800 million in 1990, and an endoscope market of $1 billion. The forecasts were promising. At zero inflation, export sales would grow from $3 million to $16.8 million between 1992 and 1995. Domestic sales would increase from 80.9 million to 121.2 million rubles in the same period. The majority of LOMO's operating costs would be in rubles, which made the forecasts of the projected hard-currency earnings even more attractive. After considerable negotiation, the share ownership interests were broken down as follows:

Soviet Companies Fund	31%
LOMO	31%
Representatives of Soviet state	18%
Employees of LOMO and the joint stock company	10%

Principal suppliers and domestic customers (Ministries of Health, Metallurgy, Agricultural Complex)	5%
City of Leningrad	5%
Total	100%

We were also negotiating with other enterprises that had impressed us, including the Kiev Airplane Production Association (KAPA), which, as I mentioned, built the world's largest cargo plane and the craft that carried the Soviet space shuttle.

KAPA is located in Kiev, Ukraine. In the coming months, we would gain more awareness of Ukraine's desire for independence. At the time of our first meetings, however, we were simply happy to learn that Kiev shares the Russian language with St. Petersburg and Moscow. During one of our meetings, KAPA's chief engineer, a pleasant man named Yuri Roik, was interrupted by an important phone call. Fluency in Russian was not required to understand that the person on the other end of the line was being criticized to a degree that seemed unimaginable in any U.S. institution except, perhaps, the Marine Corps. That told me that Yuri Roik, whose products were the exception in their excellence, was still a Soviet manager of the old school.

One of KAPA's newly built cargo planes in the final stages of testing.

We watch as the cargo plane taxis down the runway for a test flight. (It was successful.)

At the time of this photo, our salad days in the spring of 1991, we did not fully appreciate the significance that would attach to KAPA being located in Kiev, Ukraine, and its design partner, Tupolev Aviation, being located in Moscow, Russia.

KAPA proposed a collaboration with the Tupolev Design Bureau, located in Moscow, which was responsible for many of the greatest achievements of Soviet civil and military aviation, including the Blackjack and Backfire bombers. Together they would produce, market, and support the Tu-334 airliner, whose prototype incorporated the latest technological advances and would offer airlines something comparable or superior to any existing or projected 100- to 140-seat aircraft in the world. The potential advantages were large demand, both domestic and foreign, low-cost production, and a completed design.

However, I had not been impressed by the KAPA plant and recommended a coat of paint for its interior before our next visit with potential investors. When we returned, I noticed at once that they had followed my suggestion, but at the last minute. When I touched a wall, my hand came away green. I hoped that this was not evidence of the old Soviet habit of rushing furiously, after long periods of torpor, to meet production quotas. Yet KAPA was not our undoing. It would be LOMO, for all its plexiglass displays and lab-coated technicians, that would prove the true Potemkin village.

CHAPTER EIGHT

Coups

THE EVENTS THAT LED to the August 1991 coup against Gorbachev came rushing on, loud and clear, but the coup against Batterymarch arrived stealthily, in dribs and drabs. Suddenly, our drivers insisted on being paid in dollars. The ruble was depreciating by the hour; government drivers would no longer accept government money. The sums involved were minuscule. Still, our agreement with the State Commission—that the Soviets would pay our local expenses—was not being honored. We did not want to jeopardize large, promising deals with LOMO and others over a minor difficulty (which, in any case, was caused by the government and not the enterprises), so we paid the drivers their dollars. What was always odd—sometimes amusing, at other times troubling—was the Soviets' inability to read our business mentality. To them, we were saviors, sharks, or fools to be fleeced. And, of course, they were wrong on all three counts.

Decades of propaganda had conditioned Soviets to believe that profit was immoral, owning private property meant theft, and business was crime. (One young woman, a pioneer in brokering Russian real estate, told me that her mother, upon learning of her daughter's new profession, exclaimed: "You help human beings find a home and for *that* you charge money?!") This prejudice against private enterprise was confirmed when the *mafiyas* (the Russians used the word to refer to any group organized for a nefarious purpose) moved in at the first relaxation of the laws governing private enterprise to buy or steal state-produced goods. They then sold the goods at inflated prices on the private market in transactions accompanied by extortion and violence. With their society collapsing and no security for a stable future, some Russians decided to grab while and whatever they could.

Thus, we could see the drivers' logic in demanding dollars. Soon we were notified that we had to pay our telephone bill, too, in hard currency. Next it was domestic air travel, which was an expense payable in rubles if ever there was one. But this extra money was insignificant compared to the more precious currency of time, which was getting shorter.

I wasn't yet terribly bothered by the murky, fragile Soviet situation and was amused to learn that an old Russian saying summed up my thoughts: The fishing's best in troubled waters. But I *was* worried that our position would not be solidified when the troubled waters reached flood level. And, maddeningly, we were finding ourselves unable to rely upon the Soviet government when it counted.

The gap between that government's words and its deeds was disturbing. The country wanted foreign capital, foreign investment, and foreign expertise, yet offered precious little help in the ways that would have been of direct, visible benefit to their own desperate nation.

We could not open a simple bank account, at least one that would be recognized as such in the West. A $5 million deposit in a Soviet bank might or might not be available for you to draw against. And communications were a nightmare. As we invited more and more investors to visit LOMO and other facilities, our itineraries for them read: "5:00 P.M., check into Grand Hotel Europe, Sea Glory Square, St. Petersburg (there is no direct dial; international operator assistance needed)." After "needed," we did not add "but not generally available." Reaching an international operator was a feat in itself.

A less obstinate government would have made it easier for foreigners, whose dollars it needed, to do business in the country and potentially create millions, even billions, in profits. An enlightened government would have allowed, even assisted, the first hardy souls undertaking the Herculean task of facilitating this conversion to have a success story to showcase. The country stood to earn enormous profits if even part of its industry and research could be salvaged and brought to the international marketplace, instead of allowed to crumble with the rest of the economy. But the idea of large profits was overwhelming to the Soviets; any profit at all was distressing.

They were also suffering from other psychological problems. With astonishing speed, the country was slipping from its status as superpower to that of supersupplicant, a cause for jubilation on the part of some Westerners and bitter humiliation for the Soviets. Europe and the United States were sending relief packages. Although the recipients were grateful, accepting charity can be very difficult, especially for people who, the day before yesterday, thought of themselves as great and mighty. Every Soviet citizen felt the national shame, from street sweeper to intellectual. "I grew up in this country," protested Grigory Yavlinsky, one of the country's leading young economists. "I think it's rich enough to take care of itself." He spoke for everyone, but, again, almost everyone was experiencing a rapidly falling standard of living and a terrible dread that the entire economic system was headed for total collapse; they anticipated the political turmoil that was certain to follow.

People like the active, ambitious Yavlinsky wanted to use the country's resources intelligently. But others, overcome by shame and inertia, asked why *they*, who were doing so badly, should make things easier for *us*, who were doing so well. There was more than a little childishness in this and more than a smattering of resentment and hostility, even a self-destructive perversion, from a people who in other respects—in their personal relationships, say, and their World War II sacrifices—could be magnanimous.

Not only Russians suffered from faulty logic; many Western leaders and businesspeople felt the same way. Our bet was less on the Soviet Union than on the West. We thought that Western businesses and governments would jump at the chance to join together with this formerly dangerous enemy to create a mutually beneficial economic partnership, if for no other reason than to ensure that it would not become dangerous again. That Western governments and business leaders would play a crucial role—whether the Soviet Union became a democratic society with a free market or a chaotic wreck, abandoned by those who could neither foresee the future nor forgive the past—was indubitably clear. With this in mind, I was baffled by the lack of common sense and basic humanity displayed by some of the executives I tried to interest in our project. Others considered their tour with Batterymarch as a chance to gloat over the pitiful writhing of a once-formidable foe, rather than as their chance to witness history or do business. Ironically, had they conducted business in the Soviet Union at that time, they would be *making* history.

My concern became acute in the spring of 1991 as the leaders of the Group of Seven, the G-7—Canada, France, Germany, Great Britain, Italy, Japan, and the United States—prepared to assemble in London for their annual meeting, this one in mid-July.

Public sentiment was evident in Moscow when thousands attended this independence rally in February 1991.

My friend Graham Allison, former dean of Harvard's John F. Kennedy School of Government, shared that concern about the Soviet Union's future and worked with energy and intelligence to perfect a proposal that he and Robert Blackwill, also at the Kennedy School and a former aide to President Bush on Soviet affairs, called the "Grand Bargain." They first used that term in "America's Stake in the Soviet Future," an article published in *Foreign Affairs* (summer 1991). Likening the Soviet situation to that of Europe after World War II, they suggested a modern Marshall Plan for the U.S.S.R.: aid of $15 billion to $20 billion a year for three years in order to keep the nation on a democratic, free market track. Compared to the Cold War's almost ruinous expenditures, that would be, they argued, a grand bargain. They had no illusions, however, that it would be either quick or easy. "A U.S.-led effort to help transform the Soviet Union would certainly be significantly more difficult than the challenge undertaken by the United States through the Marshall Plan," their article concluded. "Nevertheless, there are more than enough reasons of self-interest and values to try."

Many disagreed. Among them was Henry Kissinger, who argued in a *Washington Post* op-ed in the summer of 1991 that it was "No Time for a Grand Bargain." Kissinger believed no one in the Soviet government was able to make the necessary 5- to 10-year commitments. The West, he warned, "should not maneuver itself into imposing conditions that can later be blamed for causing great suffering. The grand bargain should be avoided if only for that reason."

I thought Kissinger was absolutely wrong. His specialty was foreign affairs; mine was bargains. Although temporarily impoverished, the Soviet Union was a rich country that could develop into an enormous market for American products. Important historical events underlay the animosity most Russians felt toward the Germans and the Japanese, but, despite all the poisons of the Cold War, they admired Americans. Indeed, it was not accidental that the dollar, not the yen or the deutsche mark, had become the unofficial Soviet currency. To take advantage of our great reservoir of goodwill in Russia, we needed to act quickly and boldly to pursue a pragmatic long view, and such action is not the strong suit of our politicians.

Investment doesn't happen without people whose strong convictions and venturesome spirits make it happen. My opinion was not based on the fact that Batterymarch was spending time and money investigating Soviet companies. It was the other way around; I undertook the project because that was my viewpoint. Graham Allison and I were in constant communication about the "Grand Bargain." He wanted Batterymarch's ideas, which were now supported by some experience about converting Soviet military plants. I said it would work *if* six things happened: There was hard currency to buy Western equipment; Soviet enterprises had confidence that they could compete in world markets; the Soviets acquired experience in finance, marketing, and company organization; they learned to adapt their business culture to Western modes; they recognized that although initially help would come from the West, ultimately they had to stand on their own; and they committed themselves to reorganization, privatization, and withdrawal from government funding.

Some of the ideas Graham and I developed found their way into a report for the G-7, which he was working on with the young Soviet economist Grigory Yavlinsky. Graham was representing the J.F.K. School of Government's Strengthening Democratic Institutions Project, and Yavlinsky the U.S.S.R.'s Center for Economic and Political Research. This report was nothing less than a blueprint for politically safe and economically sound relationships between the Soviet Union and the rest of the world. (Other brilliant contributors included Jeffrey Sachs, whose "shock therapy" program for Poland promised significant success.) This was no "giveaway . . . bailout, bribe, or blackmail," as the report made clear and as Graham emphasized to me. "The central concept of the 'Grand Bargain' is long-term, strategic interaction and support by the West on a step-by-step and strictly conditional basis, occurring if, and only if, the Soviet Union and its participating republics take practical and tangible steps toward democracy and a market economy."

The 52-page final draft, entitled "Windows of Opportunity: Joint Program for Western Cooperation in the Soviet Transformation to Democracy and the Market Economy," detailed the West's interest in the Soviet Union's future. It opened with a quote from Shakespeare that captured the nature of this moment in time:

> There is a tide in the affairs of men
> Which, taken at the flood, leads on to fortune;
> Omitted, all the voyage of their life
> Is bound in shallows and in miseries.

"The time to start is now," the report concluded, "beginning at the July G-7 summit meeting in London," just weeks away. The Germans seemed to have the best understanding of what was at stake, perhaps attributable to their strategic geopolitical position and their experience in reuniting East and West Germany. President Gorbachev requested a hearing in London for a plan to integrate the U.S.S.R. into the free market economy. The weekend before the summit, Chancellor Helmut Kohl invited Gorbachev to a ski resort in Kitzbuhl, Austria, to help him prepare for his London appearance. Fully aware of the supreme importance of the occasion, the two carefully reviewed Gorbachev's 47-page paper. Then, on the eve of the meeting, Gorbachev sent a personal statement to the seven heads of state.

In it, Gorbachev acknowledged Batterymarch's role as an investment pioneer in establishing trust between Western investors and Soviet partners in combining "the capabilities of the best Soviet enterprises with the expertise of leading Western corporations in the areas of finance, technology and marketing. . . . Models for such funds already exist, e.g., the October 1990 agreement with the Batterymarch Financial Management Company of Boston, U.S.A., to establish a joint fund of up to one billion U.S. dollars for investment in Soviet enterprises." If that amount seems ludicrous, it was a start. I was gratified to learn that some of my ideas helped shape Gorbachev's thinking via the Allison/Yavlinsky report. It was even more gratifying to hear public praise for Batterymarch's initiative.

Of course, what really mattered were the results of this unique, dramatic summit. Would a Grand Bargain really be struck? Gorbachev's early message to the G-7, a forerunner of his London statement, began with a declaration that marked the end of 74 years of Soviet Communist history.

The agenda for the future, he said flatly, was "recognition of the primacy of universal human values." He hailed the G-7 meeting as "a turning point in the efforts to bring about the Soviet Union's organic incorporation into the world economy." He wanted to "reform every aspect of Soviet society," which meant a multiparty political system, laws protecting human rights, demilitarization of the economy, and the individual republics' rights under a new constitution. Even more to the point for the G-7, he pledged a "radical shift toward a market economy . . . a de-statization and privatization of property . . . remov[al] of multiple bands and constraints . . . stimula[tion] of work effort and business activity . . . [and] support for entrepreneurship."

A Thomas Jefferson–Adam Smith collaboration could not have defined an emerging free market nation any better.

Gorbachev went on to specify the conditions of change: Western expertise and advisers, stabilization of the ruble, abandonment of unpromising projects, budget cuts and new taxes to reduce the deficit, and decontrol of retail prices. Along with this, he promised a "social safety net" for the lowest Soviet income groups. He said firmly that the Soviet Union would both service and repay its foreign debt, on which the country traditionally had a good record. Gorbachev asked for money from the West in the form of investment in privatized, joint-venture companies and in grants or loans for a series of reforms: land redistribution and private farms; ruble convertibility; and restructuring the foreign debt. He also raised the possibility of Russian membership in the International Energy Agency (IEA), the International Monetary Fund (IMF), the World Bank, and even the European Community (EC). Surprisingly, he also suggested lifting COCOM's restrictions on the Soviet Union.

An addendum called "Proposals for Drafting Economic, Scientific, and Technological Cooperation Programs" might better have been called "Dreams of Glory." Dry, bureaucratic language described a utopian, almost science-fiction, vision of the future Soviet Union. Eight enormous new areas of oil production would open, together with several new gas fields. Pipelines would crisscross the U.S.S.R. and deliver enormous energy resources to Western Europe. The environment would be cleaned through the modernization of thermal power plants and the production of liquid carbons from coal. Agricultural yield would greatly increase. Western technology would transform meat processing, the dairy industry, and farm machinery production. A twenty-first century transportation complex of air-, rail-, and highways would link Western Europe with the U.S.S.R.'s Pacific coast. Satellites and an extensive fiber-optic network would serve a superb telecommunications system.

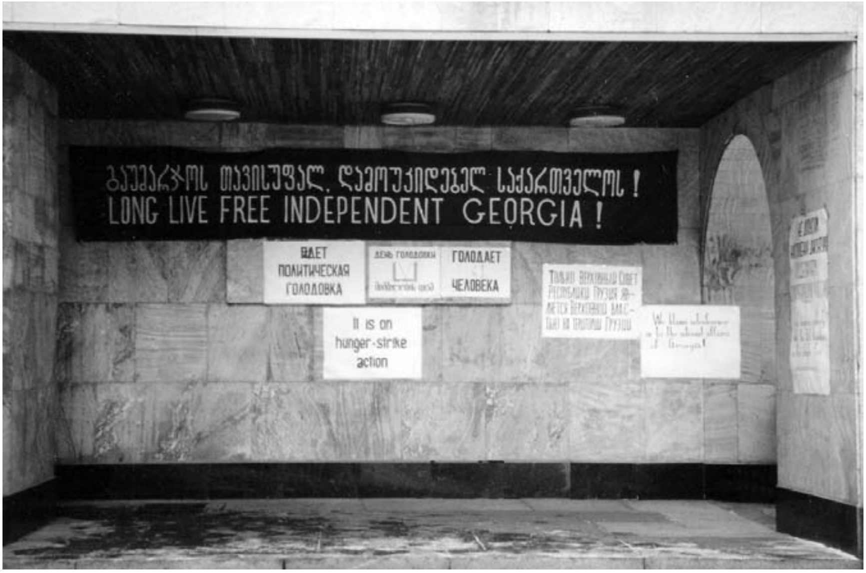
Gorbachev's dazzling picture of a reformed sinner avid to make the world a better place transformed the dream of a people's socialist utopia into a dream of a high-tech, neocapitalist utopia. As overreaching as his proposals seemed, they had grandeur; his London appearance may have been the high point of optimism for peace and international cooperation in our lifetime.

Yet the reaction was not what he had hoped. Perhaps it was because he sensed coldness in his audience that he limited the presentation of his new world to 25 minutes, scant time for a Russian speech. U.S. President George Bush was primarily interested in completing the strategic arms reduction treaty (START), and the Europeans were concerned with making the nuclear ban against Iraq stick. To them, Gorbachev's vision of the future may have looked risky, costly, and grandiose. In any case, despite Gorbachev's ominous prediction that failure to engage would produce a "Yugoslavia with nuclear weapons," Bush and Toshiki Kaifu, Japan's prime minister, shook their heads, and the others followed suit. No deal. The West missed a once-in-a-century opportunity, and I was haunted by Shakespeare's famous words before the meeting ended.

Though the press criticized Gorbachev for lack of coherence, the truth was that no amount of his clarity or organization, even with his international reputation and Nobel Peace Prize, would have convinced the G-7. Given only a vague promise of associate membership in the IMF, he left London empty-handed. From then on his career was over. When news reached Kiev, Tashkent, Minsk, Baku, Tbilisi, and the other Soviet capitals that, in effect, the world was abandoning the Soviet Union, the republics decided to go their own separate ways.

A month after the G-7 summit, Gorbachev felt his only recourse was to sign an agreement with the Soviet republics known as the Union Treaty. The terms barred the Soviet central government from levying taxes unless each of the republics separately agreed. The Soviet Union could no longer tax, a power vital to any state, and this fiscal impotence marked its demise.

I arrived in Moscow with a group of potential investors on Sunday, August 18, the eve of the day on which the Union Treaty would be signed. The potential investors were Robert E. Angelica, director of pension investments for American Telephone & Telegraph; Robert Burns, assistant vice president of BellSouth Enterprises; Robert H. Jeffrey, president of The Jeffrey Company; John Meyer, president of Harvard Management Company, Inc.; and Dennis Tito, chief executive officer of Wilshire Associates. They accompanied us to Moscow for a preliminary survey of several Soviet enterprises that we believed could be privatized,



Sentiment in Moscow: "Long Live Free Independent Georgia," one of the 15 republics of the Soviet Union. Gorbachev's 1987 democratization measures were being interpreted quite literally.

On the Sunday night of our arrival in Moscow, August 18, 1991, we began our program with an enthusiastic overview.


Our dinner guests at the dacha that evening included Vladimir Koblov . . .


. . . and Anatoly Kiselev . . .

. . . and other American and Russian friends. (Graham Allison is seated to the left of this speaker.) Following dinner, we adjourned outside for a fireworks display for Aviation Day, "Red Square by Night."

and we had plans to return in September for a closer look. Our timing could not have been worse.

At breakfast in the dacha the following morning, Graham Allison told us that President Gorbachev was reported ill and had been replaced by his vice president. We turned on the television. Some channels were blank, while others played music. The main government channel was running a film version of *Swan Lake*. Experienced Soviets called this a very bad sign. Still, so far we had not seen or heard anything explicitly disturbing. With a sense of unease, we left the dacha.

En route to downtown Moscow, we saw many tanks guarding bridges and more roared by, their engines echoing like artillery and their tons of steel chewing up the streets. Exhaust filled the air with the reek of diesel fuel. Still more tanks patrolled the ring road around Moscow's electric utility plants. It looked to me less like they were guarding the utilities and more like they were getting ready to move on the center of the city. The crews looked serious. The situation seemed ominous, and far worse when we heard that a group of hardliners opposed to the Union Treaty was, right then, attempting a coup d'état, having kidnapped President and Mrs. Gorbachev.

On Monday morning, after an evening of good cheer and fireworks, the new reality of these tanks, their engines running, would mark our change of course.

The atmosphere was charged. The danger felt very real. Concerned for our safety, we decided not to keep our appointments in downtown Moscow, and we modified our day's agenda. I told our pilot, Andy Sullivan, to fuel Batterymarch's Gulfstream. There seemed to be enough military guards at the dacha to get us to the airport. I felt that as long as the airport remained open and the plane was fueled, we could wait; we proceeded with our program.

The same day, after a business meeting on the outskirts of the city, I arranged for anyone, including all of our Russian employees, to stay in the dacha if they chose to do so to take advantage of whatever safety it might provide. Perhaps I was influenced by pictures of the evacuation of Saigon; in any case, I thought it would be better if everyone were assembled in the same place in case we needed to make a speedy departure. The alternative—chasing people all over the city—seemed too dangerous. With that accomplished, I felt relatively secure. While some of our group remained apprehensive, others were excited to witness history in the making. But, to me, it was all too clear what kind of history was being made.

We attempted to maintain normalcy in our modified program.

Though we visited enterprises on the outskirts of the city, our thoughts were overshadowed by concern for those at the "White House" in Moscow.

Boris Yeltsin and other loyalists would remain behind these barricades for several days in defense of the White House, the seat of the Russian government.

Barricades were erected in strategic locations in Moscow.

I believed that a straight line led from the G-7 meeting to the Union Treaty and now to the tanks in the streets. The West had "cheaped out." Now the real price would have to be paid. Though the Soviets we were in contact with were dismayed by what was occurring, they did not think that it would affect them or our business transactions. We had planned a meeting and banquet for that same Monday evening at the dacha. My advisers from the State Commission on Military Industrial Production told me not to worry.

They were right about the banquet, at least. Everything went as planned. One of our guests was Vitaly Shlikov, a member of the Supreme Soviet of the Russian Republic. He left the machine gun he was carrying at Moscow's "White House"—the government building of the Russian Federation—and rode to our dinner in a car provided by the Soviet government; afterward, he returned in the same car to resume his post. Although the country's political future was in severe doubt, the Russians' commitment to economic reform seemed to be holding firm. That was encouraging.

The following day we kept our appointments. Several times we had to cross fields and speed the wrong way up or down one-way streets in

On Monday night, we again hosted a dinner at the dacha for enterprise directors and officials from the Soviet and Russian governments. In the uncertainty of the moment, emotional toasts of good wishes were heartfelt.

On the staircase in the entry hall of the dacha, we were joined by General Vitaly Shlikov, who then returned to his defense post at the White House. Our American group included Dennis Tito (first row, second from right), CEO of Wilshire Associates, on his first visit to Russia. In late April 2001, at a cost to him of $20 million, Dennis would become the world's first "space tourist" on a Russian mission.

order to escape angry crowds. I told the drivers not to stop for anyone. We were in Kremlin cars, and an anti-Kremlin feeling pervaded the air. Soviet drivers protecting American capitalists from Russian democrats made for an odd moment.

Later that day we flew to Ukraine, where in Kiev the feeling was that what went on in Russia was Russia's business. Ukraine was about to break away and declare its independence. At the time, Ukrainian sovereignty was more important than the economics of everyday life. Anatoly Malashin, the general director of Kiev Aircraft Production Association (KAPA), informed us that the political situation could have an adverse impact on the discussions between his company and the Tupolev Design Bureau, a joint venture in which we were considering investing. The Design Bureau was in Moscow; he and his aircraft works were in Kiev. Though we had not considered that a big problem, it certainly would become one if Ukraine indeed became independent.

Only when we returned to Moscow did it become apparent that the

Aboard the Gulfstream II we flew to Ukraine, the second largest republic in population. Its desire for independence would take immediate precedence over that for economic reform.

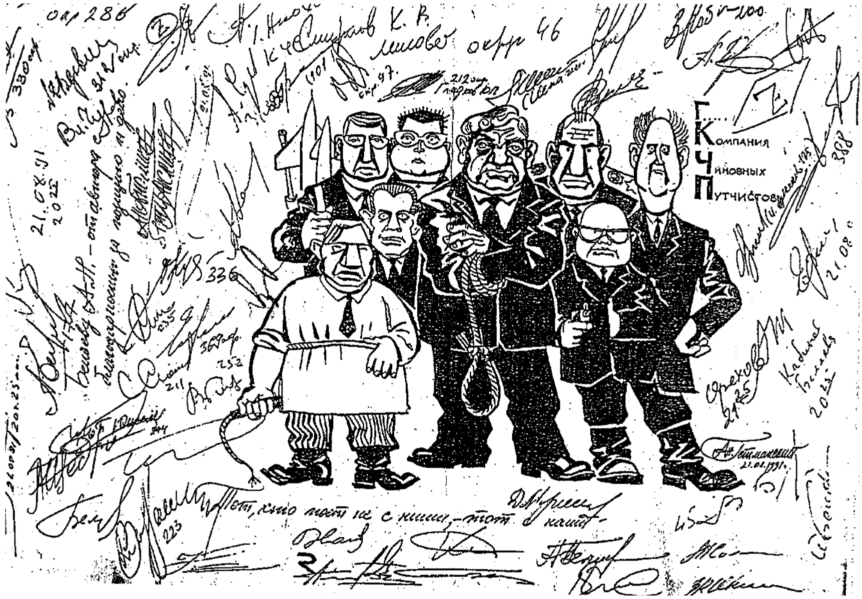
junta was comically inept. In the coup's critical opening hours, they made none of the expected moves, even failing to eliminate the leader. After that, they lost their moment and their momentum. We drove near the White House and saw the large crowds fraternizing with the soldiers. Smiling, relieved people brought them flowers, food, vodka.

On Thursday, three days after the launch of the coup, we flew to Leningrad. By then the world knew that the coup had failed. The city's euphoria reminded me of the heady feeling in the United States at the end of the Persian Gulf War. Here, day and night, people paraded through the streets with banners reading "Svoboda" . . . Freedom.

Mayor Anatoly Sobchak, who hadn't slept for three days, gave me a drawing with the signatures of everyone remaining in Mariinsky Palace, the seat of the city government, where anticoup stalwarts had congregated to defend the government offices there. (One of Mayor Sobchak's key aides at the meeting was Vladimir Putin, who would become, eight years later, President Putin. Having served as a colonel with the KGB in East Germany, Putin had moved to Leningrad and the offices of Mayor Sobchak, his former professor, where he was put in charge of privatization and sale of state assets in the city.)

In Moscow, the soldiers' relief was palpable—they felt no honor at the prospect of a military engagement against their fellow citizens.

Batterymarch staff and clients—Kim Malone, Jack Meyer, Bob Burns, Bob Angelica, and Joel Barber—atop a now-silent tank.



This historic memento was rather like a Russian Declaration of Independence, which, at the time it was given, could still have been a dangerous document to some.

On August 22, 1991, the third day of the attempted coup, we met with Leningrad Mayor Sobchak and other key people in the city, including (to Mayor Sobchak's left) his aide, future President Vladimir Putin.

It seemed reasonable to assume that this was a sign of trust. In our meeting with Mayor Sobchak at the City Council, he delivered a message of such optimism that it was hard to imagine that the country had been on the verge of a takeover, even a civil war, a few days before.

"The day after victory is the day reformers must get to work," he said. Leningrad was about to establish a "free economic zone," and the key people in government and state enterprise were eager for partnership and investment, which they recognized as the only way to bring the Soviet Union into the world economy. And, in that time of high spirits, we all agreed.

Sobchak was impressed that we had remained in the city; many foreigners had not. That gave us a certain bravado image and helped convince him of our seriousness. "We really need banks," he confided. "If you want to open one here, I'll see that you get a license." Sobchak also said something that would prove chillingly prophetic. "We now have a six-week honeymoon," he told me. "Watch what we do in the six weeks. If we make extensive reforms, constructive moves, that's good. If we don't and we waste this period, we're in for a bad time." I did watch what they did: next to nothing. The time *was* wasted debating matters like whether to re-

Despite not having slept for three days, Mayor Sobchak greeted us very warmly, and we renewed our mutual commitment to the quest for economic reform.

In St. Petersburg's Mariinsky Palace, we were filled with optimism. At the time we were hopeful of establishing a new bank in St. Petersburg.

sume Leningrad's former name of St. Petersburg, and whether street names should be restored to their prerevolutionary names.

The honeymoon was over, the good feeling faded. Even Mayor Sobchak's bank idea evaporated. Having discussed the matter with Larry Fish, the former president of Bank of Boston, who found it feasible, we proposed to open a bank if St. Petersburg provided a suitable building. Given the sums involved from our side, the city's contribution would have been more a sign of good faith than anything else. But even the forward-thinking Sobchak succumbed to the mood of exploitation and get-it-while-you-can. He demanded money for the building. The deal foundered.

Shakespeare's tide had not been taken at the flood. Everyone missed it—Gorbachev, the junta, Sobchak, the West, and Batterymarch. After the failed coup, the Soviet Union entered its brief twilight. Gorbachev returned to the presidency of a country that was falling apart around him. The real power shifted to Boris Yeltsin, the president of Russia, the largest and strongest republic of the former Soviet Union. Russia would survive no matter what happened—survival was Russia's specialty. But Batterymarch's star was hitched to the Soviet Union, not to Russia.

Yeltsin was surrounded by impatient, young go-getters in their 30s. Although they would find use for the kind of men we had been dealing with—that is, seasoned hands with practical experience as well as a genuine zeal to reform, perhaps best represented by Vladimir Koblov, our "godfather"—Yeltsin's people had another vision that shared very little with that of the older men. We were losing Koblov, and the weakening of central authority worried me. Despite the command economy's faults, some aspects of it could have proven useful in the transition period. In fact, some were essential in the same way that strong leadership is essential to any company that is reengineering from old processes to new, although at first glance that may appear paradoxical. It is difficult to be democratic when the job is to allocate scarce resources for future development rather than to satisfy immediate needs. The weakening of central authority damaged the reform process.

Indeed, after the abortive coup in August 1991 that resulted in Gorbachev's downfall and the turmoil of the first free Russia, I found that I was occasionally meeting people I had met before, only now they were in different government jobs. At the enterprise level, the coup seemed to have had no effect at all. Whether the party was in or out, the people heading individual enterprises for the most part remained in place.

I continued to hope and to act. A *New York Times* article on August 26—"Coup Barely Slowed These U.S. Investors"—commended our persistence and quoted me as saying that everyone, on all sides of the conflict, was demonstrating that the coup would not affect the business arrangements under discussion. "The Soviet Union needed us before the coup, and still needs us now." That was true enough, except that the Soviet Union had exactly four months left to live.

However, the possibility of the vast empire's dissolution did not seem entirely bad. As Eastern Europeans had learned, the world you awakened to on the first day after communism looked remarkably like it did the day before. LOMO would be making endoscopes no matter what flag flew over the Kremlin. In fact, the same *Times* article reported that Alexander Kuznetsov, LOMO's designer, saw only a positive outcome; he was convinced that a successful coup would have inhibited economic reform, and many in the West agreed with him. When *The Wall Street Journal* referred to our potential investments in the Soviet Union as a "mini gold rush," my contrarian instincts were troubled. Consistently operating on the principle to "find a crisis, then invest," I now began to feel a gnawing doubt, even though I surely had a crisis and investors as well. But unless I was going to cut my losses and leave, I had to show the world a brave face regardless of my misgivings, which were heightened by another fateful date. The one-year anniversary of my first, somewhat impulsive, exploratory trip to the U.S.S.R.

At LOMO, we were interviewed by local television and newspaper reporters.

We were said to be the only foreign group to remain in the country during the attempted coup.

was approaching. From the very start I had told myself, "It's got to work fast to work at all." And it hadn't.

A driven man in violation of his own principle, I still pressed on, willing to be blinded by optimistic signs. In late August, shortly after the coup attempt, Alexander Kuznetsov arrived in Boston, armed with a 25-page prospectus and a five-minute video. He made history of a sort by being the first Soviet businessman to make a presentation on behalf of his company to U.S. stock analysts. "If analysts expected to see a pasty-faced Soviet apparatchik," allowed *The Boston Globe*, "they were in for a surprise. Kuznetsov, 40, looked more like a rising young actor than a bureaucrat. And the message he carried was that in the new and still emerging Soviet landscape, the opportunities for making money from companies like his are substantial."

Irving J. Arons, head of Arthur D. Little's Ophthalmic and Medical Laser Consulting Group, was impressed enough to write to me immediately, offering to help Batterymarch find a strategic marketing partner for LOMO. Spirits rose again. At a late September reception in the St. Petersburg City Council building, our delegation was cheered for its "Ode to St. Petersburg," sung to the tune of the "Battle Hymn of the Republic": "Our

At a reception in St. Petersburg one month after the coup, with Mayor Sobchak's key aides, Vladimir Putin (left) and Oleg Gapanovich (center).

A dinner toast that evening by Vladimir Putin to St. Petersburg's free and open markets.

eyes have seen the glory of St. Petersburg today, / Its free and open market is really here to stay, / With global corporate partners from the good old USA / It's Battery-marching on!"

The next day, I opened a meeting at LOMO by joking that LOMO's proposal may have been more widely circulated than Tolstoy's novels in his day. More to the point, the meeting was frank, businesslike, and effective.

There were other good signs and real progress, as well. In October, the Overseas Private Investment Corporation (OPIC), moved by Gorbachev's reference to Batterymarch in his pre–G-7 message, agreed to extend its investment guarantee to Russia. OPIC, which described itself as a "self-sustaining U.S. government agency whose purpose is to promote economic growth in developing countries by encouraging U.S. private investment in those nations," proposed to insure us up to $100 million against inconvertibility, expropriation, and political violence. Still, that did not allay the dread I had been feeling ever since the G-7 talks left Gorbachev twisting in the wind.

The worldwide recession helped cause that failure of the imagination. Again, the timing could not have been worse. The end of the Cold War presented the West with a unique opportunity to ensure peace by expanding markets; but the money simply was not there. The recession also kept U.S. chief executives from making the rapid decisions that only they could make. Why would a tractor maker who was laying off people in Iowa want to invest in the Kirov factory's little K-20, no matter how nifty its turning radius? Others who had been skittish about traveling during the Persian Gulf War were interested in Russia now, but not through us. I spoke with the chairman and chief executive officer of Cummins Engine Company, Inc., but he was afraid he would be getting into the pond with another alligator. Cummins eventually allied with KamAZ, the big Soviet engine and truck manufacturer. The deal was made in the backseat of a limo, with not much money involved, but now the chairman had an option that would keep his competitors out.

At least he acted. Only chief executives could make quick decisions, and if they *weren't* quick, junior investment people and lawyers entered. Protective of their careers, such people always move slowly; lawyers, especially, are famous for complicating matters, and that is precisely what happened. They insisted on more than customary precautions in a situation where even these were expecting too much. Since, in this situation, it was impossible to offer protection and guarantees because there were none to be had in the turmoil of post-coup Russia, they tried to exact them from me. First, they insisted that I reimburse them out of my own pocket for any lost investment; then they demanded that I, personally, spend much of my time supervising the activities of the Soviet Companies Fund.

Responsible for billions of dollars belonging to the same people in other areas, I foolishly agreed. Why? No doubt my enchantment with Russia played an inappropriate part: vast yet humble Russia, where nothing seems to work, but people seem larger than life and the usual rules don't seem to apply; where you feel somehow emotionally enriched despite, or because of, the political and economic mess through which you and your friends must persevere. I was hardly the first foreigner to have been captivated by the Russians' personal magnetism or to be flattered by the intense personal attention they devoted to Westerners. In any case, I felt that strong bonds of loyalty, trust, and affection had developed between many Russians and myself, and those personal feelings clearly influenced my business decisions.

During the White Nights in St. Petersburg, twilight lasts until dawn. No matter how clichéd it sounds, those June nights, when the burdens of winter and almost everything else are lifted, are in fact magical. On one such night in 1991, I drove with Alexander Kuznetsov and his wife, Vera, to see the church where her grandparents had been married, and which was used for storing potatoes when communism waged war on religion.

Vera showed me the statue of her great grandfather, a well-known scientist. Removed when communism waged war on “class enemies” and imagined traitors, it was now back in place. That night, Vera gave me a watercolor painted by one of her ancestors, a quintessential Russian landscape of a lake surrounded by birch trees. “Don’t forget us,” she said, knowing that I could walk away from Russia, and they could not.

But I didn’t walk away in the fall of 1991, even when the doom in the air became as palpable as the foul autumn weather that makes even Russians long for winter. I stayed, at least in part, because my friendships with Vera, Alexander, and others were very strong and inspirational, despite the fact that they had no place among the criteria for investment.

This was not the first time that Russia had more than one government during a period of transition, which in that country always meant a period of crisis. Three governments were operating in Moscow by early 1992: the Soviet government, the government of the Russian Federation, and the municipal government. Three governments, yet no clear authority. Predictably, the void filled quickly as people scrambled for whatever they could grab today, and tomorrow be damned. The pressure on us for “gifts” mounted. Until now, the officials with whom we dealt asked, some discreetly, others directly, for goods like jeans and cowboy boots from the United States. We interpreted these as acceptable tokens, although certainly I would have preferred not to be asked at all. Now, the “requests” were for television sets and videocassette recorders (VCRs). If jeans and boots could be considered souvenirs, since they symbolized the United States, requests for heavy electronic items were, unmistakably, attempts at bribery.

Unfortunately, it did not stop there. Since Russians were unwilling to accept their own currency, we had to pay more and more of our agreed-upon ruble expenses in dollars. Everything involving Russian officialdom grew more and more suspicious. Finally, my friend and lawyer Paul Rugo, who was coordinating the project on-site in Moscow, looked at me hard and asked, “What are we doing? We’ve always run our lives like an open book. And here we are, expected to be running around with bags of cash?”

Another great wave of history broke over Russia at the end of 1991, which effectively, though briefly, diverted our attention. President Gorbachev resigned on Christmas Day. Vast crowds gathered outside KGB headquarters, the infamous Lubyanka, and cheered with fierce passion as a crane removed a giant statue of Felix Dzierzhinsky, the first head of the secret police, which was established only six weeks after the 1917 Revolution. The statue proved hollow. Not far away in downtown Moscow, someone painted over the inscription that was chiseled into the pedestal of a bust of Karl Marx. “Workers of the World Unite!” became “Workers of the World, Forgive Me.” Dramatically, the red flags with their hammers and sickles flying atop the Kremlin were replaced by the white, blue, and red of the new Russia.

The Union of Soviet Socialist Republics, our landlord at the dacha, no longer existed. As the new year and new era began, representatives of the Russian government insisted that our old agreement was no longer valid, but $100,000 would take care of the problem. Maybe it would have, but in the confused state it was impossible to determine the authority of those claiming to represent the new Russian government. They could easily be simple opportunists eager to fleece the capitalists, especially since they also hinted darkly about money we owed for back rent. Clearly, serious sums of money could disappear into this black hole without leaving a trace, let alone improving our situation. I refused to pay until things were clarified. But clarity was in even shorter supply in Moscow than were most other necessities.

To make matters worse, complications arose with LOMO. We had managed to secure Zeiss, the highly respected German optical firm, as its strategic partner. When it was time to finalize the deal, we learned that

The Russian flag replaces the Soviet flag in St. Petersburg’s Decembrists’ Square, near Mariinsky Palace.

endoscopes, one of LOMO's principal products with a chance of competing successfully in the West, would not be part of the package. Behind our backs, they had negotiated with Olympus, the Japanese optical firm, to market the endoscopes. Since LOMO was the linchpin of the package, this betrayal was a deal buster.

It would take time for the details of LOMO's double-dealing to emerge, and even then the picture remained ambiguous. Meanwhile, I was in St. Petersburg in February 1992, still hoping to salvage something from the wreckage of my dream. The phone in my hotel room rang. It was a junior staffer in Moscow, breathless with anger and confusion. "We've been locked out of the dacha," he stammered. "There's a huge padlock on the door."

The image of the padlock evoked a video of the whole experience inside my mind, from my initial vision in Boston of profitable cooperation in place of ruinous enmity, the fateful year when hopes soared and communism fell, and now the latest stab in Batterymarch's back. Of course, dollars could have opened the little padlock, but my mouth was bitter with the taste of betrayal and defeat. There was another taste, too, of the wisdom that comes too late; it is the taste of Russia that I will remember for quite some time.

"Get the staff together," I said. "Get on a plane and leave this country—now." After spending one and one-half years, about $5 million, and countless more in emotional investment, the tragicomedy was over; I'd brought the curtain down.

I often reflect upon, relive, perhaps even feel nostalgic about the events of late 1991 and early 1992, and wonder if my decision to leave would stand up to both time and dispassionate scrutiny. I discuss my ruminations more fully in Chapter 15, but I will say here that my primary feeling toward my decision is relief. The restoration of Russian pride and nationalism was beginning in 1995, and the wounded bear would remember that the West had not fulfilled its promise of aid. The election that brought Boris Yeltsin's successor, Vladimir Putin, to power in 1999 was a call to reinstate pride in central control.

It may be that Putin will find a compromise that blends capitalism, social freedom, and authoritarian rule—tight politics and easy economics. Under Putin, Russia is more likely to develop a nationalist party that monopolizes power rather than to revert back to communism. Though its ties with communism are severed, Russia will, most likely, include some communist rhetoric and policies in its nationalist program, but its legitimacy will be based on other foundations. Within the "tight politics and easy economics policy"—reminiscent of South Korea, Singapore, Malaysia, and Taiwan, but also Chile under the rule of General Pinochet—the ruling elite, in close partnership with the government, is in a position to exploit the climate of privatization, which may, ironically, make future investment prospects in Russia quite attractive. But I have long held the view that investing in countries undergoing structural change, as Russia is, depends upon direct, personal associations with the people and a major commitment of time, resources, and energy. I already made those investments, without success, and it was time to move on.

PART TWO

China

CHAPTER NINE

The Fifth Dragon

When China reopened its doors to foreigners, I jumped at the chance to be among its first visitors. The country had been sealed from the outside world since 1949, when Mao Zedong's Communist forces seized control of the immense Chinese mainland. With Mao at the helm, China became, as it had been for so much of its earlier history, a mysterious and impenetrable land. Two events changed all that: President Richard Nixon's visit to China in 1972 and Mao's death in 1976. That a mere four years later, in spring 1980, I would be allowed to travel with relative freedom indicated that China had set her sails to a different wind. So I went, both as an individual fascinated by that ancient land and as an investor curious to see where that different wind might be blowing.

I had a triple image of China. First, and most vividly, I saw China as the land of legendary inventiveness. The Chinese created paper and paper money and were the first to cast iron and then make steel, which they called "great iron." The Chinese engineered the crossbow in the fourth century B.C. and were the first to observe that snowflakes have six sides. They invented the umbrella, seismograph, spinning wheel, fishing reel, playing cards, and whiskey; their first design for the steam engine dates from 600 A.D. The Chinese had kites in the air two thousand years before any European flew one. They were using printing presses in the eleventh century and had, in fact, produced the first printed book in 868 A.D. The first suspension bridge was Chinese; and the first segmented arch bridge, which the Chinese built in 610 A.D., is still in use in central China.

In the year 1192, when a Chinese man jumped unharmed from a tower in Canton with the aid of a parachute, the Chinese had already been experimenting with these devices for hundreds of years. The emperor Gao Yang, who reigned from 550 to 559 A.D., tested "man-flying kites"—an early form of hang glider—by having condemned prisoners thrown from a tall tower clinging to bamboo contraptions; one prisoner flew two miles before crashing. Chinese sailors utilized rudders while Westerners were still steering with oars. The Chinese invented gunpowder, but wisely limited its use to fireworks. And, of course, China has for centuries been famous for its silk. Even spaghetti turns out to be Chinese, brought back to Italy by Marco Polo.

That inventiveness endured into this century; when harsh political repression stifled individual creativity in China, people took their resourcefulness elsewhere. Thirty million Chinese now live outside China. These "overseas Chinese," as they are widely known in Asia, have settled into different countries and contribute to those economies in far greater proportion than their numbers suggest. (That these émigrés also refer to themselves as "overseas Chinese" implies that they have never broken their ties to their homeland.) Everyone knows about the success of Chinese businesses in Hong Kong and Taiwan, but the Chinese play powerful roles in the economies of Indonesia, Thailand, Vietnam, Malaysia, and Singapore as well. One prominent analyst of Asian affairs argues convincingly that, excepting Japan and Korea, the relative success of the principal Asian economies is directly proportional to the percentage of their Chinese populations.

In Singapore, which is completely bereft of natural resources, the Chinese create success out of their intellect, determination, and will. They have locked up most of Indonesia's nonoil trade, as a result of which Malaysia felt compelled to enact legislation that would prevent the Chinese minority there from controlling nearly all of that country's private assets.

The 1.5 million Chinese citizens of the United States boast the highest median annual income of any ethnic group in the country. London's *Financial Times* estimates that among all of America's ethnic groups, the Chinese have the most billionaires. *Fortune* magazine reports that Chinese executives are rising through the corporate ranks faster than members of any other minority group. Chinese entrepreneurs now head many of Silicon Valley's high-tech companies. In nearby San Francisco, where Chinese comprise 3 percent of the city's population, they own 10 percent of the commercial real estate. Their drive and imagination flourish wherever their living conditions are acceptable.

The old China, noted for its inventiveness, was prey to political turmoil, rule by warlords, and foreign invasions. Ultimately in the twentieth century, after the foreigners were driven out and the warlords subdued, there were two great opposing forces left: Chiang Kai-shek's Nationalists and Mao's Communists. They fought a civil war that went on for 23 years, from 1926 to 1949, when Mao emerged victorious (although Chiang's forces took most of China's gold reserves to Taiwan).

My second image was of Mao's China, if only because that was the China of my time. Certainly, Mao was a great and charismatic man who successfully imposed his will on masses of people, such that he was able to build his following from the 100,000 ragged peasants who comprised his army in 1926 into a national cult. Though Mao lost nearly half his troops during the 6,000-mile Long March of 1934–1935, in a retreat from Chiang's more powerful army, the people still followed him. By 1949 Mao's peasant army, swollen by recruits who became experts in guerrilla tactics, controlled the country and cities and forced Chiang Kai-shek's Nationalists to flee to Taiwan. Mao proclaimed a new country of and for the peasant, the People's Republic of China (P.R.C.), under its leader, Chairman Mao.

Mao believed in the power of China's peasants and thought them capable of accomplishing anything they were inspired to do. Since they had won the war against Chiang's well-armed troops without foreign help, Mao saw no reason that his nation would need foreign capital or technical assistance to build a modern industrial economy. Also, he considered himself the right person to guide them. On both counts, he was wrong.

With the exception of two trips to the Soviet Union, China's leader never left his own country during the time he ruled China. Knowing little of the world and less about trade, industry, and technology, he had an abiding faith in the people and in his army experience. He organized the people as a commander-in-chief would and then launched three great campaigns over the next three decades, all of which proved to be calamitous.

Mao's first priority was to ensure that China's military and industrial facilities, located mostly in the heavily developed coastal cities, were secure from attack by American bombers and ground troops. His plan was to move them—literally to pick up the heavy machines and equipment and transport them—to new factories built farther inland. He called this program the Third Front.

The Third Front was completed in three to four years, but its quality and planning were sacrificed to haste. The plan necessitated retraining a large part of Mao's military-industrial workforce, because as the new factories were built the original staff of each factory was divided: Half stayed at the original factory, while the other half moved to the new one. Many people, including accountants, engineers, and other highly specialized workers, had to learn new jobs.

The Great Leap Forward was another of Mao's unwise plans. In 1957, at a Communist Party conference in Moscow, the Chairman boasted that within 15 years China, with its primarily agrarian economy, would surpass Britain in steel production. He would organize China's peasant farmers into an industrial army the same way he had organized them into a military force.

In 1958 most of China's rural villages were restructured into communes. Family-held farms were collectivized. Private homes were razed and replaced by barracks in which peasant families would henceforth live together, sharing everything—food, furniture, pots, and pans. In accordance with Mao's vision and orders, China's people dressed in uniforms without insignia or rank: blue-clad worker ants laboring for the state. Some would farm, of course, but the Great Leap Forward also encouraged the building of peasant-operated industries and small steel mills in rural backyards. By the end of 1958, 90 million peasants had abandoned farm work to make steel in homemade smelters. Most of them had no skills, little instruction, and lacked the raw materials necessary for the job. The Great Leap Forward did not live up to its name.

With the move away from farming, food production dropped precipitously. Grain was not harvested and seeds were not sown, partly because individuals forced into communal living felt little incentive to work. Moreover, the peasants who built smelters had neither pig iron nor ore to feed the smelters, so perfectly good shovels, rakes, pitchforks, plow blades, soup pots, and working machinery were melted down and converted into low-quality steel, fit for absolutely nothing. Hillsides were stripped of trees for charcoal to fuel the smelters. Estimates are that during the Great Leap Forward, which continued in some form until well into the 1970s, approximately 30 million Chinese perished from starvation.

Thus, China's eventually successful industrialization was delayed by the faulty execution of Mao's ill-conceived plans. At the time, of course, not a word of these policy failures reached the public, either in or outside of China. Chinese newspapers only reported an increase in steel production, and party bureaucrats were, understandably, not eager to report the real news to their chiefs. It is possible that Mao himself was unaware, at least for a time, of the magnitude of the disaster that his simplistic thinking brought about.

However, the greatest and most destructive plan of all was the Cultural Revolution, which Mao began in 1966 when he was 73 years old, an aging dictator fearful of his younger rivals in the Communist Party. But Mao's efforts to discredit and disarm these rivals were only partly responsible for the ensuing violence and chaos. He was also reacting to the growing conservatism of party and government bureaucrats, whose decisions and actions he felt were motivated more by self-interest than revolutionary zeal. Believing that even his own political allies had embarked on a revisionist course similar to the Soviet Union's under Nikita Khrushchev, Mao resolved once again to mobilize the Chinese masses in his own cause and, as the late *New York Times* correspondent Harrison Salisbury wrote in his book *The New Emperors*, "lead them into a new and greater revolution."

In the name of the Cultural Revolution, millions of Chinese citizens, guilty of nothing more than having a better education or bourgeois sympathies, were arrested, tortured, exiled, or killed. Children spied on parents, and neighbor turned on neighbor in a national paroxysm of self-destruction. To be seen reading anything that did not clearly praise the cult of Mao was cause for censure, at a minimum. To wrap fish in a newspaper displaying Mao's photo was to risk arrest.

People who urged moderation became targets for public humiliation, if not worse. They were paraded through the streets wearing dunce caps and forced to retract their guilt before jeering crowds. Some had to stand for hours, bent from the waist with their arms outstretched, in what was called the airplane position. The houses of so-called counterrevolutionaries and moderates were plundered by schoolchildren. Incidents of torture and beating were routine; darker horrors, from immolation to cannibalism, were suspected.

Yin Yafei, my colleague at Batterymarch, who was a child in Hefei City during the Cultural Revolution, remembers following a noisy mob one day as it moved from the street to a meeting hall. The local revolutionary committee was about to denounce someone, and to Yafei and her young friends it was great fun—until she saw her parents, both university professors, stumble to the front of the room. It was they who were being denounced. Both were subsequently banished to the countryside for "reeducation," and Yafei was raised by a housekeeper until age 13, when she, too, was dispatched to the countryside to work on a duck farm.

We in the West knew something of the battles being waged inside China during the last years of Mao's life, but details of the horror and

Three generations of the Yin family in the late 1950s, before the Cultural Revolution. (Yafei is standing in the front row, right; her parents are in the back row.)

cruelty that millions of Chinese suffered have only recently become known. Of the great mysteries surrounding the Cultural Revolution, perhaps none equals the organization and proliferation of the Red Guards. Identifying enemies of Mao everywhere, they beat, tortured, and killed thousands in their leader's name. It is appropriate to call their methods Stalinesque, for it was Stalin's security boss, Lavrenty Beria, who tutored Kang Sheng, the head of China's secret services, the Gonganbu. And, as we now know, Kang was also the chief organizer and protector of the Red Guards.

Kang, the former lover of Jiang Qing, the actress who would later marry Mao, with whom he remained a friend and political ally, trained in Moscow during the 1950s. Kang learned from Beria such tricks as providing his leader with a regular supply of sexual partners and pornographic material. (Supposedly Mao particularly liked foldout guides to exotic sexual positions.) In early 1966 Mao summoned Kang and spoke to him metaphorically about expunging "the little devils" and "disrupting the royal palace." Kang understood his leader implicitly: Mao's fear of being ousted and his mistrust of his party associates gave birth to the Red Guards.

At its heart, the Cultural Revolution was a war of China's young against its old. Chinese youths were primed to join the Red Guards, at least in part because the Communist Party had failed them. Most young people had been denied educations in the few good Chinese public schools, which the party elite reserved for their own children. Others saw their own ambitions blocked by Mao's peasant guerrilla army that still monopolized powerful party positions across rural China. With no hint of official sanction, yet with plenty of undercover help from Kang, Red Guard units sprang up almost overnight in dozens of high schools and universities. They plastered campuses with posters, remnants of which were still clinging to walls during my first China visit, and swore undying allegiance to Chairman Mao. By the winter of 1966, schools and colleges throughout China were closed as millions of students set about destroying China's past. Anything or anyone that did not "facilitate the consolidation and development of the socialist system," according to one tract, was to be struck down: old temples and ancestral grave sites; schoolteachers; and party bureaucrats. Gangs of Red Guards roamed the countryside razing every trace of ancient Chinese tradition they could find.

There were some exceptions, a matter of luck or, as in one instance I heard about, bold inspiration. A mob of Red Guards was working its way toward one of Shanghai's larger Buddhist temples, whose treasures included a larger-than-life white jade reclining Buddha. In a matter of minutes, the head monk had the front gates of the temple plastered with portraits of Mao. When the Red Guards arrived they faced a dilemma; they could not destroy the objects from the oppressive past without first profaning the image of Mao. After a minute of argument and hesitation, they left.

Mao and the infamous Gang of Four, consisting of his wife and three party zealots from Shanghai, did everything in their power to stoke the Red Guards' outrage. They publicly vilified the usual villains, from American imperialists to Russian revisionists. China, Mao said, depended on the masses to fight the foreign devils to the bitter end. Tragically, the Chinese were in fact at war with themselves.

While the Gang of Four reigned, any movie, play, or opera predating the Cultural Revolution was summarily banned and people were treated instead to Jiang Qing's "Revolutionary Model Operas," with titles such as "The Chuang Minority Loves Chairman Mao with a Burning Love" and "The Production Brigade Celebrates the Arrival in the Hills of the Manure Collectors." Mao's collected works comprised nearly the entire inventory of most bookstores. Frequently, meetings began with a ritual reading from the Chairman's "little red book." One of Mao's favorite sayings—"Hello, seize the revolution!"—was as widespread there as "Have a nice day!" is here.

The party organizations that once ran the cities, neighborhoods, schools, and factories were abolished and replaced by revolutionary committees made up of zealots who had demonstrated their commitment to the cult of Mao. Thousands of purged party members, including Deng Xiaoping, who would become Mao's successor, were imprisoned or sent to labor on farms or in remote factories. After Deng was denounced and temporarily removed from power, he learned that Red Guards sought his son, Deng Pufang, a physics student at Beijing University. They locked him in a university laboratory contaminated by radioactivity and, to save

Chairman Mao's "little red book" is pocket-size for ease of reference.

himself, the young man leaped from a fourth-floor window, an act of desperation that shattered his spine and left him paralyzed for life.

In the midst of this chaos, the shards of China's national government were held together by Chou En-lai (Zhou Enlai), the country's prime minister and Mao's closest associate. Zhou managed to save some purged party leaders from even more severe treatment. If imprisoning a friend saved him or her from something worse, Zhou quietly arranged it. Zhou, whose forte was diplomacy, never opposed Mao so openly that the fanatics had an excuse to get rid of him, although in July 1967 the Red Guards did hold him captive for a time. Zhou was the one man in China's hierarchy able to preserve some sense of sanity and dignity. For instance, he dissuaded Mao from razing the Forbidden City, the chief symbol of China's dynastic past and the place from which emperors had ruled since 1406.

Framed pictures of Zhou still hang in many Chinese homes today, and it is always the same picture: the late premier, who died in 1975, is wearing an austere gray Mao jacket, his right arm bent at the elbow. While these pictures express respect for the man, they also symbolize the

If not for Zhou Enlai, the Forbidden City in Beijing—one of the few remaining monuments to China's historic past—would not have been spared the wrath of Mao.

nation's mourning for the China that would have been destroyed even further had it not been for Zhou's efforts.

Mao's reign ended as it began, in turmoil and violence. Perhaps that was the only way the failed experiment could end and the next phase of China's development begin.

The Cultural Revolution died with Mao's death on September 9, 1976, and many of the tears shed in China at the Chairman's passing were actually tears of relief. A group of purged party officials quickly staged a coup, arrested the Gang of Four, and reestablished party control over government functions. The fate of Jiang Qing, Mao's widow, symbolizes what happened to the cult. Sentenced to life imprisonment, Jiang developed throat cancer and was placed under house arrest to facilitate her medical treatment. The outside world heard almost nothing about her until June 1991, when it was officially announced that a deeply depressed Jiang had committed suicide some three weeks earlier.

The China I visited in 1980 was just emerging from the madness of the Cultural Revolution. The new, evolving society illustrated my third image of China, the one that might yet come to be. This image, along with my fascination with the country, derives from the early 1960s, when as a student at the Harvard Business School I encountered the work of Barbara Ward, then editor of *The Economist*. In her 1962 book, *Rich Nations, Poor Nations*, Ward pointed out the growing disparity between a relatively few rich, industrialized countries and the rest of the world. The gap promised to widen, she wrote, until the poor, overpopulated nations had no alternative but to use violence to redress the inequities of their condition. China, in her analysis, was one such nation.

Ward's analysis and her predictions of the coming conflict between rich and poor stayed with me. Her ideas, in fact, became conventional wisdom in the West for the next 20 years, although the actual scenario varies from the one she predicted. Rich nations, as it turned out, needed the poor ones as markets for their advanced industrial products, just as the poor countries needed the wealthy ones to absorb their low-priced goods. But the developing nations also needed something else: the capital that only the industrialized countries could provide. I began to think that one role I could play as a professional investor was that of facilitator: someone to encourage and effect transactions between China and investors in the United States and other developed nations.

After all, China has tremendous natural resources: more tin reserves than any other nation and three times the tungsten reserves of the rest of the world combined. Its coal reserves are estimated to be second only to the former Soviet Union's. One of the largest nickel deposits in the world was discovered in China in 1958. China, I believed, was too big and its people too enterprising and creative for businesspeople and investors in the rest of the world to ignore.

Periodically, I wondered: what would be the result if the 1.2 billion people in China—one-quarter of the world's population—were to advance to the same economic state as, say, the 22 million Chinese people in Taiwan? A statistic I once read noted that if the incomes of the Chinese people in China had grown just one-third as fast since 1949 as the incomes of Chinese living in other countries, the global economy would be some 25 percent larger than it now is, and China's would be the largest economy in the world. A country so large and with such energy and inventiveness, freed of the economic constraints of communism, would almost certainly become Asia's fifth "economic dragon," joining and eventually eclipsing the other four: South Korea, Taiwan, Hong Kong, and Singapore.

That was the image of China past and future that I brought with me in May 1980 when I went to observe that fifth dragon for myself and to see if the time was right to seize the beast by the tail.

CHAPTER TEN

A New Leap Forward

I GOT THE VERY LAST TICKET, and it was startlingly expensive. But it was for a 21-day trip down the Yangtze River, only the second such excursion ever open to foreigners.

In May 1980, four years after Mao's death, with the once-purged Deng Xiaoping in control of the party, about 40 Westerners, mostly retired American executives, managers, and their spouses, boarded the *Kun Lun*, a boat large enough to accommodate 600 to 800 passengers. They would have been less pampered than we would be. The boat was considerably cleaner than the government-owned ferries on which the ordinary Chinese citizen traveled, but otherwise it was not much more attractive—at least on the outside, which was painted the same government-issue pale green.

I soon discovered why my ticket had been so expensive. A guide showed me to my room, opening the door with a flourish. The suite was enormous and decorated with ponderous communist-style ostentation. The furniture was oversized and overstuffed, the draperies made of heavy damask, and the windows bulletproof. "The *Kun Lun* belonged to Chairman Mao," the guide explained with a proud smile. "It was built for him to entertain foreign dignitaries, so it didn't get much use. You are staying in Chairman Mao's suite!"

The irony of a Western capitalist sleeping in Mao's bedroom was too obvious to miss, but there was even more to the irony. Like China itself, the *Kun Lun* had once been Mao's, but it, too, was no longer on the course the "Great Helmsman" had designed for it.

In 1980, Westerners were not yet free to travel independently through China, and most of the interior was closed even to escorted tours. Consequently, a trip down the Yangtze was as close as I was likely to get to the real China; but because of the river's enormous significance for the Chinese, it may have been the best vantage point from which to view the country.

The Yangtze is the ancient heart of China, serving as its main artery, its major waterway, and the source of much of its history. In addition, the river provides income and food for about half of the Chinese population. What we thought were shiny black inner tubes on the surface of the water were actually "river pigs," a species of dolphin that the Chinese consider edible. In some places, winter floods create rapids that make the Yangtze one of the world's most dangerous rivers. To control the flooding and harness the Yangtze's power, the National People's Congress approved, in 1992, construction of the Three Gorges Dam, the world's largest hydroelectric dam. Located about 800 miles west of where we boarded the *Kun Lun* in Nanjing, the dam is scheduled for completion in 2009, with the first group of electric generators scheduled to go online in 2003. The dam is controversial; displacing an estimated 2 million people, the 350-mile-long reservoir formed by the dam will submerge 140 towns and 300 villages, ancient temples and other historic sites, countless acres of farmland, and the spectacular canyons for which the Yangtze is famous. In what many view as the government's characteristic insensitivity to people and to nature, construction goes on.

In some places, the Yangtze is one of the world's dirtiest rivers. Chinese factories spew industrial waste and many people defecate into it. Once, from our deck, I saw a corpse floating downstream, which, it turns out, is a fairly common sight, according to my interpreter. Still, people bathe and wash their clothes in its water. There is a well-known story reported by the Chinese press in 1980 about peasants working on a commune near Shanghai who threw a smoldering branch into a river and were astonished to see the river burst into flame. The fire destroyed a bridge and some high-tension power lines before it was brought under control. A Chinese saying holds that if you have not been up the Great River, you have been nowhere. The nation's first emperor founded China on the rich flood plains where we embarked. Centuries later, Mao's troops crossed these plains on their Long March. Clearly, the Yangtze is China's cultural center.

On our journey, the *Kun Lun* sailed from Nanjing, a city of about six million people, on a voyage that would end three weeks later and 180 miles to the southeast, in Shanghai.

My first impression of China was that modern industry was recently grafted onto an ancient civilization. Nanjing, long considered one of China's most beautiful cities, with its wide, tree-lined boulevards and a backdrop of the Purple Mountains to the east, was originally settled in the fifth century B.C. It has occasionally served as China's capital, the last time in 1912 when Sun Yat-sen was proclaimed president; in fact, the city's name means "southern capital," just as Beijing means "northern capital." As far back as the sixteenth century, it was a major river port for

Memorial to Dr. Sun Yat-sen in Guangzhou, in southern China.

silk production and grain storage; over hundreds of years, it was repeatedly invaded, conquered, destroyed, and rebuilt.

By 1980, the city seemed merely exhausted as it lay under a thick blanket of industrial grit and pollution. To first-time tourists, the most obvious sign of both China's industrialization and its Cultural Revolution was how different from our expectations it looked. In Nanjing and in most of the other large cities we visited, little of the country's architectural past remained, and few of the contemporary structures retained any elements of traditional Chinese style. Ugly, squat, unpainted, and concrete, the buildings resembled those in any developing third world country, or in the post–World War II Soviet Union, for that matter.

Life on the Yangtze, by contrast, had barely changed over the centuries. In one museum, I saw a painting of junks and sampans from the Sung dynasty, more than a thousand years old, but it could have been painted the day I first set foot on the *Kun Lun*. The river and the boats in the painting were identical to the ones we saw, down to their sails, masts, and rigging.

Spanning the Yangtze near Nanjing is the spectacular Chang Jiang bridge, a structure of which the Chinese are justifiably proud; a ride across it and an elevator ascent up one of its towers were part of our tour. The bridge was built at a time when no rail link existed between Beijing and Shanghai. When the Chinese government showed Soviet experts their plans for a four-mile bridge—so long that walking from one end to the other took 40 minutes—they were told it was impossible. Nine thousand workers labored for eight years to prove the Soviets wrong. One of our tour guides explained the problems of constructing such a bridge and emphasized that during a time of heightened Sino-Soviet tension, when the Soviets withheld the shipment of 100,000 tons of steel in an effort to stop construction, the Chinese made the steel locally, and not in those backyard smelters, either. The bridge, which opened on December 23, 1968, at the peak of the turmoil brought on by the Cultural Revolution, is high enough to allow large ships to pass beneath the four lanes of traffic on the upper deck and two rail lines on the lower. The guide also informed us that the bridge's steel profile, set against the ancient rounded hills along the Yangtze's banks, was intended to symbolize the new China and its capabilities.

While China was now eager to show off for tourists, it wasn't entirely ready to receive them. The country lacked hotels that Western standards deem acceptable, so we spent most nights aboard the boat or at government guest houses, which were not particularly clean. In a society that was theoretically egalitarian, persuading someone to scrub someone else's bathroom was difficult, as our guides explained.

Judging China by contemporary Western standards is always risky. To our sensibilities, for example, one of the least charming Chinese practices is eating dog. In China, though, *canis familiaris* is not considered a pet, but a food source, and in restaurants, which one often enters through the kitchen, we frequently saw skinned or half-skinned dogs hanging from hooks along with other meats. The consumption of dog meat is consistent with the Chinese practice of wasting nothing. For example, as in most Asian nations, the Chinese haul human excrement from the cities to fertilize farm crops.

We also had to get used to seeing people spit on the floor in their homes as well as in public places. This habit could be attributed to the fact that the tea bag was yet to be introduced to China, and the tea that is served comes with a thick layer of leaves floating on top. One sips and spits them out. As a result, floors are filthy all over China, and Americans disapprove, just as nineteenth-century British visitors to the United States disapproved of the common American habit of chewing tobacco and using spittoons.

I anticipated some discomfort, which was one reason I chose a boat tour of China; I assumed that the country's normal means of travel would be underdeveloped and uncomfortable for Westerners. Maintaining adequate highways, modern passenger railroads, and well-appointed airports in a country as enormous as China required an enormous outlay of money and labor, and Mao obviously had other priorities. Consequently, the country had few tourist facilities and few interpreters, although each of us on the *Kun Lun* was assigned two or three. But these interpreters were new at it and were getting on-the-job training, which was frustrating for us. Every conversation we attempted ashore took several times longer than it should have, because each interpreter demanded an opportunity to participate.

China was eager to develop a tourist trade in order to build its foreign currency reserves. At the same time, Chinese officialdom inadvertently made buying anything as complicated as possible. Chinese currency, called yuan, was issued in two forms. One, *renminbi*, or "people's money," was used by ordinary Chinese. The other, *waihuijuan*, or "foreign exchange certificates," was a scrip used by foreigners inside the country. Although the two were supposed to be of equivalent value, *waihuijuan* were worth more than *renminbi* on the black market. Accordingly, every purchase we attempted involved multiple currency transactions between two parties who did not speak the other's language, and, though they were eager, our inexpert interpreters could not offer much help. Buying something was rarely worth the effort.

This Office of the China Foreign Exchange Trade System in Shanghai would later facilitate currency exchange.

The rather anomalous existence of two currencies has been a great temptation for people to profiteer on the black market. One of the promises of the Chinese Communist Party in the 1940s was to clean up the corruption and extortion rampant during the Chiang Kai-shek regime. It was a bold attempt to outlaw a thousand years of the Chinese business practice called "squeeze," known to Americans as payoffs, kickbacks, or influence peddling. For a long time the communist morality worked; by and large the communist cadres and officials stuck to an unprecedented standard of honesty. But in the 1980s, when an underground economy developed, standards started to slip. After a period of known corruption with no apparent repercussions, the government began to prosecute cases actively and selectively in the mid-1990s, handing down severe punishment to those unlucky enough to be targeted as examples.

When the post-Mao government began to expand foreign trade, U.S. businesspeople seeking a market in China reported that the ministries they dealt with routinely expected a 2 percent kickback to be deposited in their secret Swiss bank accounts. One example of government corruption is the embezzlement scandal involving the Coal and Geology Ministry; in 1985, it was reported that during a period of two years about nine billion yuan (about one billion U.S. dollars) of the Chinese government's funds had disappeared through fraud and waste. As private enterprise and foreign trade increased, so did opportunities for corruption, which was still flourishing when I returned to China in the 1990s. On the whole, however, my impression was that if some officials look as though they could star in a gangster movie, most of the young economic zealots of the regional and central governments are dedicated and honest. Except for black-market currency trading on the street, I witnessed no evidence of corruption.

We tried not to let our frustration with financial transactions permeate other aspects of our long and eye-opening journey. I was more interested in gathering impressions of the Chinese people and countryside as our boat proceeded down the river. The boat motored for miles past tiny farms chockablock along the river's banks. People of all ages worked bent over and ankle-deep in green rice paddies. Others scurried along raised paths among the paddies, carrying huge baskets or parcels wrapped in cloth on either end of bamboo poles across their shoulders. Peasants without water buffaloes pulled their own plows. In their blue Mao jackets, baggy blue trousers, and wide-brimmed hats worn against the sun, the men and women were indistinguishable. Watching them labor, I thought of the passage in *Ulysses* when Joyce writes that the world's revolutions are "born of the dreams and visions in a peasant's heart on a hillside." The people stared back at us silently and impassively, blank-faced, and did not answer our friendly waves. This was not only an expression of disdain for gawking tourists; considering the Cultural Revolution, sensible Chinese peasants continued to be wary of showing interest in a boat full of white foreigners. In that respect, this was still Mao's China.

Daily, we went ashore into villages and towns. Sometimes as we walked along the streets, I stopped to bounce a small red rubber ball against a wall. Almost immediately, onlookers—first children, then adults—joined me in a game of catch, where, in a perfect instance of communication without words, we laughed at mistakes and cheered at miraculous saves. It was my first unstructured social contact with the Chinese. I always left the ball behind as a memento of most likely the first Westerner these villagers had ever seen, or at least the first one they played ball with.

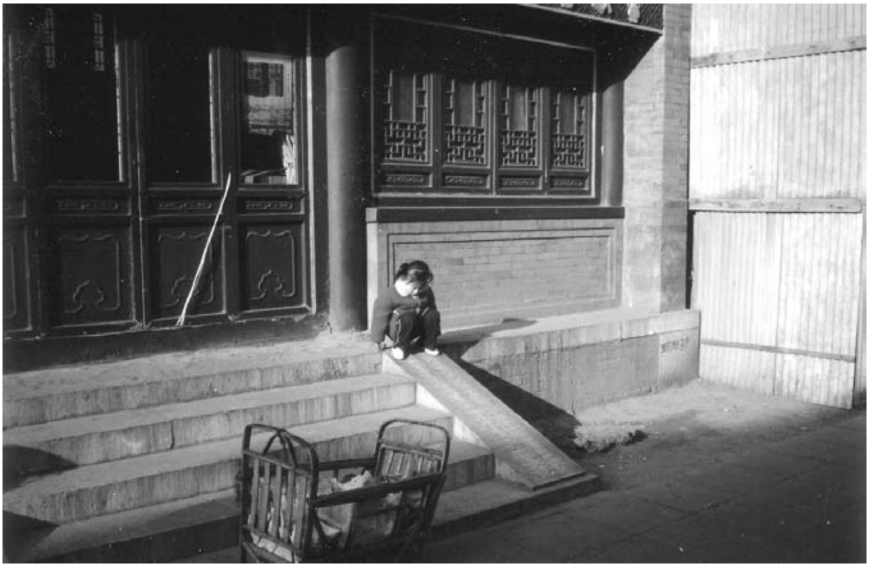
Consistently, we were taken to the local provincial art museum. It seemed as though someone told the Chinese that tourists demanded art museums, so, even when there was no art worth displaying, which was often the case, we saw it: usually propaganda art identified by crudely handwritten signs. But if art of any value miraculously survived a hundred years of revolution and war, it was almost certainly destroyed in the Cultural Revolution's mission to expunge the past.

The Chinese wanted Western business and deserved credit for doing what they considered appropriate to attract it. Many years later, during the Gorbachev years in the Soviet Union, a Russian said to me, "Just tell us what we have to do to do business with the West, and we will do it." Though the Russians didn't follow through, the Chinese did.

If social equality was one of Mao's goals, our first impressions of China suggested he had achieved it. Adults on the town and village streets were dressed asexually in the blue cotton pants and tops that Mao himself had usually worn. People rode bikes that resembled the fat-tired Schwinns of the 1950s or thinner Raleighs without gears. The scenes were picturesque; yet as day followed day we became more discerning and realized that what had seemed charming might, in fact, be the effect of being just plain poor.

These rural communities, primitive and impoverished, reflected life that was not much different from what it would have been centuries ago. Farm animals, which were expensive, were rare. The villages teemed with brightly clothed children, however, since the official one-child policy dating from 1973 has proven nearly impossible to enforce in the countryside. Peasants still relied on the traditional Chinese pension plan: the more children people had, the better they would be cared for in their old age.

A side street in Beijing.



For the moment, this cute little "pension plan" is without responsibility, enjoying a sunny day in Beijing.

Certain things are universal—children having fun with hula hoops.

Though they were not on the tour, I visited the one-room stucco schools in the tiny riverside towns. Each school had rough wooden tables, chairs, and propaganda posters on the walls, including pictures of Chinese soldiers killing Americans, probably scenes from the Korean War. Most of the pictures, in fact, celebrated Chinese victories over another country's troops. The message to the children was that China continually had to fight the foreign devils.

The more time we spent ashore, the more differences we detected in what had at first looked like a uniformity in people and places. A social hierarchy did exist in China; even if there were no classes, there were ever-present signs of rank. For instance, we learned that someone who carried a pen of any sort in the breast pocket of the blue cotton jacket was an individual of elevated rank. A fountain pen bespoke an even higher status. In fact, we learned that the supposedly egalitarian Chinese are actually formally ranked within their occupations and are paid according to their place on the scale.

The country's functionaries were divided into 24 different grades, with ordinary clerks at the lowest, grade 24, and only Deng Xiaoping at grade 1, the top. One could determine people's ranks, we were told, by noting the chairs they sat in. People above grade 13 were allowed a

On a later trip, Yafei and I visited a classroom in Beijing . . .

. . . and were entertained by schoolchildren performing their daily exercises.

leather swivel chair; officials in the lower grades 13 through 16 got a soft upholstered chair; grade 17 officials were entitled to cushions for their wooden chairs; and people of lesser rank made do with plain wooden seats. This system, established soon after the communists took power, survived repeated attacks during the Cultural Revolution, as did the party-dominated bureaucracy, members of which we met.

Almost every night of our trip, the *Kun Lun*'s operators hosted a political banquet for the river authority official whose domain surrounded the town where we were docking that night. The dinners had several purposes. The passengers and officials had an opportunity to meet in a relaxed atmosphere, and the tour-boat operators had a chance to ingratiate themselves with the officials who controlled and dispensed dock space and fuel along the river.

Unfortunately, neither we nor the Chinese officials learned much from these dinners. They were usually shy, and the conversations developed a pattern: what we saw that day, the next day's itinerary, and our impressions of the boat and the river. Not once were we asked about the world outside China. While the Chinese seemed curious about us, they were reluctant to indulge their curiosity and ask us direct questions. For years these people had been ordered, sometimes under threat of death, to shun the corrupting influence of the outside world, and such fear dies hard, if at all.

As our journey continued, many of our first impressions of the poverty and backwardness of life in China were reinforced repeatedly. Perhaps we were beginning to know China.

Early one morning our boat left the wide Yangtze and turned south for about 12 miles along the muddy Huangpu River, which was lined with docks on both sides. We were approaching Shanghai, China's largest city. After disembarking about six miles upriver, we were transported there by bus.

At first, Shanghai seemed a city lost in its own smoke. Industrial chimneys shaped like enormous cigars rose on both banks and, behind them, outlined through the smoke, was a jagged skyline that belied the Hollywood Shanghai of the 1930s. In that Shanghai, low wooden buildings lined misty streets, shadowy secret agents made deals in steamy bars cooled by ceiling fans, while, in the background, Marlene Dietrich sang to Gary Cooper. My first look at the real Shanghai from the waterfront was more reminiscent of George Orwell's vision in *1984*: a depressing, futuristic vision of life in a world overrun by people. Tankers, cargo boats, and bulk carriers, most flying the red and gold flag of China, jostled one another in the harbor, while junks with crosshatched sails nudged through the traffic. The odor was appalling, a stew of sewage and dead fish.

But first impressions cannot be trusted, especially in China. When I explored a little further, another Shanghai emerged: China's only cosmopolitan city. Like Russia's St. Petersburg, Shanghai, too, was created by fiat to connect the country with the outside world. Peter the Great began his namesake city in 1703, and in 1842 the British transformed Shanghai, then a modest town of weavers and fishermen, into colonial China's portal to the world.

As we approached the city, our interpreters told us stories about prerevolutionary Shanghai. "Now," my interpreter proclaimed, "it is very different!" He quickly listed the benefits of the Communist Party's reign in Shanghai: no more slums, the rehabilitation of the opium addicts, the elimination of child and slave labor, no more prostitution, and so on. It was a partisan and much-condensed history of what was once one of the richest, most powerful, and, admittedly, most iniquitous cities of the modern world.

A city of slums, sailor haunts, back alleys, coolies, rickshaw drivers, deformed beggars, child prostitutes, disease-ridden infants, student activists, strikers, and intellectuals, Shanghai has been called the Paris of

Shanghai, today, is a city that reflects the past and the future.

the East, Whore of China, and Queen of the Orient. In a small brick house on a street corner in the French concession, Mao Zedong, a young poet, met with 11 other conspirators one July day in 1921 to found the Chinese Communist Party; they managed to escape just before the French gendarmes arrived at the house. Our guide informed us that in the 1930s Shanghai was replete with millionaires, grand houses, elegant restaurants, and posh hotels, but nearly all of the money belonged to foreigners.

In the 1840s, British troops and gunboats forced a weak imperial government to open "treaty ports" to foreign commerce and, later, to concede extraterritorial "concessions" in cities, including Shanghai. British and American traders flooded China with opium, foreshadowing the century to come. In 1847, following the first Opium War (1839 to 1842) and the establishment of the British concession, the French arrived en masse. The International Settlement that was established in 1863 and the Japanese enclave staked out in 1895 were quite autonomous and immune from Chinese law. With its strategic position at the mouth of the Yangtze, massive foreign money invested in it, and an endless supply of cheap Chinese labor, Shanghai was advantageously poised to become a booming port and a major industrial city.

By 1900, the population had reached one million and was growing fast. The city's foreign population, in turn, grew from a few thousand adventurers in the 1860s to 60,000 in the 1930s. The International Settlement had the tallest buildings in Asia at the time, as well as the most spacious movie theaters. Indeed, Shanghai had more motor vehicles than any Eastern metropolis, which was also more than all other Chinese cities combined. Powerful foreign financial houses, including the Hong Kong & Shanghai Banking Corporation (which the British once nicknamed Honkers and Shankers); the chartered banks of India, Australia, and China; and the National City and Chase Manhattan banks of New York established offices there. So, too, had the blueblood British firms of Jardine & Matheson, Sassoons, and others (that got their start with the opium trade), as well as new and aggressive American firms. Guarding it all were American, French, and Italian marines, British tommies, and Japanese bluejackets. Foreign ships and submarines patrolled the Yangtze and Huangpu rivers and the coasts of China.

Shanghai was the locus of the largest single foreign investment anywhere in the world: The British alone put in 400 million pounds, which they kept a close watch on. For example, after Chiang Kai-shek's coup against the Communists in 1927, Chiang's Kuomintang and the British-controlled concession police cooperated to suppress labor unrest and jail dissident labor leaders.

If you were rich and wicked, you could have anything you wanted in Shanghai in the 1920s and 1930s. Around you were luxury and sin, including great clubs, restaurants, dance halls, opium dens, gambling halls, and dimly lit brothels offering a choice of some 30,000 prostitutes.

Significantly, this was all built on the backs and muscles of the Chinese workers, 200,000 of whom were employed in the factories alone. A high percentage were children, young boy and girl slaves, laboring 12 or more hours a day. Each child had been sold into slavery by his or her family for periods lasting four to five years.

It is likely that no other city in the world has been intruded upon by foreigners to the extent that Shanghai has. This includes refugees, such as the White Russians who arrived after the Communist Revolution in 1917, as well as conquerors. How do the Chinese look at intruders from the outside world? On this and all my subsequent trips to China, I have tried to observe and understand their feelings. "Round eyes," "big noses," "old hairy ones," and "foreign devils" are some of their names for Europeans, and, given the troubles that outsiders have caused China throughout history, those are not harsh designations.

Under Mao, of course, there was a new rejection of foreign influences except for the Soviet Union's, and that was a unique case. In the 1940s and 1950s, the Chinese needed Russian technological support, but the U.S.S.R.–P.R.C. alliance was a joyless marriage. The Mao regime remembered that the Soviets had supported Chiang Kai-shek and had moved into Manchuria at the end of World War II in order to dismantle and appropriate Chinese factories. Mao revered Stalin, despite blaming him for the Korean War, and enacted a truce with the Soviet Union as soon as Stalin died in 1953. But Mao actively disliked Khrushchev, and after one of several uncomfortable summit meetings with him Mao supposedly observed that the Americans were bad enough, but at least they were honest; the Russians were bad and liars to boot.

Confirming that feeling, the ordinary Chinese had an antipathy for the Soviet Russians, regarding them as arrogant, clannish, and crude. As for the proletarian utopia in the U.S.S.R., the Chinese had a joke. They said that Russians were like Adam and Eve; with no clothes and just one apple to eat, they continued to believe they were in paradise.

The Chinese attitude toward the United States and its citizens was my most significant question if I were to have business dealings there. Relations between the two countries were cordial in the early twentieth century, and missionaries, who were the only Americans the ordinary Chinese were likely to encounter, were well received. Still, when I thought of the virulent hate-America campaigns that the Communists conducted from the 1950s to the 1970s, I wondered if that hostility had been passed on to the present generation.

The best way to get a sense of Shanghai and its history is to walk along the Bund, an Indian word meaning an embankment on a muddy shore. The Bund had been both the showcase of the foreign wealthy and the citadel of their wealth. British ladies and gentlemen strolled in the gardens here to "take the air" (presumably the Huangpu was more fragrant in those days) without worrying about meeting dogs or Chinese, since both were banned from the area.

I was especially interested in the Bund because it had been Shanghai's Wall Street, and I was surprised at how many vestiges of that era survived. From the still grandiose but now shabby buildings I glimpsed their former glory. Modern Shanghai has its skyscrapers, but the Peace Hotel (once the Cathay) and City Hall (once the headquarters of the Hong Kong and Shanghai Bank) reminded me of the early 1900s, when a pound was worth five dollars and redeemable in gold.

Europeans settled Shanghai, and consequently we saw many extraordinary homes and buildings in what could be called Sino Art Nouveau, a perfect blend of styles; the flow of the French style merged seamlessly

Along the Bund in Shanghai with Dr. William Wirth, the Huangpu River behind us.

with the Chinese' prevalent use of the calligraphic line. Today those homes are among the most valuable real estate in the world. I was also pleasantly surprised at how much of ancient Shanghai managed to survive the ravages of time and war. To enter the old city from the crowded streets is, for a few moments at least, to enter a fabled image of China: pagoda after pagoda decorated in favorite Chinese colors of black, bright red, gold; a bridge over a pond thick with water lilies and carp that zig and zag nine times to throw devils off your trail as you cross; the undulating brown tiles on a long wall that prove to be the tail of a dragon as its roaring head is finally revealed. A portion of the old city remains as it always was, but another part has undergone commercial development—even TCBY has a franchise there.

But nothing was as astonishing as the streets. The pace was so fast that I thought of news footage showing people being evacuated from cities. We watched what looked like an infinite number of people carrying or transporting huge packages in a variety of vehicles that were mind-boggling. Hybrid vehicles of two, three, and four or more wheels made from bike parts careened through the streets. At one intersection, I saw a legless rider using his hands to crank up the rear bike drive; he was followed by a semitrailer-class tricycle whose rider was pedaling backward.

A thriving shopping area in Shanghai.

Pedestrians, bicycles, and cars easily coexist on this street in Shanghai.

Everyone was on the move; almost no one loitered in Shanghai. Even the Buddhist monks are active, resourceful, and brash in this seaport city famed for colorful criminals and gaudy living. Anyone who knows Brooklyn, New Orleans, Marseilles, or Odessa will recognize something familiar in Shanghai.

On our second day in Shanghai, we visited the Palace of Children. The Palace is actually a beautiful, immaculate house that once was a foreigner's grand establishment. The children who now attend after school to learn dance, music, and other arts were selected, our guide told us, with great care. We saw youngsters taking viola lesson from tutors; later, a little girl picked an American from our group to introduce to the other little girls, who were dressed like ballerinas. It was clearly a friendly gesture, and I was pleased to see that our hosts were trying hard to impress foreigners.

The message of this display was that the Chinese valued their children and, at the same time, valued Western culture. Many doctrinaire revolutionary countries—Iran under the Ayatollah Khomeini was a prime example—seem determined to reject what they consider "capitalist decadence." Yet here were Chinese communist children taking lessons, not in socialist realism, but in music and ballet at what used to

At the Shanghai Acrobatics Theatre with Yafei and her daughter, Fan.

be a foreign millionaire's imperial mansion. In my view, a subtler message lay beneath the overt one: The Chinese wanted us to know how much and how well they cared for their children; in other words, they cared how we regarded them.

That afternoon we flew from Shanghai to Beijing on China Air, the government-owned airline, which exemplifies what is wrong with Chinese business practices under communist bureaucracy. The concept of providing passengers with service was nonexistent. That the bureaucrat in charge had the satisfaction of asserting his authority over anyone presumptuous enough to consider boarding one of his airplanes was the top priority. The next priority was to ensure that everyone conform precisely to each and every official regulation. If you want to buy a plane ticket, for instance, you can't do it just anywhere. You must get it in the city from which you wish to depart, but not at the airport. We had to purchase ours at the China Air office, which was nowhere near the Shanghai airport. Only then could we fly the 700 miles north, approximately the distance from Boston to Buffalo, to Beijing.

Arriving in Beijing, we were driven to a government guest house more luxurious than any we had stayed in so far on this trip. Called Angler's Rest House (or so it was translated to me), it stood behind a guarded gate in a compound of perhaps half a dozen brick buildings. I discovered that my suite was the number one suite in the number one guest house, previously occupied by Henry Kissinger and later by President Nixon. With its bulletproof windows, heavy maroon drapes, and overstuffed furniture, it bore what I later came to think of as the unmistakable style of Stalinist Russia circa 1950. Even the bathroom—or, more accurately, *especially* the bathroom—was designed to give the impression of massive power. Everything was oversized. The tub was more than six feet long.

One of the first things I noticed in Beijing was that the city people dressed like those in the countryside. Almost everybody wore the familiar blue cotton pants and shirt. This was in marked contrast to Shanghai, where dress is much more cosmopolitan, making that city feel more a part of the international community.

We saw the obligatory sights in Beijing, including, of course, Tiananmen Square, the 98-acre parade ground of Communist China and, supposedly, the largest plaza in the world. The original square on this site, which was much smaller, is where Mao first raised the red flag of his new nation. Later he enlarged it by 75 acres. He lies embalmed in his mausoleum here.

If the architectural efforts of dictators—think of the construction or-

The tomb of Chairman Mao in the distance, across the plaza at Tiananmen Square in Beijing.

dered by Hitler, Mussolini, and Stalin—reflect a wish to make everything jumbo size, the Chinese apparently want everything jumbo plus one. Tiananmen Square dwarfs Red Square in Moscow. Lenin's tomb in Red Square is imposing, but Mao's mausoleum trumps it in sheer bulk.

Adjacent to Tiananmen Square is the Forbidden City of the emperors, which contains exactly 9,999 rooms and is situated on 175 acres of magnificent gardens and pavilions. (Here again, the equivalent site at the Kremlin covers 90 acres.)

The streets around Tiananmen Square are on the same grand scale. One of our tour guides explained that they were designed to serve as airplane landing strips in time of war (just like some Moscow streets, as I would later discover), though it is possible that party architects envisioned them as a quick way to get tanks and troops into the city. If so, that plan was implemented in dubious fashion in June 1989, when the army crushed the student demonstrations in the square.

Now, though, we saw bicycle traffic, not tanks and troop carriers. If we were drawing conclusions about countries based on their traffic patterns, we would say that the Chinese are orderly, disciplined, and temperate, particularly compared to many in South American cities, where

Another side of the plaza at Tiananmen Square.

Waiting to enter the Forbidden City in Beijing.

The Forbidden City is monumental in scale and history.

This symbol of China's dynastic past, off-limits for 500 years, was opened to the public in 1949.

In Beijing, bicycles and . . .

. . . more bicycles.

drivers and cycle riders seem to be either temporarily disoriented or certifiably insane.

From the square, we drove past one of the city's largest department stores, where television sets were displayed in the front window. Later, in the Friendship Store, which was at the time the only place tourists were allowed to shop, I was struck by how variable and seemingly illogical the prices were. For example, some little plastic trinkets carried a high price tag, whereas finely crafted objects were offered at modest cost. Antiques were almost totally unavailable, both because so few of them survived the Cultural Revolution and because the Chinese are understandably reluctant to have those few leave the country. In Beijing, more than in any other place I visited on this trip, foreigners could shop in stores off limits to the Chinese themselves. Not only were the amenities in these stores better, but they also dealt strictly in hard currency.

Mao's tomb had been closed the first time I visited Tiananmen Square, but I did get my chance to see it later on. In October 1992 I went there with Yin Yafei, a Chinese woman in her middle 30s and Batterymarch colleague. The daughter of two university professors, she is a graduate of the Fletcher School at Tufts University, where she participated in a special program created for Chinese studying international

The Beijing skyline.

Two generations of the Yin family in the 1990s.

business. Later, also at the Fletcher School, Yafei earned a master's degree in economics and international business.

Though she retained her Chinese citizenship, she was now living in the United States and working at Batterymarch on our China investment fund. When we arrived at the square, a long line was waiting to get into the tomb: We saw a few Western tourists, but mostly Chinese. Inside the mausoleum was a huge statue of Mao sitting in a chair, rather like a Chinese version of the Lincoln Memorial in Washington, D.C. Around the statue's base were dozens of potted flowers. A red carpet led into the next room, where the Chairman himself was laid out. Visitors stared quietly and respectfully for the brief minute allowed. To me, Mao seemed artificial, his skin resembling waxed leather, leading me to doubt that those were really his remains. Apparently Beijing morticians had not been up

When in China. . . . On an earlier trip in 1992, Larry Speidell (right) and George Russell, near the entrance to the mausoleum of Chairman Mao.

to embalming their late leader, so they flew in Vietnamese specialists who had recently preserved Ho Chi Minh's body for posterity.

When we were outside, I asked Yafei her reactions to the experience. "It made me feel like saluting," she replied. "It made me very proud." When I looked quizzical, she added, "He was the father of our country."

But that remark, made by a woman whose parents had been persecuted during the Cultural Revolution, reinforced something I felt during my first trip to China. Then, gazing at Mao's monumental tomb, I asked myself the hard question: Was this still Mao's China?

After Mao's death and the end of the Cultural Revolution, Deng Xiaoping ascended to party leadership in 1979. Deng himself had been purged and "rehabilitated" several times during the chaos of the Cultural Revolution, but he emerged relatively unscathed to assert control over the next phase of China's history. In his speeches and pronouncements, Deng articulated a world view very different from Mao's vision. He spoke of a China at ease with the West, a nation stronger economically than it was militarily, a nation no longer mired in third world poverty. A lifelong communist, Deng was not proposing ideological reform or tampering with Marxist-Maoist doctrine; he was concerned simply with reforming China's economy.

Like Stalin in the U.S.S.R., Mao established a centrally planned command economy driven not by market forces but rather by supposedly scientific decisions. His decisions were disseminated through a bureaucratic web that reached from Beijing to every city and remote village in the country. Mao's image of capitalistic competition was a poisonous snake with two heads, which refers to an ancient Chinese story. The two snake heads fought over food and finally killed each other in the struggle. Mao thought central planning—a snake with one head—a much better idea.

Inarguably, economies in which bureaucrats and autocrats supplant markets in setting economic priorities and goals are capable of production, even on a gigantic scale. The ancient Egyptians constructed pyramids, temples, and impressive roads without a capitalist market system. Early Chinese and Roman emperors ordered the building of structures—the Great Wall and the aqueducts, for instance—that remain as remarkable as the Chang Jiang bridge over the Yangtze does today.

In times of crisis, natural or otherwise, even the proudly capitalistic United States has relied on centralized authority to direct economic activity, such as during the Great Depression and World Wars I and II. (Some would say that today's attraction to a national "industrial policy" is central planning under another name.) Japan's postwar rebuilding and industrial development were centrally directed, first by General Douglas MacArthur as head of the occupying American forces and later by ministries of the new Japanese government. Japanese industrial strategies and priorities were, and still are, established in government offices in Tokyo, not in the corporate offices of Japan's largest companies, which may account for some of Japan's economic problems in the 1990s. The government of South Korea, another country noted for its production capabilities, also does not leave industrial strategy in the hands of its business leaders.

The problems that beset China and the Soviet Union beginning in the 1960s stemmed not from the fact that some production decisions were made in government bureaus. The difficulty was that, unlike the system under the emperors and tsars, *all* planning and decision making were centralized. Even during the reigns of the despots, peasants were allowed to choose some of the crops they grew as well as how to grow them. This simply was not permitted under totalitarian Communist regimes. In the Communist system of central planning, there was no mechanism by which the market could balance or correct the errors of bureaucratic decisions regarding pricing, production, and allocation. Moreover, in nations as vast as China and the U.S.S.R., central planners had no direct experience or understanding of the needs and capabilities of tens of thousands of very diverse enterprises. This lack of knowledge led to waste of a magnitude so enormous it was unimaginable by bureaucrats in other smaller, less resource-rich countries.

During our voyage on the *Kun Lun*, a minor Chinese bureaucrat asked: "Tell me, please, who is in charge of food distribution in your country?" When I answered that no one was in charge, that distribution was controlled by supply and demand through mechanisms such as commodities exchanges, the man was incredulous. That something so important and basic to a nation's survival could happen without benefit of a central authority was outside the realm of his experience and, hence, unfathomable.

Food distribution in China is based almost entirely on supply (what is available at a given time and place) and responds little to demand (what people want). When a crop comes in, people have plenty of whatever that crop happens to be, but little else. Larry Speidell, a colleague of mine at Batterymarch, spent six weeks one summer teaching at the National Center for Science and Industrial Technology Management in Dalian, China, a port and resort city on the Yellow Sea. During July, the watermelon season, Larry was given watermelon 11 times in six days, for breakfast, lunch, and dinner. When in desperation he went to seek something, anything, else to eat from the street vendors, all they had for sale was more watermelon. However, I was later astonished that the economies of both China and Russia ran as well as they did, considering the staggering burden placed on the central planning system and that most administration was performed without the benefit of modern data-processing computers.

What central planning and administration could never provide were efficiency and productivity, which declined steadily in China as the country became more modernized. In 1957, according to a study published by the Brookings Institution, the Chinese generated $34 in profits and taxes from every $67 invested in factories and industrial equipment. Twenty years later, an equal investment generated only $13 in profits and taxes. By 1976, Chinese factories had too many machines and workers and were operating at only 20 percent capacity.

Central planning had obviously not brought efficiency. Like the Soviets, the Chinese central planners emphasized the development of heavy industry at the expense of consumer goods. Between 1949 and 1979, the Brookings study points out, China built more than 350,000 factories, most of them steel and other heavy manufacturing plants. In order to generate capital to operate these factories, the government taxed the labors of the Chinese masses, though not directly. Citizens paid no income tax because that would have created unequal classes. However, the government extracted money from them by setting prices high and wages low, thereby generating factory "profits" at the expense of worker income. These earnings were then reinvested in more plants and equipment.

The same Brookings study reports that from 1949 to 1979 China financed industrial development by reinvesting nearly a third of its gross domestic product (GDP) annually. The United States, by way of contrast, averaged a 6.6 percent reinvestment of its GDP in plants and equipment during the same 30-year period. Beijing's strategy of exploiting low-wage labor to generate reinvestment capital left so little money for consumption that the average worker's standard of living barely improved over these three decades, despite the impressive GDP gains the government could claim.

This policy of keeping the standard of living artificially low makes for countless big and small domestic hardships. For example, one of our interpreters told me he earned the equivalent of only U.S. $25 a month. He could not buy a bicycle, which cost three months' pay, because he was saving for furniture, which he needed before his wife, whose work unit was located a hundred miles away, could get permission to transfer. Once she transferred, they hoped they could retrieve their six-month-old baby, whom they had not seen in four months, from the interpreter's parents. While the government saving and reinvestment plan is an example of thrift, the social and personal costs feel unbearable.

A foreign visitor may think that in a centrally planned economy wages and prices are both low and in balance. It is true that some consumer items were cheap and abundant in China. Silk bathrobes sold for $10, cloisonné necklaces cost $15, and a quart of Tsingtao beer was 25 cents. But the necessities, such as bicycles and furniture, were beyond the reach of most Chinese, and the quality of even the expensive goods was poor.

Poor quality was a fact of life that pervaded most aspects of life in China. The guest house at Dalian where Larry Speidell stayed was 10 months old, but looked prewar. The problem is so common that the Chinese have a name for it: "instant aging." The bathroom was a mosquito-infested disaster, with ill-fitting tiles and crumbling grout, a slimy floor, and a shower curtain in two pieces fastened by paper clips to a piece of plumbing pipe jammed into a crack in the wall.

Off the main tourist routes, the carelessness that leads to poor quality showed up in depressing scenes of disrepair and disorder. Construction debris was abandoned, buildings seemed on the verge of collapse, and odors from bathrooms and kitchens cried out for Clorox, Comet, and a good bristle brush. Japan became a world contender and an economic powerhouse when it began to apply rigid standards of quality control throughout its production. In China, that was an idea whose time was yet to come.

I heard some Chinese people express the opinion that socialism emphasized certain of the worst aspects of the Chinese perspective. Traditionally, they make a very sharp distinction between private and public space, the home and the street. Even a tidy person would throw slops and garbage out the window. Under Mao and the Communists, pollution had reached truly grotesque extremes. Perhaps the explanation is that when everything belongs to the state, it belongs to no one.

In 1980, China had tremendous obstacles to overcome. The economy was in a shambles, and old fears remained in people's hearts and minds. Deng's ideas were good, but he had only been in power for a year. When I thought about the country's future, one incident kept returning to mind. At a point along the Yangtze River, my fellow tourists and I made an excursion to a Chinese movie theater, a small diversion that gave us a sense of how one Chinese woman responded to a glimpse of the world beyond her borders.

An allegory about the union of China and Taiwan, which is a goal of the Communist Party leadership, the movie focused on a young Taiwanese woman who travels with her parents to visit old friends on the mainland. The friends have a son who is a soldier in the Chinese army. The two young people meet, fall in love, and want to marry, but can't because she is from Taiwan, which is under the influence of the corrupt West. That denouement expressed a central Maoist principle: The two Chinas can never meet unless they agree to terms laid down by the party.

The young actress who played the heroine appeared in different outfits every few minutes, sometimes in the same scene, and none even remotely resembled the plain blue cotton suits of the ordinary Chinese. The character's clothes and Polaroid camera were intended to show that she was rich. Just four years earlier, while Mao was still alive, anyone admiring such a display of materialism would have been admonished or punished. But the interpreter, who whispered in my ear throughout the movie, was not offended by the heroine's wealth and wanted nothing more than to see the young couple get together.

"She is in love," she kept telling me, "and she feels that the union with the boy will bring their two families even closer together." In fact the interpreter was captivated by the film and made no secret of it, weeping from beginning to end.

What struck me then, in 1980, just four years after the end of the Cultural Revolution, was that the Chinese people were more ready than their government imagined to join the rest of the world. When people and policy were in better harmony, it would make sense to consider investing here. But that would take years, maybe decades.

The time wasn't ripe, and ripeness is all.

CHAPTER ELEVEN

The Cat Changes Color

I COULDN'T BELIEVE MY EYES. Was this the same China? Following my 1980 trip, I did not return until 1988. Those eight years could have been an eternity, for the China I encountered on this next visit was virtually unrecognizable to me.

Chinese young people sported the T-shirts and blue jeans familiar to their counterparts all over East Asia. I saw women in the cheongsam, the traditional dress with a slit skirt and mandarin collar commonplace on the Chinese mainland before 1949, when all such traditions were banned.

Rock music blared from radios and loudspeakers on Chinese streets. Television antennae bristled on both urban apartment complexes and farms. Vendors in the bustling markets sold meat, vegetables, and clothing to eager buyers. Enthusiastic audiences patronized Western movies and welcomed the revival of traditional Chinese music, drama, and art.

Throngs of foreign tourists and business executives in the nation's coastal cities stayed in modern new hotels managed by Sheraton and Holiday Inn. They ate in fancy restaurants operated by Maxim's of Paris and some of Hong Kong's toniest restaurateurs. Streams of foreign cars, trucks, and buses (particularly Japanese models) vied with the ever-present bicycles to create unprecedented traffic jams in Beijing and Shanghai.

Daughter (in modern attire) and mother (in the blue cotton of the Mao period) at the Forbidden City.

An open-air market in Beijing.

All modes of transport on the streets of Beijing.

The future had suddenly been opened up for the Chinese and they were streaming into the breach, especially the Shanghainese who had been waiting for this to happen. At last there was a chance to make a real living and a real life. But I also quickly discovered the limits on the new freedom.

There are places where the Chinese, wanting some little favor, awaited foreigners. In Shanghai two such spots are the Bund and outside the newly built (1991) Mandarin Hotel (a good approximation of a luxury establishment, except there is no hot water in the afternoon). Those encounters can be annoying, but they can also be quite valuable. The people eager to meet foreigners are daring and will often express opinions voiced publicly nowhere else in China. And, since they usually speak English, the burdensome need for an interpreter is eliminated.

During one of my later trips, Mr. Hao, a gentleman in his late 70s, would wait outside the Mandarin Hotel. He wears the Chinese ear muffs that simply fit separately on each ear like cozies. Nicely dressed, he is proud of his well-tailored overcoat, which has lasted many years because he was unable to wear it during most of the Maoist period. It drew too much unwanted attention in the years of blue workers' outfits. The fact that now he can wear the coat and feel free to chat with foreigners reflects the distance the country has traveled in recent years.

"Things are quite a bit better than they were," says Mr. Hao, which is a vast understatement, since his point of reference includes the horror and insanity of the Cultural Revolution, of which he was a victim. (It appears to be a dependable equation: Anyone educated enough to speak English suffered during the Cultural Revolution.) "I had the chance to go to Hong Kong in 1949, but my wife couldn't bear to be apart from her parents," he tells me with a smile too polite to express regret for the conventional Chinese virtue of filial devotion. But he is not too inhibited to ask for newspapers, magazines, anything written in English that communicates what is going on in the world. The pleasure and appetite with which Mr. Hao receives a few editions of the *Herald Tribune* and the *South China Morning Post* bespeaks the great hunger for information among the Chinese intelligentsia. And they also reflect the forces thwarting those intense desires for knowledge.

The Chinese media remain state-controlled. Sometimes what they report is accurate, but only when the truth serves the state's interest. And without outside corroboration there is simply no way to distinguish fact from propaganda. In 1988, the tension between the desire for factual information and the propaganda machine would not be long in erupting; the great demonstration and massacre on Tiananmen Square was less than a year away.

Heightening the contrast between this visit and my previous one was the fact that when I first traveled to China in 1980 I was a tourist. Now I was a guest, invited to speak at a conference sponsored by the People's Bank of China, the country's central bank. The conference itself was taking place under the auspices of the International Finance Corporation (IFC), a branch of the World Bank, whose mission is to promote local capital markets and private industries in developing countries by, among other ways, providing financial assistance to private-sector enterprises. My job was to explain to the several hundred Chinese government and business leaders in attendance what the role of institutions like pension funds and insurance companies could be in providing capital to private businesses.

For two days I listened to the IFC experts talk about the administrative structures of changing interest rates, worldwide economic trends, and so on. It was all high-level, theoretical stuff that the Chinese, in their infinite wisdom, did not care about. The audience was bored—unfailingly polite, but bored nonetheless.

After a few days of sitting through tedious presentations, it was my turn to address the conference. Rising to speak, I removed my suit jacket, lifted the microphone from its stand, and deliberately began moving

We would gain mutual insights during later meetings with Chen Yuan, chairman of People's Bank of China, in Beijing . . .

. . . and in Boston, when Chen Yuan visited Batterymarch's office.

around the room in a more informal, eyeball-to-eyeball manner. Not knowing what to expect, the group perked up.

I told them that institutions such as Batterymarch are always looking for desirable investments around the world, and that institutional capital inevitably moves to the places providing the highest rates of return. If those rates were available in China, I promised, investors such as my firm would surely follow. The motivating principle, I told them, is that as water seeks its own level, profit will also.

Other speakers discussed stock exchanges even though the Chinese at the time had none. They advised the Chinese at the conference to send representatives to apprentice at the New York Stock Exchange; then they would return home and teach others how the system works. This process, they emphasized, would take several years to come to fruition. But the results would be worth the long wait.

Nonsense, I said (politely, of course).

The whole process would take about a week, I estimated. How? I pointed out that the Chinese could get an industry giant that is eager to gain visibility in the country to sell them the requisite computers at below cost, or even to give them the computers. IBM is an example of such a company. Then another corporation, anxious to gain a toehold in the largest nation on earth, would help them install the appropriate software. Operationally at least, they would then be in business.

My blunt message was well received by the Chinese in the audience, who were attracted to a plan rooted in pragmatic speed, rather than talk and bureaucratic delay. Importantly, we were both—the Chinese and Batterymarch—embarking on an accelerated learning curve at this conference. That the institutional investment community was, for the most part, ignoring opportunities in China interested me and roused my contrarian instincts.

But did that alone determine that the time was ripe? I tried to form a converging picture of what I had observed in the streets and at the conference with respect to the country's historical and political background. It was clear that Deng Xiaoping, the longtime Communist Party official who succeeded Mao, deserved the credit for China's economic progress over the past several years. When Deng stepped out of the wreckage of the Cultural Revolution, of which he and his son were both victims, the Chinese people were exhausted and dispirited from a decade of political strife and economic constraint. Deng set out immediately to repair the damage. His success belied his diminutive stature and relative obscurity on the world stage.

The chain-smoking Chinese leader, standing just under five feet (shorter than Napoleon), came from an isolated village in Sichuan province, in south-central China. Unlike Mao's family, Deng's had for generations enjoyed respect, if not great wealth, as scholars and public servants. At age 16, in 1920, he traveled west with his uncle to Lyons, France, to participate in a work-study program. There he experienced capitalism from both sides: first as a laborer at the iron and steel works in Le Creusot and at the Renault auto plant, then as a locomotive fireman, and finally by owning and operating a tiny food market. It was also there in the West that in 1925 he joined the Chinese Communist Party.

Returning to China in 1926, he served as an effective military and political leader in the guerrilla war against the Nationalist forces led by Chiang Kai-shek. Under Mao's leadership, Deng helped mop up after the 1949 Communist victory. In 1950 he was appointed vice premier, a post he later lost, regained, then lost again, as he fell in and out of favor.

When Deng was not in power he was usually in prison, purged during the Cultural Revolution as a "capitalist roader," meaning someone who, in the eyes of Communist Party zealots, endorsed the principles of Western economics. His accusers were, in fact, right about his economic leanings.

Deng believed that the Third Front, the Great Leap Forward, and Mao's other economic development strategies failed because they were rooted in illusory notions of establishing a socialist utopia. He recognized that in some ways Mao's plans left China poorer than it was prior to 1949. Deng had his own ideas of how to restructure China's economy, and they differed radically from the past in both substance and implementation.

Deng was given an opportunity to enact his theories when, in 1962, Mao announced that he was retreating from day-to-day decision making and, in a dramatic move, turned over responsibility for the country's economy to two of the party's faithful: Deng and Liu Shaoqi, China's president. There was an end to backyard steel mills and inflated rhetoric. Quiet, off-the-record experiments in profit motivation for peasants became a high priority. The reforms, however, barely had a chance. Four years later, in 1966, Mao launched the Cultural Revolution, with Deng and Liu its main targets. Only Deng survived.

In 1979, three years after Mao's death, Deng had another chance to reform the economy, which he tried to do by initiating a package of extreme economic measures that he dubbed the Second Revolution. During this revolution, Deng told the men and women of his country that the party aimed to liberalize the mechanisms of commerce, rather than the politics of government. Deng developed a strategy in which increasing autonomy was granted to *everyone*, including farmers, government officials, and company managers. In this way, he liberated economic activity from its forced adherence to central state planning. He also initiated what the Chinese call the "economic opening" to the West.

This economic about-face proceeded remarkably well with due speed and relative calm, especially considering the stakes involved. This time the Chinese weren't betting all their chips on one shaky poker hand. Three times since their 1949 victory over Chiang Kai-shek's army, China's Communist leaders, under Mao, gambled their country's future on massive economic and social experiments, none of which worked. The unfortunate failure of these policies resulted in the deaths of millions, and severely set back China's hopes for economic and political modernization.

From these catastrophes Deng learned to hedge his bets. Instead of mandating enormous reforms from the top down, he continued the changes that he had begun in 1962 but had been forced to abandon. He encouraged people in selected areas of the country, called special economic zones (SEZs), to test ideas that might or might not work. If they did not, the strategies were easily discarded. If they did, however, the people in those particular special zones were encouraged to expand them. In this way, Deng minimized or localized serious mistakes and blunted the objections of party critics. The party's Central Committee introduced new reform ideas and evaluated old ones at its Plenary Sessions, which were (and still are) held every five years.

By moving steadily but carefully, the government built and, more importantly, maintained economic momentum without the painful upheavals that would beset the Soviet Union. At the same time, successful economic reform in China was never intended to end the party's control and, in fact, has not done so; that control continues to be enforced by repression when government leaders consider it necessary.

Although, in most ways, Mao and Deng approached the project of economic reform quite differently, their plans did share one significant aspect. Both initiated change at the bottom of the economic ladder with China's peasants. In other respects, the ideas of the two leaders are antithetical. In fact, Deng's agricultural reforms gave birth to China's free market revolution.

Deng's first step was to decollectivize agriculture. He dismantled the rural communes—a process he and Liu began in 1962—and turned that land back to individual households, allowing them to farm on their own terms, not the government's. Recognizing that financial re-

Vendors at a produce market in Beijing.

ward acts as a powerful work incentive, Deng introduced reforms that finally allowed peasants to sell much of their harvest on the free market, a practice that had been forbidden since 1949. Even when the peasants were required to sell a percentage of their yield to government buyers, Deng insisted that it occur at prices high enough to encourage production.

Fueled by a new ideology, Chinese agricultural production shot up, climbing by one-third between 1978 and 1984, with an average annual growth rate of 5.8 percent. As rural workers grew more affluent, cottage industries (providing repairs and producing everything from leather bags to scarves), small textile mills, and service shops began to expand and proliferate across the huge nation, which I could see for myself on my 1988 trip.

As a result, the mass migration from country provinces into crowded cities eased. Newspapers and periodicals carried feature stories on successful rural entrepreneurs, which gave economic reform a high and, obviously, a positive profile.

Deng recognized a truth that earlier Chinese reformers had overlooked or purposely ignored: A financially comfortable farmer also tends to be an eager consumer of manufactured goods. By making agricultural rehabilitation his first step down the long road to reform, Deng created a potential market for goods made in China, which, in turn, provided jobs for urban workers. When his critics complained that Deng's policies resembled capitalism, he replied: "It does not matter whether the cat is black or white, only that it catches mice."

After tackling agricultural reform, Deng turned next to the industrial sector. State policy now declared that individuals be allowed, even encouraged, to test their entrepreneurial talent and try to accrue some degree of personal wealth; needless to say, this was another, perhaps the most, mind-boggling transformation following 30 years of Marxism. Managers of state-owned enterprises were given profit-and-loss responsibilities for the plants they controlled, and individual workers were persuaded by cash incentives, not exhortation, to increase their own productivity and the quality of their work. Predictably, skeptics in the party asked: Wouldn't this new course undermine class solidarity (as if it were better for the entire population to remain impoverished rather than risk some citizens profiting more than others) while the country was undergoing an economic rebirth? Deng sensibly paid these critics no heed.

In 1985, the Communist Party's Central Military Commission, which is China's supreme decision-making body in military affairs, gave economic reform a significant boost. The Commission concluded that since a major war seemed unlikely before the end of the century, China could accelerate the moderate rate of military cutbacks that had been in effect since the late 1970s.

Military modernization would remain important to China, officials agreed, but it was assigned the lowest priority of the "four modernizations"—agriculture, industry, science and technology, and defense—which the party, under Deng, was promoting. (The four modernizations were introduced by Zhou Enlai at the People's Congress in January 1975; the aim was to achieve them by the year 2000. When Zhou died a year later, in January 1976, Deng adopted his program, completed specific details, and supplied the drive to ensure its implementation.) The Chinese leadership had wisely come to believe that national security depended on economic strength as well as on military power.

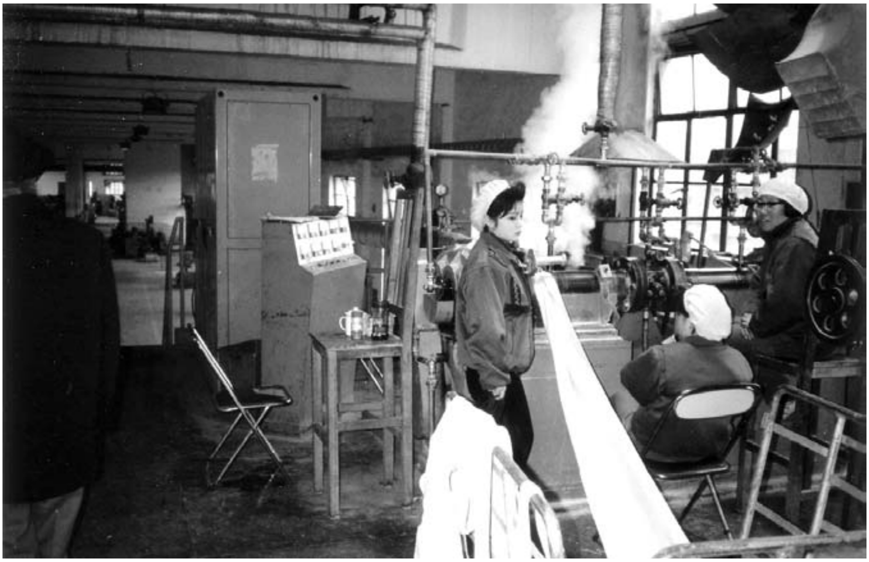
Equally significant, Deng slowed military production; he did so not by shutting down arms factories, but by diversifying them through a partial conversion to consumer goods production. Factory managers were not ordered to make any particular product as they were in Russia. Rather, they were given the same direct responsibilities for profits and losses that managers enjoyed in the industrial sector, while Deng's government reduced standing orders for military equipment. Therefore, when they made decisions regarding conversion, plant managers had little choice but to shift at least some factory capacity to civilian production. The central government helped further by providing tax breaks and inexpensive credits for plants that made this commitment.

The result? China's military-industrial infrastructure now produces bicycles, cars, medical instruments, textile machinery, television sets, and washing machines. These products have met with domestic success for two reasons: Demand for them is high, and their quality surpasses that of goods produced by most civilian plants.

The Chinese have converted more than arms factories to civilian use. Airfields, dock facilities, railways, and telecommunications lines once reserved exclusively for the military are now open for civilian development. Military personnel have been retrained as well. Local government authorities and the Chinese army, which since the late 1970s has shed more than a million officers and enlisted personnel, have retrained former soldiers in industrial skills that should make them more employable in the future.

Well over half of China's one-time military production capacity is

A significant portion of the production of this Shanghai textile company is exported.



These plant workers demonstrate how they process the fabric.

Our hosts proudly show us the well-made and exotic fabrics displayed in the company's showroom.

now devoted to the civilian side. (By 1994, the military's commercial income was roughly equal to the country's defense budget of $6 billion.) Understandably, perhaps predictably, the conversion process has not been an unqualified success. Some managers have made poor choices. Other plants have failed to lower costs sufficiently to make civilian production profitable. Unemployment among former army personnel, especially in urban areas, remains high because the availability of jobs doesn't meet the demand for them, and the retraining programs are inadequate.

Moreover, military conversion does not mean that China has abandoned arms production on a scale that this very large effort may suggest. Much of the profit earned on civilian goods is used to support military research and development. Part of the reason China has become a major world arms supplier is that military factories, watching domestic orders dwindle, decided to produce weapons for export. Foreign sales now account for a significant percent of China's arms production (the actual figures are secret). Bombs have not entirely been replaced by bicycles; instead, China has become one of the world's biggest arms producers. In fact, former enemies Russia and China have discussed the sale of state-of-the-art Russian arms technology to China, so that the latter can manufacture more sophisticated weapons to sell throughout the world.

But it is crucial to bear in mind that China's military-to-civilian conversion program is easily reversible. The central government has both the power and the capacity to change course and will surely do so if circumstances dictate.

The next step in the country's ongoing metamorphosis was opening China to outsiders—tourists, investors, traders, teachers—and, likewise, opening the world to the Chinese people. By the time of my second trip in 1988, China was earning close to $2 billion a year from tourists, who arrived by train, plane, and cruise ship. Tens of thousands of Chinese, including the children of party officials, factory workers, and farmers alike, were (and continue to be) enrolled in U.S. colleges. Thousands more were studying in other Western countries, and most, if not all, will return home with changed perspectives of the world and what China's role in it should be. New and radically different books, movies, and art were now appearing in China, reflecting the sudden influx of fresh ideas into this long-isolated culture.

It was indisputable that by 1988, nine years after economic reform began and eight years after my initial trip to the People's Republic, China had made impressive progress. Despite the fact that China's

One view of life in Beijing's Liu Li ("Antique") Street.

One of the smaller merchants in Liu Li Street.

Larry Speidell and Yin Yafei shop in Liu Li Street, looking for more unusual items than are available at the Friendship Store, which caters exclusively to foreigners.

At this television tube manufacturing company in Shanghai . . .

. . . we viewed its production facilities . . .

. . . and inventory waiting for shipment. This company is one of the many that contribute to China's growing trade surplus.

leaders continued to deny that it was abandoning communism, the country was quietly becoming a capitalist society in which the free market model offered optimistic promise.

The question I confronted as I sat through the International Finance Corporation conference in 1988 was whether the time was now ripe to invest in China; the question remained with me on the plane ride home. I tried to make sense of everything I had seen, heard, and felt on the streets, at the conference, and in the various enterprises I visited. Clearly the country was awakening. The atmosphere was vibrant with energy and purpose. My impulse at the conference was, of course, the contrarian one since no one else seemed interested in investing in China at that time. While this could certainly mean that the majority was wrong, I knew that going against the majority can be just as automatic as following it. I knew I had to decide for myself.

As the plane neared the United States, I began jotting down ideas. First, I noted, the government not only was sincere about moving China toward some version of a market-based economy, it had already shown that it could competently and confidently do so. When Deng first rolled up his sleeves in 1979, state-owned businesses accounted for more than 90 percent of industrial output. In 1988, that figure had dropped to 63 percent. By the end of 1991, it would fall to 50 percent. At the same time, per capita income almost doubled. Numbers like these are impressive to any investor.

Second, the Chinese, in contrast to the East Europeans and Russians, boasted an economy that was open to the outside world. Its trade surplus with the United States was then approaching $8 billion. Also, Hong Kong, Taiwan, and the rest of the overseas Chinese community comprised ready-made sources of investment and commercial tutelage that much of the developing world could only envy.

Third, I reminded myself, the entire workforce was animated by the ambitions and expectations of the private sector. China's huge consumer market had blossomed with astonishing speed. Scores of U.S.-based consumer giants were doing booming businesses in everything from shampoo to baby food. On my notepad were the words of one Chinese economist I met, who said, "Everybody—army and party people and state factory managers, as well as entrepreneurs—wants to make money."

My fourth reason for being bullishly enthusiastic toward Chinese investments was that, viewed as an extension of the Pacific Rim (where Western investors have long held a significant stake), China didn't really

A continuing theme, shown on this billboard in Beijing: "Continuing economic reform and open markets. Building socialism with Chinese characteristics."

seem so remote after all. Moreover, Asia was sprinkled with examples—South Korea comes immediately to mind—of one-party regimes that have presided over long-term economic miracles. China could achieve prosperity as well, I decided, without totally overthrowing traditional communist rule.

Fifth, Chinese currency was convertible into other currencies, meaning investors could move their profits out. This was not necessarily the case in much of Eastern Europe or in the then Soviet Union.

The prospects for profit seemed favorable. Chinese businesses were doing well. Their earnings were increasing and—bottom line—investors could make money.

So I thought, why not create a special investment fund earmarked for China? First, of course, we would have to research the field thoroughly, a task that I could already see performed well by Larry Speidell, then the number two person at Batterymarch. We, too, would proceed like the Chinese, by small deliberate steps. As our plane circled Hanscom Field, west of Boston, the decision was made.

Later, when clients expressed concern about investing in this emerging market, I would tell them the story of the two shoe salesmen from different companies who were sent into the Amazon jungle. One wired his office: “Get me home! No one wears shoes. No chance for sales.” The second salesman telegraphed:, “Great opportunity! Everybody barefoot. Send stock. We can corner market.”

That was always good for a laugh, but to get the last laugh I would have to make some real money.

CHAPTER TWELVE

Flowers on an Iron Tree

FLYING INTO HONG KONG is breathtaking. On a clear night you can see the city's lights glittering like diamonds on black velvet from more than 200 miles away. Before the 1998 opening of the new Hong Kong International Airport on the island of Chek Lap Kok, 24 miles west of Hong Kong's central district, flights landed at Kai Tak International Airport on the Kowloon peninsula. Descending over the inner harbor, incoming passengers would swoop over an armada of giant supertankers and small Chinese junks.

Landing in Hong Kong, and I speak now as someone who learned to fly planes as a young man, was one of the scariest touchdowns this side of a moon mission. Planes did not fly directly to the Kai Tak airport. First they would cross the city, at window level with high-rise apartment buildings, heading for a large red-and-white checkerboard target on a nearby hillside, instead of for their touchdown point. Then, just before a plane would crash into the hill, the pilot would execute a sharp 47-degree right turn to line up with the runway and quickly drop the plane the remaining 675 feet to the ground.

When I landed in Hong Kong in April 1991, it had been nearly three years since my last trip to China. In the interim, the Chinese had been busy creating public stock markets so that investors could participate in,

Hong Kong harbor from the Grand Hyatt Hotel.

and help finance, its burgeoning capitalism. Batterymarch had been at work setting up its China fund for client investors. Unlike our work in Russia, we did not establish an office in China. Making frequent trips to China, I was "learning the territory" and beginning to understand the thinking of government and business leaders, while Larry Speidell and Yin Yafei were scouting attractive companies; meanwhile, our staff in Boston was developing the legal framework for the fund. It was time to bring the results of our respective efforts together.

With a number of promising Chinese enterprises about to go public, I wanted to see for myself those "flowers on an iron tree," to use a Chinese saying that refers to a hardwood tree native to southeast China that blossoms once every 60 years.

Sleek and stylish though it is, Hong Kong is all business. The world's twelfth largest trading power and one of the top four financial centers, it leads the world in clothing exports and produces more watches than any other place in the world. Totaling only 1,070 square kilometers, Hong Kong is unmistakably Chinese in character. (In 1997, adhering to its negotiated treaty, Great Britain returned the city to the People's Republic; thus, Hong Kong is no longer a colony of the Crown.) An old saying has it that Hong Kong found the perfect formula for success: British police and Chinese merchants, which means that the police weren't bullies or bribe takers, and the merchants knew how to make an economy work. In other words, the system was one of law and order, but without a heavy hand.

Almost everyone shared in the prosperity and did so without socialist central planning.

Hong Kong is certainly one of the handsomest cities in the world. Wrapped in modernistic looping freeways, its skyscrapers fan out, one from the other, in an unbroken line, which is uniquely different from the peaks and valleys of Manhattan's skyline. It seems that almost everyone walking on the sidewalk is talking on a mobile phone. The streets belong to the old British double-decker buses, ironclad and riveted like World War I battleships. But a swift, clean, and efficient subway system runs under the city. A pleasant feverishness penetrates the air; Hong Kong lives for today, satisfied in its independence.

During this visit in 1991, fashionable cafés had the date "1997" on their coasters. Though some people insisted that the transition would make no difference—and, ultimately, it did not—the date had acquired some of the mythic significance of George Orwell's *1984*. Having anticipated the date, many salted their wealth away and lived abroad long enough to acquire foreign citizenship and foreign passports, and then returned to Hong Kong. Some people viewed the transition as a blessing, because at least the "Brits" would be gone. Yet, for all their insouciance and assurances at the time, I detected anxiety beneath the surface. A way of life seemed to be coming to an end, and uncertainty was the mode and the mood.

On the morning after my flight, Larry Speidell and I were driven to Shenzhen, which is about 90 minutes out of Hong Kong across the Chinese border. I was immediately struck by how much more convenient it was for business visitors in China than it had been in Russia. In 1990, as an official guest of the Gorbachev government, I was forced to present my travel documents for inspection at every conceivable opportunity. In China, as guests of a private company in Shenzhen, we experienced no such nuisance, even when crossing an international border.

Any U.S. public relations firm would have been proud of the glossy, full-color annual report, printed in both Chinese and English, that was placed in the car for us to read during the ride. The brochure opened with a letter from Mr. Ma Fu Yuan, the chairman of Shenzhen Electronics: "In the upsurge tide of China's reform and opening to the outside world, Shenzhen Electronics Group (SEG) emerged as the times required. . . . SEG has been growing steadily in its exploration to develop an export-oriented economy and to establish a socialist group corporation."

That phrase "socialist group corporation" jumped out at me immediately. Though I wasn't sure what it meant, it was clear to me that something new was happening here. Little more than a sleepy border town until a few years ago, Shenzhen had become a vigorous and thriving city in one of the special economic zones of coastal China. Joint-venture capital from Hong Kong and Macao made a visible impact.

Larry and I paused to check into the Fulin Hotel, a typical glass-towered, Western-style hotel, before continuing to Shenzhen Electronics for a formal welcoming ceremony. If we needed proof that change was underway in the Chinese provinces, we had only to look out of the window. The entire town seemed under construction. Larry remarked on the number of tall buildings that had not been here when he visited only a year before; he noted, too, that if Shenzhen had a zoning plan, its constraints were few.

We drove past apartment buildings, office towers, restaurants (including China's first McDonald's), karaoke lounges, movie theaters, and a train station on the Hong Kong–Guangzhou (Canton) line. Enormous luxury hotels designed with traveling businesspeople in mind had appeared all over the city—one of them topped, inevitably, by a revolving lounge.

Traffic in Shenzhen was, and continues to be, terrible. The streets are filled with a dangerous mix of cars, trucks, buses, and bicycles, all sharing the available roadway at different velocities. Accidents are commonplace; I grew accustomed to seeing one a day, often more. I also got used to seeing the people of Shenzhen dressed in Western-style clothes: dark business suits with white shirts for the men, Western-style skirts and usually white blouses for the women, T-shirts and blue jeans on the teenagers, none of whom were wearing the blue peasant suits common to rural China. Moreover, with its accent on youth, anyone older than 30 in Shenzhen is considered a senior citizen. The modern Chinese believe that the young work harder and are not politicized in the way the preceding generation was.

Shenzhen is a late-twentieth-century gold-rush town, attracting fortune hunters from all over China. The rush now is not for gold, but for economic freedom. In a city where the entrepreneurial spirit is cultivated, a person such as Shenzhen Electronics' Mr. Ma Fu Yuan can find capital, labor, and an export market. In addition, there is a circle of global-thinking businesspeople—"capitalist roaders" as they were called during the Cultural Revolution.

We arrived at Shenzhen Electronics in time to meet Mr. Ma and some of his associates for lunch. As we were to learn, the business lunch is the meal that matters. The Chinese have yet to discover the power of breakfast and, unless something is being celebrated, the people with whom we were working prefer a quick, light, and early dinner. Business cards are presented on all possible occasions, and the traveler is advised to have a good supply—bilingual, of course. We took our places at round tables, where, as tradition dictated, we were assigned our seating by rank. Food was placed at the center of the tables, and each dish was described by the host, who at my table was Mr. Ma himself. This was an opportunity to do what I call "face investing."

As in the Soviet Union, the criteria I used to analyze the investment possibilities in China were, for the most part, the same as those I use to evaluate potential investments in any emerging industrial country, such as Argentina or Brazil. I was looking for world-class companies that I want to see with my own eyes, not read about from a spreadsheet. The only way to get a feel for the directors' psychology and the range of their thinking is to meet and talk with them face-to-face.

In Chile, a vintner I know, whose firm is called Concho y Toro, produces wine from the perspective that he is competing with the best in the world, even though until recently he was selling only to the local market. Someday, he thinks, his label will be as well known as Pouilly-Fuissé and Nuits St. George.

In Brazil, I investigated a company that made shock absorbers and engine blocks, relatively prosaic stuff. The company sold to 60 different markets, and in each market it composed its correspondence in the language of the country, even if the customers replied in Portuguese or English. That is a sign of a world-class company.

In "face investing," you have to look with a very discerning eye; appearances can be deceiving. In France, for many years the most elegant mansions and châteaux had shabby and neglected exteriors, because the tax assessor, who was not allowed inside, had to estimate property values from the lawn. So it is with many companies in countries such as India and Chile: The prosperous interior of the company may not be apparent in the accounting exterior so as to protect the business from the tax collector. In addition, companies may be financed internally or by debt. Any or all of these circumstances will make a company want to fudge its earning figures downward.

Only when there are well-developed stock exchanges or public markets do the numbers offer reliable clues to a company's success. Usually an American company wants its numbers to reflect its success in order to prepare the way for new stock issues. My general rule is that, both in the United States and abroad, accounting figures are always suspect as a yardstick of company performance. At worst the numbers lie; at best they mislead by lagging reality.

When I was a young analyst, I examined a company in which the numbers were a blatant lie. It was a printing machine outfit operating three shifts per day and selling everything it made. Its profit figures made the company look like a very good one. The problem was that it shipped to a distribution subsidiary across the street, whose warehouse was full of unsold printing machines. Deliberately, the management had not consolidated the subsidiary's accounts with the parent's, which was an intentional misrepresentation.

More often, accounting numbers simply mislead, as they did at an insurance company in which Batterymarch invested. Every year for five years the company's adjusted earnings figure rose by 10 percent or more. Real profitability, however, actually declined in each of those years. The truth lay in the numbers, provided you knew where to look. Management took reserves from various accounts to boost the company's reported earnings, and assumed each year that it could replenish those reserves with the following year's profits.

However, numbers often lag behind the events of life. Even when there is no intent to lie or even obscure the truth, accountants often have no way of indicating changes in the company that will eventually affect its growth and profitability. For example: The founder of one company in which Batterymarch invested died and left control split equally among three people in the next generation. The momentum of the business carried it for a few years and its earnings remained unchanged. For quite some time no numbers were able to indicate the growing disagreement that was splitting the new management and would eventually leave the company a shadow of its former self.

The accounting figures will lag even when there are no obvious changes within a company. When a business reports its earnings per share, it is logical for an investor to assume that this figure represents cash in the till that could be used either to pay dividends or to reinvest in the business. Actually, earnings per share often include an accountant's *estimate* of cash to be received. Insurance and leasing companies routinely and, according to accounting conventions, correctly include projected cash in their current earnings. But you can't spend projected money; therefore, if when the actual cash is received it falls short of what has been projected, the investors have unwittingly allowed themselves to be misled.

Competent management was another criterion in evaluating potential investments in developing countries. Mr. Ma, who was once a deputy minister of electronics for the Chinese government, decided that the future lay in the private sector. He told me, without elaborating, that five years after taking his government post, he became head of China's largest electronics company. He moved the company from Beijing to Shenzhen, because he wanted to be closer to Hong Kong; in addition, the Chinese government had designated Shenzhen as a special economic zone where companies were encouraged to experiment with Western-style business practices.

By the time Mr. Ma and I met, the company, now called Shenzhen Electronics Group, employed 30,000 workers to produce goods ranging from very low-tech kitchen appliances to extremely sophisticated integrated circuits. Ma planned to manufacture these circuits in Hong Kong, even though wages there were three to five times higher than in China; and he had good reason. Integrated circuits made in Hong Kong were not subject to the defense-related restrictions imposed by Japan, the United States, and most European countries. Moreover, he said, the manufacturing technology he needed was available in Hong Kong. He was also negotiating for Shenzhen Electronics to buy a plant in Mexico and eventually would export semiconductors to the United States.

Ma Fu Yuan was clearly an entrepreneur who thought in global terms. I knew I wanted to invest in his ventures. When the time seemed appropriate, I asked Mr. Ma what parts of his company he thought would offer stock for sale and at what price. He stopped me, gently but firmly. "Mr. LeBaron," he said softly, "we have a developing friendship. It is important that we understand each other very well and deepen our understanding before we talk business."

That he was doing his own research impressed me. He wondered how I came to be interested in the investment potential in both China and the Soviet Union. I did my best to answer, outlining the opportunities I saw in the two non-Western superpowers. My remarks about the Soviet Union, he said, reminded him of a trip he took to Hungary, where he saw black-and-white television sets being sold for the equivalent of $10 each.

"Well," he said, lifting his arms expansively, "we can make them in China for $2. Therefore, we should be exporting our black-and-white televisions to Hungary and other Eastern European countries."

When he asked me about Russian labor costs, I said they were as low as in China. Again, the expansive arm gesture. "Well, maybe we should buy a factory in Russia and make televisions there to ship to Eastern Europe," he said.

It was a very interesting remark, and it showed how little he understood about Russia or the Russians. What is immediately noticeable about China is that no one stands still. Everyone moves and works all the time,

Dinner at the Grand Hyatt in Hong Kong with Ma Fu Yuan, chairman of Shenzhen Electronics, and his son, David Ma (right, standing).

in striking contrast to Russia, where you often see people standing around doing nothing. My impression is that regarding their accomplishments the Chinese are humble. Though they are confident of their own abilities, they understate them. Yafei once commented, "When Chinese people say they can do one thing, they can do two. When Americans say they can do two things, they can do one." I would add: When the Russians say they can do a dozen things, they can do one. If the Chinese undersell, the Russians oversell. It is the difference between a real poker player and a bluffer.

Many Chinese companies are experiencing increased success in trade and merchandising, reflected in the fact that clothes made in that country can be found everywhere in the world. Still, behind that success remains the terrible exploitation that provoked Karl Marx to denounce certain workers' conditions. The factories producing those lovely cotton garments are, in fact, sweatshops. The light industries, such as clothing manufacturing, employ predominantly women who work long hours under great pressure. In these modern-day sweatshops, which are crowded, often noisy, and far from spotless, workers put in 12-hour days with few, if any, breaks. Ruthless employers demand that employees stick to the work and are equally ruthless about firing them if they don't.

Unlike the Russians who have conflicts with both imitating the West and accommodating Western visitors, the Chinese have no such difficulties. At Baoshan Steel in Shanghai (the fourth largest steel plant in the world and one designed to produce minimal pollution), the mill buildings were separated by attractive green lawns and flower beds. I knew that the management wasn't especially interested in horticulture, but they did want to impress their Western visitors who were considering buying the company's steel or investing in its production facility. Reflecting marketing savvy, Baoshan Steel even built its own hotel, which allowed the company extended opportunities to impress foreign guests. At the same time, the arrangement gave the company more control over its visitors' schedules and their exposure to the plant.

While most educated Chinese were aware of their people's technological achievements in the distant past, they also knew that China had been technologically backward in the twentieth century. This explained, in part, why the Chinese were so unabashed about borrowing successful ideas and methods. I didn't doubt that they would evolve their own

My Batterymarch colleague, Larry Speidell, is accompanied by George Russell (right, from Frank Russell Company) at Baoshan Steel in Shanghai.

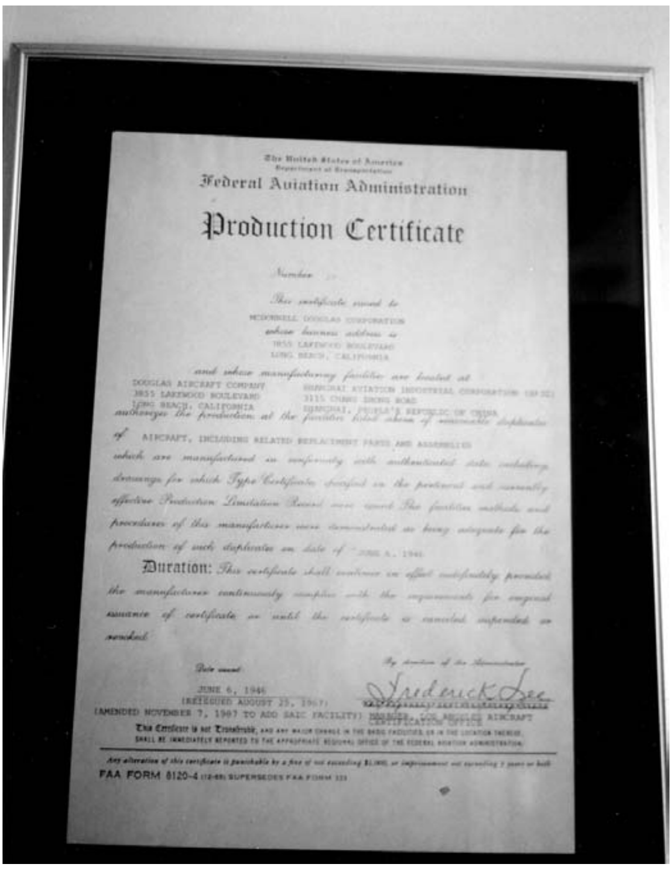
brand of capitalism as time went on, but, at the time, they were content to observe and copy the technology and business organization that they saw in Singapore and the United States.

That process of imitating became almost comical later when I visited the Shanghai Aviation Company plant. Shanghai Aviation has a joint-venture contract with McDonnell Douglas to manufacture the MD-82 aircraft, a short- to medium-range commercial jet similar to a DC-9 or a 737. McDonnell Douglas invited several dozen of Shanghai Aviation's best technicians to Long Beach, California, for training. The technicians then returned to China to build an exact replica of McDonnell Douglas' plant outside of Shanghai. It is identical down to and including the inventory

A mission statement at Shanghai Aviation Company stresses: "Quality. Management. Hard work. Best efforts. Goal."

forms and the tool crib slips. Perhaps they did their job too well since they put the tool crib on the wrong side of the plant, just as it is in the U.S. facility. When I saw that workers have to run all the way across the plant to get tools, I asked why they hadn't put it closer to the work. "Oh, no," they said, "that's not the way it is at Long Beach."

The quality control signs on the wall were in English: "Make every airplane as if your mother were going to fly in it. Each rivet has your initials on it." "Most of your workers can't read English," I noted to the plant manager. "Yes," he replied, "but the FAA inspectors can." Federal



This FAA production certificate is Shanghai Aviation Company's ticket to the export market.

Aviation Administration (FAA) certification is both hard to get and expensive. You have to dissect the planes for minute inspections, and some of them must be crash tested. The Shanghai Aviation people were understandably proud of passing the test, especially because doing so allowed the plant to sell half of its 24-plane annual production outside of China.

There are three parts to an aircraft—the airframe, the engines, and the avionics—and the cost of each part is roughly a third of the total.

The company is proud of the fact that it made a few copies of a jetliner that was entirely designed and built by the Chinese, including the engine. Twenty years ago this was a huge accomplishment, and Shanghai Aviation still has one of these planes to show to visitors. Perhaps it didn't sell, they say, but it got off the ground, which boosted morale for people who were used to thinking of themselves as the technology-poor country cousins to the Russians.

About 10 years ago the company started to manufacture components for McDonnell Douglas. Seeking any kind of business relationship with the West, it made wing and tail parts, no doubt at a very low cost.

The tour of Shanghai Aviation reminded me of a common fallacy: that a low labor-cost environment with many semiskilled workers can't use sophisticated technology. What this overlooks is the tried-and-true principle of standardization. Machinery makes standardization possible, and standardization makes quality possible, as well.

Henry Ford used machine operations in assembly lines because he aimed at standardization, and, without quite realizing how it happened, he achieved lower costs in the process. Ford did not intend to make a car that everyone could afford. Before he came to Dearborn, a car could break down and need a hand-machined part to fix it. Henry Ford's genius was discovering that standardizing parts led to higher reliability and easier part replacement in the field, as well as quality control.

Indeed, the workers at Shanghai Aviation were using many sophisticated machines. In Russia, which is another low labor-cost environment, many people still work with hand tools.

Shanghai Aviation impressed me in the same way Shenzhen Electronics and Baoshan Steel had. The Chinese operating these enterprises have relinquished any false pride in order to learn from the West everything necessary to establish their businesses in the international markets. Many of the Russians I met were, in contrast, too arrogant or too insecure to copy from the West; they were more concerned with inventing enterprises and systems that were distinctly Russian than in adopting proven Western practices.

The Chinese, who are trying to make their way by copying successful business methods, will have their brand of capitalism—capitalism with socialist characteristics—and they talk about it. They are heavily influenced by relationships with people in Hong Kong and Taiwan. They are not trying to develop a unique "P.R.C." spin on business. They want to follow the model of their capitalist brothers and sisters in Hong Kong and Taiwan.

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AS SOON AS MR. MA took me there the following day, I knew that the Splendid China Theme Park would be my favorite tourist trap in all the world. "This is not just for amusement," he assured me through the interpreter, "but an opportunity to see all of China without leaving Shenzhen."

Though Mr. Ma laughed as he said it, he wasn't joking. Within the gates of this miniaturized world lay the Great Wall, the Forbidden City, the Ming Tombs, and 60 or 70 other attractions, all modeled at a little less than one inch to the foot. Maps in hand, we became transcontinental explorers capable of "discovering" the Yangtze Gorges, the Stone Forest

Entrance to my all-time favorite, the Splendid China Theme Park in Shenzhen.

One of the fantastic scale models at Splendid China Theme Park, "The Great Wall of China."

of Yunnan, and other natural and artificial wonders of the enormous country. It took only a minute or so to walk from one to the next. Like modern Gullivers, we surveyed a Lilliputian replica of the terra-cotta army of Xian. Each of the hundreds of ceramic soldiers had been painstakingly cast, and the artistry here, as in all of the park's exhibits, was breathtaking.

The longer we spent in this incredible place, the more I came to understand why Mr. Ma was so intent upon my seeing it. Despite the hordes of tourists and schoolchildren who visited the park to learn Chinese history and geography, this was not just an outdoor museum. Entertainment and celebrations of commerce were inherent in the individual presentations of the exhibits. From the admission gates to the small food booths and restaurants dotting the park complex, money was exchanged and, presumably, profits were made.

When I asked Mr. Ma to explain the government's reasoning in establishing this miniature wonderland, he swiftly corrected me. "Not the government," he said. "This is the work of one man, a single entrepreneur." So this was someone's dream of a commercial venture, I thought, no longer puzzled as to why the only attraction that was reproduced life-size was the Old Suzhou Shopping Street.

I would encounter other puzzling developments soon enough. At 9:00 on a Sunday morning in early May, Larry, Yafei, and I left for Shekou Industrial Zone, which is within Shenzhen City (and still in China), but only across the harbor from Hong Kong. We went at the invitation of China Merchants Holding Company, a state-owned conglomerate (with a base in Hong Kong) that is a major participant, often with global partners, in such diverse fields as shipping, aviation, port development, and the development of Shekou.

Part of Shekou is built to resemble a New England village. Its developers, headed by a man named Yu Wan, knew they would need foreign experts as advisers, and that the foreigners would want their familiar amenities, such as clean water, telephones, a cinema, and a bowling alley. So the Chinese built a compound specifically to house them.

Using a photograph of a New England village as their model, they constructed an exact copy of the white houses around the village green, and of a larger white building with a tower. They didn't know it, but that was the church.

Steven Fang, assistant to the chairman of China Merchants Holding Company and a former intern at Batterymarch, provides an overview from a scale model of Shekou Industrial Zone in Shenzhen.

We can laugh at their naïveté, but not at their intention. Knowing that they would need help, the Chinese tried (successfully) to create an environment that would be attractive and welcoming to the people who could help them. This reflects a vastly more sophisticated and pragmatic approach than that taken by the Russians, who have done relatively little to make their country amenable to Western advisers and experts.

At mid-morning the three of us arrived at China Merchants' office building in Shekou for a briefing. There two men, to whom we were not introduced, approached Yafei. They were polite but serious as they asked her to come with them for a talk while Larry and I were briefed. Yafei agreed and left; the briefing continued. When after some time I asked when she was coming back, our hosts grew quite nervous. There may have been some "irregularities in her procedures," they said. I insisted on seeing her.

Yafei stepped out of the office in which she was being questioned. Everything is fine, she said. No problem. We should go on with our briefing and tour. Two hours later I insisted upon seeing her again.

"There's a problem," she said this time, "and there are going to be more questions. You go ahead and do your own program."

"No," I said, "we arrived together; we'll stay together. The program stops here if you don't come with us."

"Please," Yafei said, "that will only make things worse."

We agreed on the condition that Yafei be allowed to call us every hour; she and her interrogators agreed.

If Yafei's detention wasn't strange enough, considering the context of our visit, the next stop on our agenda proved almost stranger. We requested an opportunity to visit a Chinese family and left the selection to the Shekou officials.

Their choice was peculiar.

We met a husband and wife and their two children, a boy and girl. The man had been head of Shenzhen Life Insurance, but was fired, he said, for associating too much with Westerners. During our meeting he had only criticism for the national regime in Beijing and the local party heads in Shenzhen for their political repression. His son had ambitions of attending an American university. Clearly, this was not the all-Chinese family I had hoped to meet, and if our hosts had a reason for their choice I never learned it.

It was late afternoon by now and Yafei hadn't called. "The program stops," I told our host from China Merchants. "We're going back to our hotel and stay there until we hear from our colleague."

A weeping Yafei telephoned that evening from a detention center. She said we could probably see her tomorrow.

The next morning I contacted Yafei's former boss, the American head of an American-Chinese joint-venture chemical company. Before coming to the United States, Yafei was the top Chinese person in that venture. Her former boss had been in China for six years, and I thought he could help; but he refused. "Once these things happen among the Chinese," he said, "a Westerner pulls back. They have to solve their own problems."

Yafei was kept in a house surrounded by a fence with a guard post. We weren't permitted inside, and the official we spoke with first refused to permit her to come out. Then he relented. Yafei's sister was with us, and she brought her some clothes. It was a tense moment as Yafei was led out to the guard post. Her sister was crying, and Yafei was clearly afraid. Her crime? She was accused of forging her passport; we found out later that the problem was caused by an administrative error made at the Chinese consulate in New York.

At Yafei's insistence, Larry and I went on to Shanghai, then returned to Hong Kong, where I threw a small, deliberate fit for one of China Merchants' officials to dramatize my outrage. It was, my friend and interpreter told me, the right thing to do and gained me a greater measure of respect in the eyes of the China Merchants official. Whether it affected the timing of Yafei's release I will never know. In any case, clearing her of the charge took four weeks and the intercession of the American consulate. She was essentially under house arrest for that entire time.

The whole incident brought home something I was aware of but had not yet confronted directly. Like most of the world, I had seen the television images of Tiananmen Square, the touchingly crude Statue of Liberty, the beauty of people speaking freely for the first time, the tanks, troops, fire, and blood.

Deng chose economic liberalization and demanded that it be accepted without challenge from the political arena. Or, to put it more directly, China was still a Communist dictatorship. People had no civil rights, and anything that resembled them could be plucked away in a second. Though it made for very bad press, the Chinese Communists had no intention of following Gorbachev, who appeared to lose in power what he gained in world approval. That the world was distraught about Tiananmen Square or that a Western businessman was upset and worried when his employee was detained was of no interest to them.

Some months after the incident involving Yafei, I would become better acquainted with Yuan Geng, chairman of China Merchants. Mr. Yuan is well regarded as an influential contributor to economic reform in China.

Perhaps I should have been more prepared for these dramatic realities. My meetings with "Carlos," a multilingual Chinese intellectual who waits for Westerners at the embankment along the Bund, hinted at this kind of oppression. Metaphorically, the embankment is the perfect place for him: On one side of the river are the solid, stately buildings of the colonial past; on the other side, the booming new development of Pudong. He belongs to neither. In fact, Carlos represents what could be called the "double loser" in the current transition. A member of the intelligentsia—a writer and translator—he suffered during the Cultural Revolution. Exiled to the countryside, the euphemism the Chinese prefer both to conceal and to suggest a multitude of sufferings, he retained his acuity during his years of isolation by learning language after language. His Spanish is especially impressive, and his English, though choppy, is fluent and intelligent. Yet what Carlos longed to do with all his heart was write an important novel about modern China.

"I wrote one," he said, "but I burned it. It was too dangerous to even have around, let alone show to somebody. And what I want to write still can't be written. Still is too dangerous."

Interestingly, Carlos' books would have been impossible within China's former ideology, and they still remain infeasible, but for different reasons. Under Mao, and especially during the Cultural Revolution, his work would have been viewed as blasphemy and sacrilege. Now that there is nothing left to blaspheme, his novels would be perceived as a challenge to the power structure and to particular authorities whose response would be as harsh and zealous as Mao's. And, perhaps even worse, it is certainly possible that readers would reject Carlos' message. In the new China, people are so consumed with the pursuit of wealth that they have no time for reflection and resistance. And so, under both systems, he has had to remain silent and take refuge in the ancient classics, which he teaches at the university for the astonishingly small sum of 400 yuan a month. This amount, equal to about U.S. $50 in 1995, is lean even by Chinese standards; it forces Carlos to share a room with seven other people, most (but not all) members of his family, and to share a kitchen and bathroom with numerous strangers living in other rooms of a once grand private apartment. Although ancient Chinese wisdom describes the ideal family as five generations living under one roof, the sages most likely did not envision them all in one room.

A series of clever partitions has made the space habitable, and it does possess one great advantage in that it is relatively close to downtown Shanghai. That means only one or two rides on Chinese buses, which are immense, filthy, and packed; I saw passengers looking out the windows with the mournful eyes of cattle being trucked to slaughter.

However, Carlos has received notification from the municipal housing agency, which owns his apartment, that in six weeks he will be relocated to a two-room apartment with its own kitchen and bath. That's the good news. The bad is that the apartment is in one of the shoddy concrete buildings on the outskirts of Shanghai, which may feel to him as though he is being exiled once again. After he moves, Carlos will have to travel for hours to reach the Bund so he can find a Westerner with whom he can speak freely in a foreign language. Many transfers, many buses. Carlos has made inquiries and learned that his current building has been bought by a developer, a "big Hong Kong boss." That means that both the Communist Party in the form of the municipal housing agency and the uncontrolled tide of capitalist development have merged against him. Against such a force no individual person has a chance.

The Shanghai bus network is overworked and overloaded.

It was critical for us to know how the Chinese authorities treated people like Carlos, Yafei, and the young democrats of Tiananmen Square. It is always important to know as much as you can about all aspects of the people with whom you are dealing. Since I am an American and a staunch proponent of all personal, political, and economic freedoms, I can't feel good about dealing with a state that suppresses its citizens' liberties.

So I had to root for the Russians who, in typical grand Russian style, were going for everything at once: a free market *and* a free society. The arguments against this were clear. Though the Russians weren't exactly failing, they were hardly succeeding. One could interpret that to mean that the Chinese approach was, ultimately, wiser and therefore more humane.

Another rationalization was that in China the older generation would soon be dying, and the new, younger leaders would be more liberal. But of course there was no guarantee of that. If I wanted to, I could remind myself that my own government continues to grant China "most favored nation" status in trade.

Thinking of the Chinese saying that a rare event is like flowers

In Shekou, Steven Fang (right) with the vice mayor of Shenzhen. I believe these young liberals will favorably influence China's future.

blossoming on an iron tree, I realized that I had been too busy examining the blossoms to anticipate that hard iron tree. Sooner or later, any conscientious American doing business in China must confront the ugly fact that it is a police state. My time had come. After all was said and done, when I sorted through all my conflicting thoughts and feelings, I faced a choice: in or out. I was in.

CHAPTER THIRTEEN

The Best Doctor

There is an old Chinese story about a lord who asked his court physician, whose brothers also practiced medicine: "Who is the most skillful among you?" The physician replied: "My eldest brother cures sickness when it is only a look in the eye, so his fame is very small. My next oldest brother cures sickness when it has just started, so he is known in several villages. But I, who treat terrible illnesses by bleeding patients and prescribing potions, am known throughout the land."

This old Taoist tale appeals to my contrarian instincts, though here the idea is not to buck trends as to catch them when they start. It was clear to me that the trends emerging in China would serve the investor who could foresee the pattern before it was obvious to all. I want to emphasize the idea of a pattern. It is crucial that one does not become distracted by particular events, whether they are the tragedy of Tiananmen Square or the anguish of one person like Yin Yafei. There are no straight lines in history, and the new is never born without pain and dislocation. Don't mistake this realization as acceptance of callousness toward individual suffering or a whole people's thwarted aspirations. On the contrary, after her ordeal Yafei told me: "Of all the Chinese people I know, only my sister came to my aid. I had been taught to think that capitalists were interested in one thing—profit. But you were the only other person who cared about me, fought for me."

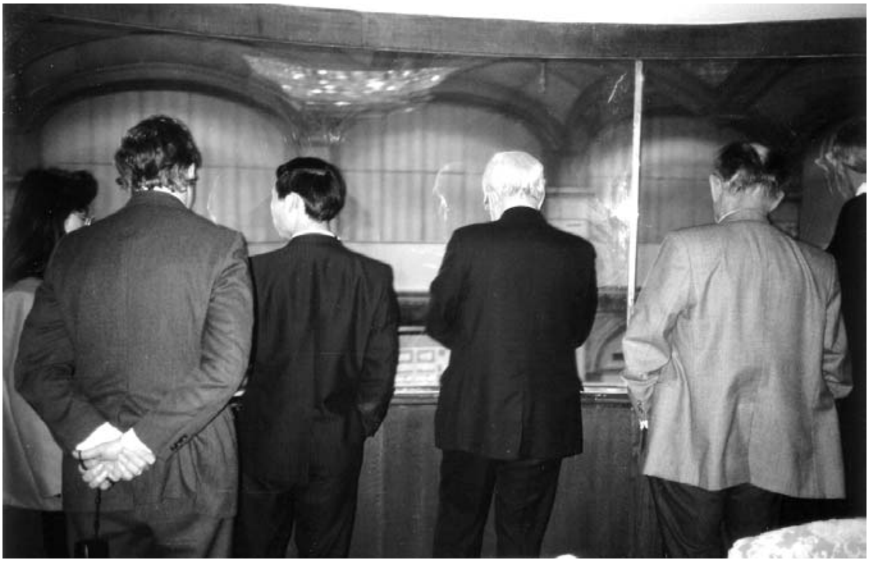
The 1989 Tiananmen Square massacre, which the Chinese refer to as the "June 4th events," was indeed shocking. Still, from an investment standpoint, the question continued: Was it an isolated occurrence or part of a pattern? If a pattern, foreign investors would be discouraged, and for good reason; they would be repelled by such overt violations of human rights and see them as a sign of the government's instability, since a political structure operating with the consent of the governed has no reason to resort to violence.

There were plenty of indications that severe political repression would remain possible. Immediately after the "June 4th events" the budget of the Security Ministry, the An Chuan Bo, was increased. Arrests, interrogations, and executions abounded. Amnesty International estimated that at least 5,000 and possibly as many as 20,000 people were put to death in China in the aftermath.

Censorship was enforced more tightly than ever. As they watched the news every evening, millions of Chinese noted that one of their favorite commentators, a young woman named Du Xian, was still not back on the air. She was fired for reading reports about the suppression of the Tiananmen Square demonstrations in a sad tone of voice. That was heresy in a country where implications of mood and meaning are so important.

Relations between the United States and China had become strained and tense. The United States suspended economic relations with China, halting trade bills and arms sales. Both countries danced a hostile minuet of diplomacy by first one, then the other, canceling the visits of senior officials. The atmosphere was murky and charged.

There were other signs, however, that indicated how things would progress. On July 3, 1991, three months after Yafei's arrest, the Shenzhen Stock Exchange officially opened. In itself, the existence of a stock exchange in a communist country is not automatically significant, which I discovered when we visited the Shanghai Stock Exchange shortly after it opened on December 19, 1990. At first I was quite taken with all the hustle and bustle on the trading floor. Using modern, computerized facilities, about 50 people were feverishly trading; clearly, this was not the New York Stock Exchange or the Paris Bourse. Still, at the time it was quite a sight. Our guide explained the scene, then led the group away. Something moved me to return to the observation area by myself. All of the activity on the floor had stopped and people were chatting or waiting around. Incredibly, all the flurry and frenzy had been a show put on for us. Good theater maybe, but not good capitalism.



In the visitors' gallery at the Shanghai Stock Exchange.

Company listings on the Shanghai Stock Exchange.

The Shenzhen Stock Exchange, however, was the real thing. Raring to go, it had started operations in December 1990, even before it was officially sanctioned, exhibiting what has become known in China as "Shenzhen speed." Formal sanction came seven months later.

The Shenzhen Stock Exchange listed five stocks representing companies in banking, trucking, textiles, and real estate development. Another 11 were expected to be listed quite soon, and 200 more were waiting in line. The volume of stock available for sale was severely limited, and demand was strong. That in itself attracted investors. The Chinese are estimated to have something like U.S. $200 billion in "under-the-mattress" savings, money the government would like to see back in circulation and used for capitalization, but there was no way the fledging stock market could absorb so much at once.

By the time the Shenzhen exchange opened, the Shanghai exchange had become more than an empty show. Once the seat of Asia's largest exchange, and the first to sell an over-the-counter stock in Communist China (Fei Lo Acoustics Company, in 1984), the Shanghai exchange was again, by 1991, a serious operation. Both exchanges have trading floors; Shanghai's is totally computerized, whereas Shenzhen prefers a combination of computers and paper. Shanghai's electronic dealing system has no backup, whereas in Shenzhen, if the computers go down prices are posted on a white board. Dealers stand on two patches of red carpet—buyers to the left, sellers to the right, gesturing frantically like Chicago's pit traders.

The government intended these two markets to operate identically, but differences developed quickly. Initially, Shanghai specialized in bonds, Shenzhen in stocks. Subsequently, Shanghai handled China's blue chips, mainly large state enterprises, which remained heavily dependent on government orders. Shenzhen handled smaller, entrepreneurial companies, which were largely dependent on the free market and on export competition. In addition, because it is so near Hong Kong, Shenzhen was the first to understand the importance of modern settlement systems, as well as other techniques to protect investors.

Although the initial listings were of A stocks, for Chinese nationals only, the market was not intended to be exclusively for Chinese. In time there would be B stocks as well, which could be purchased by foreigners, who would pay in foreign exchange for their local currency shares but earn dividends in foreign exchange.

There are several ways foreign investors would be able to participate. They could buy B shares directly from either the Shenzhen or the Shanghai exchanges or invest in B shares managed outside China. In

Investors in Shanghai track market activity.

Client Gordon Binns and colleague Tania Zouikin with Tony Town, the friendly and energetic head of a brokerage firm in Shenzhen.

In many levels of government, we would experience China's firm commitment to capital market development. In Shanghai, we meet with the vice mayor (center, front).

addition, investors could buy shares of Chinese companies listed on the Hong Kong stock exchange (H shares). Finally, a few Chinese-controlled companies have begun to appear on other major exchanges. For example, Brilliance China Automotive Holding, Ltd. (a manufacturer of minivans, incorporated in Bermuda) was one of the first to be listed on the New York Stock Exchange; it got off to a very good start.

It was clear that Batterymarch's investment strategy in China would differ markedly from what it had been in the Soviet Union. There, the effort was to find portions of companies whose products could compete in the world market. In China, we would probably be dealing directly with the stock exchanges once they listed enough stocks to create a diversified portfolio. On-site inspections and "face investing" were, as always, part of the approach, but other sources of information would be needed as well. The process of assessing a foreign country's business prospects was difficult under the best conditions, but understanding China, especially as the country experienced unprecedented transition, was like trying to learn Chinese without a teacher. If I had to sum up my credo on investing, it would be: innovate in the United States, imitate elsewhere. What

Batterymarch needed was a teacher, someone to help us imitate in China what we knew how to do in other markets.

The Chinese had anticipated this. In 1981, the government created an organization initially known as SITCO and later as SITICO (Shanghai International Trust and Investment Corporation). SITICO was China's first comprehensive financial and investment organization mandated to operate independently from the central planning system. Its original goal was the development of capital markets within China, but it quickly became apparent that it would have to function internationally. Headquartered in Shanghai, SITICO soon had offices in Tokyo, Hamburg, and San Francisco.

SITICO grew fast. Its *renminbi* capital increased from RMB 100 million to 1 billion (about U.S. $150 million) by the time the organization was celebrating its tenth anniversary in 1991. In its 10 years, it had raised $2.94 billion in overseas investment funds and attracted 67,000 visitors, mostly American and European, to China to conduct business. SITICO served as a consultant to companies such as 3M, Seagram, Bell Telephone, and Siemens. In January 1986, SITICO floated public bonds totaling 25 billion Japanese yen on the Tokyo Exchange and,

Our relationship with SITICO would be enduring—this was taken during a 1995 meeting at SITICO offices in Shanghai.

Early in our relationship, Bao Youde, chairman of SITICO, hosts a dinner in Shanghai.

two and a half years later, in June 1988, it floated public bonds worth 15 billion euro yen on the London Exchange.

Initially, the relationship between Batterymarch and SITICO was informal and friendly, as we engaged in what could be called a mutual education process. They taught us about China, and we taught them about international investment. For example, Yafei translated several basic documents for them, including "How to Read Financial Statements," put out by Merrill Lynch. In February 1991, the deputy director of the Shanghai Municipal Office for Economic Reform, Ms. Chen Yu, accompanied SITICO executives who were visiting Batterymarch in Boston.

During my trip to China in April and May 1991, I was invited to speak to a group of executives at SITICO. I discussed the dire predictions made by Barbara Ward nearly 30 years earlier in her book *Rich Nations, Poor Nations*, because I wanted to emphasize how much the world had changed since then. Previously discussed in Chapter 9, Ward's predictions of conflict did not theorize about the mutual benefit that could result if the rich nations and poor nations were to recognize that they do need each other: The former need markets, and the latter capital, know-how, and technology.

I laid particular stress on the globalization that has resulted from

A rare event, in retrospect, Batterymarch hosted a dinner in 1991 at the Bay Club, in Boston, for delegations from both Russia and China. Ms. Chen Yu (in the middle of the left frame, opposite Dean) heads the delegation from the Shanghai Municipal Office for Economic Reform.

electronic communications and electronic transfers of capital. Construction crews did not bring down the Berlin Wall; the television signals passing over it did. I also discussed a situation closer to home: Since travelers are restricted from bringing business papers over the border from the United States into Canada, we would routinely forward them electronically by satellite. At the heart of my message lay my belief that China could become a target for the kind of institutional funds that companies like Batterymarch managed, if it could create suitable conditions. The kind of variety in portfolio capital that Batterymarch offered would provide China with the rising, stable, and conservative base that was needed for its economic development over the next 5 to 10 years.

Contacts between SITICO and Batterymarch deepened in the course of the year. In July, Mr. Chen Dingping, one of SITICO's directors, an enthusiastic, professorial man in his 50s, who is quite fluent in English, came to Boston to attend a series of meetings on investment strategy, client relations, and trading. He also wanted to discuss our developing relationship.

The following month, Mr. Lou Jiwei, executive deputy director of the Shanghai Municipal Office for Economic Reform, visited me at my home in New Hampshire and helped arrange my next trip to China, which was scheduled to occur in March 1992.

SITICO then honored me with an invitation to the festivities celebrating its tenth anniversary. For the occasion the organization printed a 66-page bound book with color photographs and pie graphs reflecting its achievements during the decade. In a nice Chinese touch, a traditional

With Chen Dingping (right) in Batterymarch's conference room.

It was a fruitful week with Mr. Chen (center) during his visit to Batterymarch.

Lou Jiwei arrives on Lake Sunapee, New Hampshire, for a visit to assist with planning our next trip to China.

A brief respite for Lou Jiwei above Lake Sunapee.

painting—jade green mountains wrapped in mist—by one of the company's directors was included. Unfortunately, my schedule did not permit me to attend; as a sign of respect, one of Batterymarch's senior advisers, David Gill, went in my stead and spoke on "Financing Economic Development Zones: Lessons from Other Countries."

A special, intimate relationship was developing with SITICO, but we proceeded slowly and carefully. There was no rush since the B shares weren't due until 1992, and even then they would be very few in number. But that would change in time. The real questions were: When would sufficient B shares be available? And how does one become able to buy them?

Other, larger questions loomed as well. Between the two communist giants, when push came to shove, political struggles always took precedence over everything. China was keeping a very close eye on the Soviet Union. The Chinese considered Gorbachev responsible for "unprofitable disruption" since the "June 4th events" coincided with his visit to Beijing. Haunted by Mao's dictum "The Soviet Union's today is China's tomorrow," the Chinese leadership was, like everyone else, acutely aware of what was happening in the U.S.S.R.: a weakening of party control and a declining economy. This was not how China envisioned its own future.

Bao Youde, chairman of SITICO, with Batterymarch staff . . .

. . . and with Chen Dingping, visiting Harvard Square . . .

. . . and Harvard University in Cambridge, Massachusetts.

Deng had not hesitated to apply force at Tiananmen Square, and he quoted a cruel proverb in justification: "Kill a chicken to scare the monkeys."

The official line in China was "loose on the outside, tight on the inside." That meant the government wanted both to increase its political control and to speed up economic growth and reform. The Chinese wanted political stability *and* economic revolution. If this appears contradictory, remember that Chinese traditionally viewed the balance of opposing forces as the answer to the problems of life. Mao himself said that this was why Marxism, with all its talk of "contradictions" and "dialectics," was so congenial to the Chinese mind, which saw everything, from social unrest to physical disease, as a result of disharmony. In the process of reconciliation, opposites could easily acquire the features of each other. Mao went further: "There isn't anything that is not mutually transformable. . . . Life and death are mutually transformable." With and from this perspective, some Chinese could entertain the idea of communism transformed into capitalism while remaining politically communist.

Within the leadership there were hardliners, many of them octogenarians, who saw party control as paramount. Opposing them were

With two friends, Chen Yu and Lou Jiwei, at the Shanghai Municipal Office for Economic Reform.

those who viewed the party's role as that of promoter of a market economy; the second group was guided by a vision of the party achieving new legitimacy through prosperity. It is worth noting that there was no fundamental disagreement between these two forces about party supremacy. It was a given.

From my point of view, Soviet party control appeared shaky during the August 1991 coup attempt in Moscow. I did not share the elation of those who felt that these events had cleared the air, scattered the reactionaries, and created a favorable climate for doing business. The chickens of the G-7's failure to support Gorbachev had come home to roost, except now they looked more like buzzards.

I had to wonder how this Soviet shock wave would reverberate in China. Officially, the Chinese continued to pay lip service to Marxist doctrine. But, as one Chinese official quipped after returning from a trip to the Soviet Union: "Our policy is to talk all the time about socialism, while moving more and more toward the private sector. The Soviets are just the opposite. They're talking all the time about reform, but they still haven't changed anything. There, the state still owns everything."

Following my contrarian instincts, I was bearish on the Soviet Union, while majority opinion viewed the post-coup period as one favorable for investment. Also, I was bullish on China in this, its darkest moment in recent years.

It was not that I didn't recognize the trouble areas. According to the hardliners, China was facing potential threats to political stability. Under their centrally planned economy, citizens of China were guaranteed employment and salary, or what they called their "iron rice bowl." Socialist enterprises existed to employ and to produce; profit was not a goal. Security created stability. One-party rule and capitalism might be compatible, but a market economy was clearly the enemy of full employment.

Unemployment was inevitable, and so was a certain degree of social disruption. Though much of the population believed Deng's slogan—"To get rich is glorious"—many saw no chance to accomplish this for themselves. A popular ditty of the time expressed this sentiment: Before the Revolution we had a clay rice bowl, but Chairman Mao gave us an iron rice bowl; then Deng poked a hole in it, and since the reforms we've had a porcelain rice bowl. (A porcelain rice bowl may be more elegant than a clay one, but it is less durable than iron.)

Some Chinese did not confine themselves to song and humor. Strikes and sabotage increased. In one instance, a bank director, referred to in the Chinese press as a "daring reformer," acted without precedent when he dismissed employees he found incompetent or unproductive. In retaliation, one of them firebombed the director's house, severely wounding him, his wife, and their two children. The firebomber was sentenced to death.

Already, emergent capitalism accounted for increased crime and corruption. Narcotics and prostitution seem always to accompany capitalism. Though reprehensible, they are, undeniably, signs of enterprise. Shenzhen's hotels, karaoke bars, and massage parlors were reportedly inundated with prostitutes, mostly from Shanghai and farther north. In the summer of 1991, according to a dauntless *Forbes* correspondent, they were charging "$40 a trick, or almost two months' average wages in most of China."

Some Chinese were blasé about the upsurge of vice, declaring that "when you open the window, some flies come in." But evident signs of a breakdown in the public order are certainly a cause for worry, both for the populace and for the hardliners, who tend to view liberty as leading to chaos.

Another worrisome issue, which eventually would have enormous repercussions, was China's relationship with and attitude toward its ecological environment. The five most polluted cities in the world are in China. Its rivers are sallow with effluents, and the hills are gouged like half-scavenged carcasses. The air is brown-gray and soupy, and bicyclists wrap their faces in bandannas or white surgical masks to inhale as little of the pollutants as possible.

There is a recklessness toward nature here that cannot help but disturb a person from the West. I am not talking about our sentimental feelings on nature, though it was the Chinese who, over their 5,000-year history, chose dynamic balance as the ideal. My question: What are the real costs of this pollution? What are the costs in health care for lung diseases? costs in the reclamation of rivers? costs of air purification? These very real costs, which will undoubtedly have to be paid, are not calculated into the low prices of Chinese goods. And these low prices have fueled the country's phenomenal boom. The real price will be paid and perhaps soon.

To complicate this picture further, on December 25, 1991, the U.S.S.R. formally and officially ceased to exist. President Mikhail Gorbachev resigned, and the red flag that had flown over the Kremlin for most of this century came down, to be replaced by the tricolor of Russia. Although clashes and schisms between China and the U.S.S.R. were not unusual, China always measured itself against the Soviet

I have great respect for the ability and integrity of Lou Jiwei, one of the capable young reformers in China. During a break from a symposium at Harvard University, we visit The Country Club in Brookline, Massachusetts.

Union. That was inevitable since the latter was the communist giant. Now China was alone.

The demise of the Soviet Union had political consequences for China at the practical level, too. Up until this point, the United States needed China for leverage in its dealings with the Soviet Union; that, in turn, led to China being granted leeway when inevitably the relationship between its human rights violations and "most favored nation" trading status was discussed. China's special position disappeared with the U.S.S.R.

But perhaps most important was the fundamental change that occurred within China. The state-controlled share of the economy fell from a high of 85 percent in 1970 to 49 percent by the end of 1991. A magic line had been crossed, and the balance had shifted: More than half of the Chinese economy was now out of the state's hands.

Would it continue to shift? Or would it tilt back? Deng's challenge was formidable. In his remaining time, he would have to engineer an initiative that would create political and social stability and do so without hobbling the economic energies he had freed. Many contending forces—the hardliners, the army, the party, and the populace worried about their "iron rice bowl"; businesspeople eager for profit but wary of the future; and the democrats who, albeit a small number, are important to China's economic relations with the United States—would all have to blend in dynamic harmony. Deng would have to be the best doctor of all.

CHAPTER FOURTEEN

Year of the Monkey

According to ancient Chinese tradition every year is assigned the symbol of an animal; the year is then characterized by the animal's nature. So 1992, the "Year of the Monkey," was predicted to be energetic, aggressive, adventurous, always ready to jump into new situations. Though I wouldn't base my investment policy on Chinese arcana, this characterization certainly seemed on the mark as the year unfolded.

Deng had not been seen in public for many months, inevitably causing rumors about whether, at 87, he could rule—or even whether he was alive. Then, all of a sudden in February 1992, there he was in Shenzhen. As always, his presence was tremendously important and sent a series of signals to China and the world. First and foremost, his appearance was clearly an indication of his blessing for the Shenzhen special economic zone, which he created in 1979, and, by implication, for the other SEZs and what they represented. This rare, high-profile visit by the ailing leader communicated that China was foursquare behind economic reform. Not only had the capitalist road been taken, but the country would be quickening the pace. Deng articulated his position explicitly, not relying solely on what people would infer from his presence. When he visited the Shekou and Zhuhai economic zones, as well as Shenzhen, Deng said: "Reforms and greater openness are China's only way out. . . . Slow progress is equivalent to stopping. We must grasp the opportunities now or we will lose them." Foreign investors responded immediately. In the six months following Deng's visit, direct foreign investment exceeded the U.S. $12 billion total for all of 1991, about half of which came from Hong Kong.

Marxism was not relevant. "No longer mention struggles in the ideological sphere," said Deng. On another occasion Deng, who had lost all hearing in his right ear (and most in his left) but not his sense of humor, acknowledged his deviation from official Marxist doctrine by saying: "Marx sits up in heaven, and he is very powerful. He sees what we are doing, and he doesn't like it. So he has punished me by making me deaf."

But Deng could see all right and trained his sight on China's future, both economic and political. Referring to Hong Kong, Korea, Taiwan, and Singapore, he asked the general party secretary of Guangdong province: "Can you catch up with Asia's four dragons in five years?"

"No problem," was the answer.

Deng was also looking ahead to the Fourteenth Communist Party Congress, which was scheduled to take place toward the end of that year. The Congress promised to be a battleground: reformers against hardliners. Those involved were already jockeying for position. Deng had sent a signal, and everyone, as usual, put his or her own spin on it. On February 23, the headlines of the *People's Daily*, the official government newspaper, read: "Opening Up to the World and Using Capitalism," words that may have shocked many readers. Here again, the signals were multiple. While the party seemed to approve of Deng's call to forget ideology, his comments had to be explained and justified in tortured ideological language. While stating that "all of modern Chinese history has demonstrated that China can travel only the socialist road, not the capitalist road," the article went on to say:

> Using capitalism includes developing an appropriate capitalist economy within our country, as a useful supplement to the socialist economy. As our country is in only the preliminary stage of socialism, it is impossible to wipe out capitalism completely, and some exploitation will linger for a long while. So the important thing is to improve our guidance of these phenomena, and direct them onto a course where policy allows them.

The publication of this article indicated that the hardliners, who had installed their lieutenants in the country's chief newspapers, were losing ground and being publicly rebuked. Their revenge was to publish the article—approved, if not penned, by Deng—on Sunday, when it was least likely to be read, since the paper is delivered to offices and factories rather than to homes.

Finally, the article could be interpreted as a message to the U.S. Senate, which was about to debate whether or not to renew China's "most favored nation" trade status. At issue were China's record on human rights violations, its arms sales to the third world, and its export of products made by the labor of convicts. Another outstanding problem was China's pirating of technology, but that was formally resolved in early 1992 when China signed an agreement on intellectual copyright. That was a green light to many companies; manufacturers of software, pharmaceuticals, and computers had resisted establishing themselves in China for fear that their products would be stolen. Colgate, Motorola, General Motors, and Procter & Gamble developed or continued in their plans to market in China. Ads for Head and Shoulders and Heinz baby foods were appearing on the streets of Shenzhen, replacing the once ubiquitous posters exhorting workers to sacrifice and produce for the glory of the party.

For potential investors like myself, there was another significant layer to understand. China was signaling a sea change in policy. Deng no longer considered the special economic zones as experimental. Now they defined the course that China was about to set for itself, barring successful opposition from within or, for that matter, from without by misplaced American moralism.

Yoking the issue of human rights with business always struck me as a doomed idea. It is obviously bad for business, but it is also detrimental to the aims of the human rights activists, who are more frequently arrested when the U.S. exerts pressure. If the arrests do not occur immediately, they will the moment the United States isn't looking. For any number of reasons the Chinese Communist Party is unlikely to negotiate on this issue; they fear losing face, and, more importantly, the party needs to assert its power when it is no longer ensconced in an ideology that lends it credibility and legitimacy. Both aims—greater democracy and expanded trade—are worthy, but it is an error to link them.

There are those who believe that democracy will evolve in China organically when a middle class is established and when people are enabled, through electronic communication, to think more independently. To some degree I share this belief and indicated as much when I suggested to SITICO that television, not demolition crews, brought down the Berlin Wall. But China is unique, and we can't assume that strategies that worked in Germany, or even in the Soviet Union, will work there. Amid the champagne and euphoria, the Germans confronted painful and unpredictable problems on the night of reunification. The fate of the Soviet Union, too, is for China an example to be avoided. The Chinese, who have known the pain of chaos and the pleasure of prosperity, may, as a people and a party, decide that stability is the greatest value. But the form of that stability was to be determined by the Fourteenth Communist Party Congress later in 1992.

The atmosphere was somewhat more open after the convulsion of Tiananmen Square. The relief, though, felt shaky and tentative. Yet the stock market grew more robust and confident. The number of stock offerings increased, as did competition for the A shares. Because so many Chinese had ample savings, there was tremendous demand, which drove the prices up. So far, there was no competition for the B shares, which were still few and cheap. When they became available in interesting numbers, the smart, quick investor could pick them up at a better price than the Chinese were paying for the A shares. For a time, at least, the B shares would be undervalued.

Competitive advantage requires a combination of connections, information, and timing, and that was certainly the case in China. We had to know what stocks would be available, and when. We needed assessments of their relative value. And, most important, we had to have someone save us a place at the head of the line; competing with Deutsch Bank, Templeton, investment funds in Hong Kong, and others, we weren't the only China fund in town.

Guided by Yafei's unerring instinct about which Chinese were important for us to know, we developed a network of relationships based on mutual respect and interest. We made the right moves, accepted the right invitations, and extended the right ones, as well. Considering the question of personal chemistry, we all felt particularly close to Mr. Ma of Shenzhen Electronics, who would become the head of the Shenzhen chamber of commerce in 1993. In countries where there is no reliable legal structure, all contracts are ultimately human. Americans who are used to playing by the rules can flounder when they are conducting business in countries where the rules are not yet firmly established. They can feel the same discomfort in a bazaar where prices are fluid and haggling is the only way to decide on a price. It is probable that only the Mafia does business in that old-fashioned way, where instinct is critical, and people's words are their bonds.

When I do business in foreign countries, my credo is to pick the person, not the project. Sometimes, however, the person is a group, and they pick you, as well. In June 1992, Batterymarch and SITICO formalized their relationship with a letter of intent. Batterymarch would provide internship training for a Chinese national every year and pay SITICO an annual fee. In exchange, SITICO would consult with Batterymarch, fax weekly updates analyzing the Chinese stock market, research specific companies for us, and arrange meetings and company visits for us in China.

By April 3, 1992, our Equity Fund of China had begun to offer its prospectus and was actively seeking investors. We set an investment goal of no less than $30 million and no more than $75 million, but it could not be said that investors were beating down our doors. China seemed a little too adventurous for the cautious men and women who manage pension funds.

At the same time, investor confidence was hardly bolstered by the odd and violent events of that summer. On August 7, 1992, hundreds of thousands of Chinese converged on Shenzhen. Arriving by plane, train, bus, truck, bicycle, and foot, their destinations were 300 locations in the city. There, 5 million applications were being sold, 10 percent of which would be selected by lottery. Each winner would be awarded the opportunity to purchase up to 1,000 shares on the stock exchange. The application forms cost 100 yuan, roughly half of an ordinary worker's average monthly salary.

By the evening of August 10, trouble was brewing. The government printed too few applications to meet the demand, and, worse, the crowds learned that friends and relatives of officials had special access to applications. The summer heat was scorching, and the crowd's mood turned ugly.

At around eight o'clock in the evening, a riot broke out. Demonstrators blocked the main street of Shenzhen, burning police motorcycles and cars. Armed with batons and electric cattle prods, tear gas, and guns, the police moved in to control the mob. Several hours later the streets were calm, but two people were dead and scores injured.

The following day Shenzhen's mayor, Zheng Liangya, made a public pledge on television to adopt international practices in issuing shares, and to set up a task force to investigate complaints of police brutality. The stock market did not open that day, but did resume the next.

Trading was steady, with prices unchanged from the previous close. The Crédit Lyonnais Shenzhen A index, which reports on shares available only to Chinese nationals, closed at 2623, where it had been when trading was suspended. There was, however, panic selling in Shanghai. Shares fell 10 percent, and the Crédit Lyonnais index dropped 616 points to 5429. (The previous day, when news of the riot reached Shanghai, shares had plunged 11 percent.)

Shenzhen and Shanghai reacted quite differently to the Shenzhen riot, which was interpreted in a variety of ways. Some found favorable signs in the mayor's prompt pledge to adopt standard international procedures; others stressed the people's resentment of corruption. Those more politically conscious worried that the disturbances would arm the hardliners in their showdown with the reformers at the Communist Party Congress in the fall.

Perhaps the most significant point had yet to be recognized. Samuel Johnson once observed that it didn't matter what a talking dog said, the wonder was that it talked at all. The same was true of Shenzhen where an astonishing event just occurred: A million communist Chinese rioted to buy into the stock market.

In early 1992 I was disappointed and discouraged as I watched our deal with LOMO unravel in the first weeks after the fall of Soviet communism. Then and there, I knew that the moment to be involved in the economic history of the Soviet Union had passed, whereas in China my instinct told me that the moment was about to arrive. I did not want to miss a second chance, and scheduled Equity Fund of China's launch for the end of the year.

The Year of the Monkey was nearing its close. October found me in China again. Batterymarch's plane landed in Hong Kong after some delays that might have cost us our rooms at the elegant Grand Hyatt Hotel. It was late at night, there were several of us, and the hotel people were upset. Suddenly the manager appeared. He asked how we had arrived. He knew all about private jets; then each guest in our party was offered a suite. To some extent, that anecdote characterizes Hong Kong: monied and sensitive to money.

A small but significant piece of China, Hong Kong developed apart from the main body, but would rejoin it at midnight on June 30, 1997. All of China, it seemed, had been excitedly anticipating the "reunion" date for years. For example, in late December 1994, an electronic board that counted off the days, hours, and seconds until Hong Kong reverted to mainland control was erected in Tiananmen Square. Not all Chinese wanted to stay after the switchover; they have always liked a "back way out," and now it was rumored that Canadian passports were being sold for $100,000 each. For other countries, passports cost less, depending on their desirability and availability. Some small Caribbean countries even published glossy brochures advertising the advantages and price of citizenship.

Over time, of course, Hong Kong has changed. It is now part of China's one-party political system, which has new grounds for legitimacy. But, like any autocratic government, it rules by implied threat or, as happened at Tiananmen Square, by overt violence. The interesting question remains: How much will Hong Kong and the mainland share in each other's culture?

In October 1992, Hong Kong was replete with opulence, raw nerves,

Batterymarch's Gulfstream II is refueled at Hong Kong Airport before our departure for Guangzhou.

and chic women. It was an oasis of safety, with plenty of police who had little to do: Asian flavor, Western rules.

The distance between Hong Kong and the mainland is geographically short, but it separates two worlds.

Arriving in Guangzhou in southern China after a short flight from Hong Kong, we saw teams of men standing shoulder-to-shoulder, smoothing out freshly laid asphalt and carrying their buckets of cement on over-the-shoulder yokes the way people have transported things since time immemorial. Drivers of three-wheel bicycles, outfitted with platforms on the back, moved enormous loads—a refrigerator, a sofa, and, in one case, three sofas. Roadside rotisseries offered fresh dog. Riding in the gold Mercedes of the mayor of Guangzhou (formerly known as Canton), we felt the incongruity of our presence.

We were definitely back on the mainland, in the world of feverish and shoddy construction, air fouled with dust and exhaust, endless masses of people hurrying, working, and forever on the move. No peace, no calm. And not much to look at, either: cement stores with cement floors, tin roofs, front doors made of corrugated iron. Piles of junk were everywhere because no one throws anything out; everything is saved and used, including every inch of land in the city and the countryside.

On arrival in Guangzhou, our gracious hosts from the Foreign Affairs Office assist us through passport control in the airport's VIP lounge.

Our motorcade from the airport to the city of Guangzhou —a police car, a gold Mercedes, and a van for the American and Chinese staff bringing up the rear.

We continue to be fascinated by the shapes and forms of cycle transport.

Similar to many cities, Guangzhou has retained little of what was bright and picturesque from China's past. It preserved its love of flowers, which are planted everywhere, lending beauty, color, and life to the dust and cement. The well-dressed, well-cared-for young children are clearly adored and stand out like the flowers. China's pride is in its future. Since its laws allow only one child per family, an effort to control population size, the next generations will be very interesting. They are being raised in the perfect situation for creating yuppies.

One marker in the differences between the first and third worlds is toilets and hygiene. Once, after a meal in a country restaurant, the women in the Batterymarch party found that the facilities were holes in a dirt floor. Our interpreter, also a woman, was embarrassed by the situation and explained that restrooms were still primitive in the countryside, but, if the women could wait, there was a new, modern hotel reasonably close by. Our motorcade—police escort, gold Mercedes, and bus—streaked to the hotel, where the improved facilities were . . . holes in a *cement* floor.

We had no complaints about our housing, which was a government guest house in a guarded compound with gardens, ponds, and water lilies. Like the Moscow dacha, there were several buildings. The furnishings were in the same overstuffed Stalinist style, with some Chinese

In Guangzhou, we view the beautiful gardens outside the memorial to Dr. Sun Yat-sen, president of China in 1912.

Arriving for lunch in a country restaurant in Panyu county, near Guangzhou.

Our luncheon hosts, government officials from Panyu county, describe the area's infrastructure developments.

touches. The cooks insisted on serving us their idea of an American breakfast—white toast and fried eggs—and adamantly refused to allow us to sample the breakfast that the Chinese VIPs from the other "dachas" were having.

This was not the case at the formal and elaborate banquet given for us by the mayor of Guangzhou. The cuisine was all too Chinese, whole birds on a spit, fish with eyes intact—a great delicacy offered me as the guest of honor. I politely accepted the eyes, but declined the mayor's invitation to invest in the area's infrastructure. I explained that foreign capital could be attracted only by enterprises or a stock market.

We next visited the well-known Canton Trade Fair and saw mostly low-end novelty items: teddy-bear-shaped candles that played "Happy Birthday," cheap black-and-white TVs, and simple, rugged machinery that couldn't compete with John Deere in quality, although it could in price. While many of the novelties were fun to look at—and buy—they were not in the world-class category we were looking for.

A historic moment occurred when local officials tried to interest Taiwanese in Guangzhou shorefront property: communists selling condos to capitalists.

When I left Guangzhou, I invited some of the people from the

These are the "improved facilities" at a new hotel near Guangzhou—you can use some and just take pictures of others.

mayor's office to our plane for coffee and pastries. Though I did this to show my gratitude for their hospitality, I knew they wanted to see the plane. Some were stunned, others delighted, and a few were ill at ease. To some, a sleek jet from the West seemed like a spacecraft from an advanced planet. In a short time the novelty wore off, and again we were a group of people drinking coffee, talking, getting to know one another. All those visits and dinners and conversations add up; in fact, we knew China a little, and China knew us.

After the kaffeeklatsch we flew to Beijing, where I spoke at the Twelfth Business Leaders Symposium, sponsored by the World Economic Forum, a Swiss foundation established in 1971. The symposium

Through the good offices of the mayor of Guangzhou, we stayed at the Zhudao Hotel, a lovely VIP guest house normally reserved for government officials.

On the grounds of the Zhudao Hotel.

Before a banquet at the Zhudao Hotel, we are welcomed by Li Zi Liu, mayor of Guangzhou, and others from Guangzhou's city government and Foreign Affairs Office.

En route to the Canton Trade Fair, we would see examples of the beautiful form and function of Chinese art.

On arrival at Guangzhou's Canton Trade Fair, we are welcomed by its director.

We join thousands of others viewing the exhibits and shopping at the Canton Trade Fair.

Panyu county officials present an ambitious and comprehensive economic program.

Construction had already begun in Panyu county to develop port facilities for the proposed one-hour access from Guangzhou to Hong Kong.

Breakfast on the Gulfstream II with the friendly and helpful staff from Guangzhou's Foreign Affairs Office.

We bid farewell as we prepare to depart for Beijing.

was going on at the same time as the fateful Fourteenth Communist Party Congress.

My subject was "The Socialist Reason for Stock Markets," with particular reference to China. To maintain its 8.9 percent annual growth, China would have to attract capital: domestic and foreign. The stock market was an ideal way for it to create a "socialist market economy" (a phrase we heard frequently). The stock market would have to be a reliable means for pricing, and would also have to disclose financial information, the relevant rules and regulations, as well as who was buying and selling. All transactions must be transparent, visible to all. Honesty was not only the best policy, it was the only one. In fact, shortly after the forum, the Chinese authorities announced the establishment of a Securities Supervisory Board (SSB) to regulate its securities markets.

To demonstrate my key point that capital has no passport and seeks investment wherever reward is commensurate with risk, I had a special placemat prepared. It was a map depicting the countries of the world, sized according to their market capitalizations. Japan was very large in relation to its geographic size; Luxembourg, scarcely visible on a conventional map, was very prominent, as was, of course, Switzerland. China, for all its land mass, was tiny (as was Russia) but bracketed and colored

The World Economic Forum hosts the well-attended Twelfth Business Leaders Symposium in Beijing.

green, indicating strong potential. Whether China could realize that potential and become the fifth dragon of Asia depended on more than creating attractive stock markets. The political atmosphere had to be clear.

Deng looked ghastly when he appeared on television in late October at the conclusion of the Fourteenth Communist Party Congress. His cheeks were sunken like those of someone suffering from emphysema. The camera showed that one of his hands was clenched and trembling, hardly reflecting the image of a supreme leader. But, in fact, he had never cultivated an image. As the travel writer Paul Theroux put it in *Harper's*:

> Deng is without charisma—doesn't have it, doesn't want it. No cult of personality has grown up around him, nor will it in what remaining time he has left. His briskness and frankness are a reaction to the time-wasting and secrecy of the past. Mao, arrogant, ruthless, serene, was an emperor whose image was iconographic. Deng is a sort of blandly non-ideological CEO and is almost faceless.

Yet it is remarkable to consider how much that man accomplished. Deaf, suffering from prostate cancer, and having turned 88 a few weeks before the Congress, Deng saw his programs and people score a great victory. The old man presided over the change of generations. The other octogenarians associated with the Long March generation were out; the young technocrat reformers were in. Nearly half of the Central Committee's 309 members at the Congress were new faces. Eight of the 14 members of the Politburo resigned; 14 younger men were appointed, bringing the body to 20. The key figure of the new group was Zhu Rongji, 64, former mayor of Shanghai, now deputy premier and essentially in charge of the economy. A Dengist reformer, he was Deng's choice for the next prime minister and now holds that post. He replaced Li Peng, 64, who is an economic conservative, one of the last holdovers from the old Politburo, and the adopted son of Zhou Enlai.

Deng secured his succession at the Congress; no one great figure was waiting in the wings to oppose his choice. His policies, as well as his vision, which is now shared by the great majority of those ruling China, prevail. If no cult formed around Deng as a personality, a more significant following has been established around his ideas. The party secretary's keynote address was based, almost verbatim, on Deng's earlier pronouncements. Emphasizing the irrelevance of ideology, he said: "If a decision is good for economic growth, don't even bother to ask yourself whether it is socialist or capitalist."

Accelerated economic growth was the order of the day, both as a fact and as a vision. In reality, the gross national product (GNP) was peaking at 12 percent for the first nine months of 1992, which is well above the average growth rate of 9 percent for the years since Deng launched the four modernizations campaign in 1976. (The four modernizations were actually introduced by Zhou Enlai in 1975; after Zhou's death in early 1976, Deng provided the details, the will, and the means to implement them.) The vision included a specific goal: to quadruple the country's 1980 real industrial output ($129.7 billion) by the year 2000. At the Congress, the point was made that accelerated economic growth was not merely the country's goal and watchword until the next congress and the end of the century; it was the course set for the "next hundred years." No doubt this was rhetoric designed for domestic and foreign consumption. But, simultaneously, it was a signal of stable intent to investors, replacing the vanished ideology and reinforcing the party's role as the creator and guarantor of prosperity.

Still, there remains some of the old mumbo jumbo. None of the top leaders is willing to use the term "market economy," preferring "socialist market economy." As officially listed (by Zhou Shulian Guo Kesha, *Jingji Ribao*, August 22, 1992), the tenets of the socialist market economy are:

★ The market, not the state plan, is to be the main means of allocating resources in society.
★ Mandatory planning and administrative measures are to be further curtailed at the microeconomic level.
★ Macroeconomic policies are to be the principal means of state economic regulation, and these are to be implemented in ways consistent with the market microeconomy.
★ Macroeconomic regulation will control the aggregate rate of economic growth, smooth out excessive inequalities of income and wealth, produce public goods that profit-seeking firms have no incentive to provide, and protect society against environmental and other hazards.
★ Public ownership of property, rather than private ownership, is the foundation of the socialist market economy; this distinguishes it from the capitalist market economy.
★ State enterprises must become independent in their operations, responsible for their profits and losses, and financially accountable.
★ The government must break up regional market barriers, curb the growth of monopolistic power, and promote the development of a unified national market.

During the World Economic Forum symposium in Beijing, a luncheon meeting with noted reformers Zhang Da Wei, vice governor of Anhui province (right), and Zhang Wan Xin, vice president of the largest state-owned petrochemical company and a member of the Central Committee (left).

In this document and at the Congress, the Chinese had taken an initial step toward confronting two of their biggest problems: the growing disparity in wealth between the coastal rich and the inland poor, and the major dislocations caused by unemployment. The latter dilemma is inevitable when enterprises are privatized or made economically accountable (for example, the government itself admitted to being overstaffed by 26 percent). Under the old system, employment *was* a kind of social security, and nothing has yet replaced it. Incidents of violence occurred in the northeast province of Liaoning when state enterprises attempted to fire people. According to official figures, 100,000 workers from money-losing state enterprises had already been fired; but this number is minuscule compared to the 33 million people who would have to be cut soon if the state was to avoid becoming a black hole swallowing up the country's new wealth. The government would experience difficulty in collecting taxes from the richer coastal provinces.

Disturbances can always be put down by force, as they were in Shenzhen in August 1992. But obviously this is undesirable. First, it alienates the populace and has troubling repercussions for the army. Feeling protective of its honor, the army felt that it lost prestige when it was sent to Tiananmen Square. The officers believed that they were made to pay for the political errors of others. In an effort to reassure both the army and the populace, the Beijing press disclosed the existence of "Internal Document No. 7," which prescribed procedures for dealing with disturbances by workers or students. Officers were to avoid overreacting, and various contingency plans should be in place so that deadly force was only a last resort. This was reassuring, but also a reminder that deadly force *could* be used. If the government's legitimacy and power of the purse were impaired, it still owned the guns.

The party made it perfectly clear at the Congress that, as Claude Smajda, director of the World Economic Forum, stated: "Nobody should be fool enough to confuse economic reform with political reform—the Communist Party intended to retain the full monopoly of power." The octogenarians and the young technocrats were in complete accord on that point. Nevertheless, the party was clearly promoting a new rationale for legitimacy—prosperity and stability. The Soviet Union exemplified what can happen when economic and politic reform are attempted simultaneously: chaos (known as *luan* in Chinese and always dreaded). By promising to fight corruption and inequity, provide social services, and manage the economy, the party was shifting the traditional definition of its role from the political/ideological to the social/economic.

The party seemed to be professing that prosperity and stability were enough for now; democracy could wait. China appeared to be accepting that. "By 2010 we'll be ready for political reform," was how one Chinese described it to us. As long as there was no overt repression and the social and cultural freedoms continued to expand, many people appeared willing to consider democracy a luxury that could be postponed, but one which they expected someday to be able to afford.

For me, it was difficult to decipher how much of the euphoric unanimity projected by the Congress was public relations and how much was substance. I had to wonder whether the Chinese weren't operating on two tracks, advertising a line that was good for foreign investment while in reality moving at a much slower rate. Handing me his annual report, the head of Shanghai Automotive told me that his company would go public in two years. Why so long? I asked. We don't know enough, we have to go slowly, we can't make mistakes, he said. This was the classic bureaucratic justification for inaction. I had to consider how pervasive that feeling was in the ranks; even the smallest amount could impede any program, no matter how fully supported it was from the top.

That I had doubts about China was true, but, taken together, they did not outweigh my conviction that the country was strong and stable. It was time to stake my bet.

By December 1992, several of Batterymarch's clients, including emerging markets pioneers AT&T and General Motors, both of which had invested with us earlier in other parts of the world, agreed to join us in China. Equity Fund of China came into official existence on December 21, 1992, when the money, $31.4 million, arrived. Exactly one week later, the first stocks were bought.

And so, 12 years after my first visit, with a new year stretching before us and a good wind in our sails, we were launched at last in China.

During the first few months of 1993, share values of the Fund increased tremendously, but this was followed by a major decline lasting through most of the 1990s. Relative to the market, Equity Fund of China actually did quite well during this period; with an annualized return of 2 percent, it bested the IFC Investable China Index by about 12 percent.

Until late in the year 2000, the B (foreign investor) shares routinely traded at discounts of 80 percent of their A share counterparts. When, in February 2001, the China Security Regulatory Commission finally announced that it would open the B share market to domestic investors, the values of A and B shares began to converge; by May 2001 the discount had narrowed from 80 percent to less than 40 percent. Every indication is that this convergence will continue. The government's recent securities reform proposals—allowing foreign brokerages to trade hard-currency B shares directly through special seats on the exchanges; establishing a Nasdaq-style securities board in Shenzhen; and permitting Sino-foreign–owned joint ventures to engage in fund management—are tied to China's entry into the World Trade Organization and indicate a commitment to improving foreign investors' confidence.

As with much that happens in China, securities reform is slow, carefully crafted, and developed for the long term. And so it should be in a nation that is home to 20 percent of the world's population who have the highest savings rate in the world, abundant resources, and, best of all, dedicated and skilled leaders. Keeping this in mind, it is not hard to be an admiring and patient optimist.

PART THREE

A New Order in the Making

CHAPTER FIFTEEN

Lines on the Horizon

On a weekend in April 1992, at my home on Lake Sunapee in New Hampshire, I entertained two guests: Yin Yafei, my Batterymarch colleague whose arrest in China had so shocked me the summer before, and Alexander Kuznetsov, the deputy director of LOMO, who vowed he had nothing to do with the endoscope fiasco, and who is so likable that I believe him.

As we sat on the porch, Alexander commented that the slogan "Live Free or Die" that appears on New Hampshire's license plates "is a very important statement." Personal political freedom, which he defined as the freedom of people to make their own decisions and to be responsible to and for themselves, was the most important change taking place in the former Soviet Union.

Yafei listened to Alexander for some time before interrupting.

"You have no food to eat," she said, "yet you want freedom first? I do not understand."

In that instant on the porch, I gained a crucial insight into an essential difference between the Chinese and Russian perspectives, as well as the reason our Soviet Companies Fund had withered while our Equity Fund of China took root. I could imagine Gorbachev and Deng having this argument.

During a later visit to Lake Sunapee, the Russian flag is raised in honor of Alexander Kuznetsov and his family: wife Vera (left), son Dmitry ("Dima"), and daughter Olga.

Since that cold February day in St. Petersburg in 1992 when I received the news that our people had been locked out of the dacha, I had wondered what had gone wrong. How much of it was circumstance, how much duplicity, how much my own blindness? I knew from past experience that opening business relations in a foreign country is tricky at best, like the space stations of two countries docking in orbit. A thousand coordinates must be considered, a thousand linkages made. In China, we made these connections; in Russia, we had not.

Originally, there was every reason and every inclination to believe that, of the two, Russia would prove the easier country to get along with. Russia, after all, was European, the easternmost part of the West and of the Christian world. And religion had returned with the fall of communism.

Beginning with Gorbachev, Russia reached out to the West, initiating talks on peace and disarmament. Even more astonishing was the fact that Russia looked to the West for a model of a free market and a free society. But something went tragically awry. The embrace did not occur.

Some of the fault belongs to the West. George Bush was too "prudent" in his dealings with the Soviet Union. For someone who had devoted his life to foreign policy, he was slow to sense the magnitude of the change happening before his eyes, and on his watch. This failure of imagination, or nerve, was never more apparent than at the London meeting of the G-7 in July 1991, when he and the other Western leaders, with the exception of Helmut Kohl, sent Gorbachev home in disgrace and empty-handed. Instead of seizing a once-in-a-century opportunity to secure peace and open vast markets, the West preferred to enjoy one country's misfortune. The Germans have a word for it, *schadenfreude*, though ironically it was the Germans who took no pleasure in Gorbachev's pain. In a famous remark, Margaret Thatcher said that Gorbachev was a man we could do business with; but no one, apparently, believed her.

A month after the G-7 summit, Gorbachev felt his only recourse was to sign an agreement with the Soviet republics known as the Union Treaty. The Soviet central government could no longer tax, a power vital to any state; this fiscal impotence marked the demise of the Soviet Union in December 1991.

For decades the West tried to inspire the people of Eastern Europe and the Soviet Union to understand the importance of, and then to desire, a sense of their human dignity and the same freedoms that the West enjoyed. The United States did nothing during the Hungarian uprising in 1956 or when, in 1968, the Czechs defended their beliefs. Perhaps nothing could be done because the risk of nuclear war was too great. But that was not the case in the late 1980s and early 1990s when communism crumbled and did so with the active aid of its leaders. Politics opened; the press opened; and young reformers were visible in the front ranks of policymakers. The West opened everything except enough money, and not soon enough. Billions of dollars were promised by the West, but none materialized. Admittedly, more money came through, but it was often in the form of expensive Western infrastructure consulting and not directly to the Soviets.

I think it bears repeating: The West had "cheaped out." The failure to support Gorbachev at the G-7 meeting led to the signing of the Union Treaty and, in August 1991, to tanks in the streets of Moscow.

The Soviets must bear some of the blame. Admirable as Gorbachev was, and despite the fact that he was betrayed by the West, he made a series of blunders that proved costly for his career, his country, and our project. His fundamental error was in trying to reform the political and economic systems simultaneously. Perhaps he was a victim of an aspect of the Russian psyche that was exacerbated under communism—an all-or-nothing extremism. That would explain why Alexander Kuznetsov was drawn to New Hampshire's motto, "Live Free or Die."

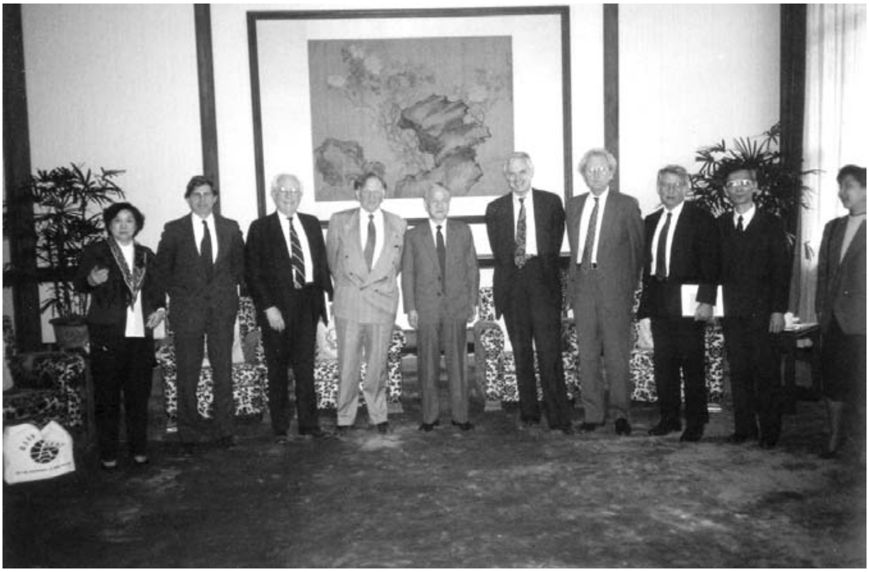
Russian history is marked by long periods of torpor interrupted by sudden, vigorous activity—the construction of St. Petersburg, the overthrow of the tsars, the defeat of the Nazis, and the conquest of space are examples. This characteristic parallels and has been attributed to the Russian climate. The seasons for sowing and reaping are short and call for bursts of energy, followed by long Russian winters and months of inactivity. This narrow either-or viewpoint has also been ascribed to Russia's failure to create a "civilization of the middle," a society with a middle class adept at compromise. Without that sense of balance, Russia races from one extreme to the next. One maxim of the Revolution was that there was no fortress a Bolshevik could not storm. The myth was that the entire society could be transformed, whole classes eliminated, and the courses of rivers reversed. Nothing was too much for the communists, yet in the end everything proved too much.

One primary reason that the Russian communists failed in those attempts at reform is that they were bad Marxists. Marxism maintains that economics determines everything. No matter how much this was the stated, overt ideology, Lenin and his followers subordinated everything to politics. Central planning was based on maintaining political control, and economic realities were made to accommodate that priority. The value of the ruble and the price of bread were set by directive; they bore no relationship to supply and demand. The Russians created a system of economic illusions, and, when the power to enforce the charade diminished, the insubstantial system failed.

Also, the Russians were hampered by their wounded pride. Suddenly, the largest country in the world, covering a sixth of the earth's land, with fantastic natural resources, a gigantic army, and space stations orbiting the planet, was forced to go hat in hand to the West, only to be spurned. Gorbachev's glasnost exposed the long-standing weaknesses and evils of the system, but offered nothing of value and substance to replace the failed ideology. The only thing of value left to the Russians was

Russia itself, and for that reason they were unable to do what the Chinese wisely did, which was to adopt Western business practices. The Chinese invited foreign businesspeople to visit, then provided them with comfortable conditions and good communications. Eventually, the Chinese implemented their own version of capitalism, but while they were learning how to proceed, they openly asked for help and eagerly accepted it. National pride did not inhibit their capacities to learn from Westerners. China, with its 5,000 years of history, has a firmer sense of itself than Russia does.

Yafei was puzzled by Kuznetsov's choice of freedom over food. Chinese leaders know that every morning one billion people will wake up hungry. The sheer scale of it inspires a certain sobriety. Deng knew that food had to come first. A population hungry for democratic freedoms and blue jeans can be distracted for one more day; a population starving for food cannot. Predicated on the assumption that people who are well fed will show more patience for and interest in other aspects of reform, Deng's first step in reforming China's ailing communist economy was to fix the agricultural sector. In this way, he quelled people's anxiety, gained



At a guest house for state guests in Beijing, we would have important and fruitful discussions with Diao Yu Tai (on my left), chairman of the China Planning Committee.

their trust, and, in so doing, bought himself time to continue his long-term project.

When, in 1987, Gorbachev initiated economic reform in the Soviet Union, he could have done worse than to follow Deng's lead and tap into the energies of the U.S.S.R.'s tens of millions of farmworkers; it was clear that they could have produced far more than the state-owned farms did. Their private plots (by 1985, 35 million with an average size of half an acre) produced 60 percent of the Soviet Union's potatoes, a third of its meat and vegetables, and only a slightly smaller percentage of its eggs and milk.

Yet the Russians stubbornly refused to follow the Chinese example. When we asked a number of officials whether they were aware of the Chinese experience, some told us they were. Then why didn't they use that knowledge? I am afraid I underestimated the long-standing enmity between the two communist giants. In fact, we were startled to hear disparaging references to "our little yellow Socialist cousins."

The Soviet Companies Fund was thwarted by a number of factors: quirks in the Russian view of the world; the failure of Western foresight and nerve; and uncontrollable events, including the recession and the Persian Gulf War, which frightened Western chief executives from traveling. Also playing major roles were dishonesty and duplicity. Influenced by decades of propaganda that presented business as a branch of crime, the Russians were unable to understand one fundamental fact—business operates on trust and honesty. LOMO's top management people were deceptive in their concurrent negotiations with us and the Japanese. The Russian officials who assumed responsibility for the Soviet Companies Fund from the Soviet officials succumbed to greed, escalating their demands from jeans to VCRs to outlandish rents for the dacha. Good faith, which is the basis for all business dealings, simply eroded.

Without faith in the future, people become shortsighted. Surprisingly, this was true of the late Anatoly Sobchak. Had he, as mayor, supplied us with an empty building (St. Petersburg had many), a trusted and respected bank would have been established, but his demand for payment was offensive and a deal buster.

For the purpose of learning something for the future, I tried to evaluate where I had failed, and where I had allowed myself to be blindsided. Had I been led astray by optimism, ambition, or affection for the Russians? The principal fault, I believe, was not heeding the advice I gave to others, which was that the project had to work quickly if it was to work at all. People who fail to follow their own rules are asking for trouble. And trouble is what I got. The real loss was not money; it was

I am grateful to many in Russia who gave of their time, energy, and emotion. On this winter day, I accompanied Evgeny Vitkovsky on a boar hunt outside of Moscow.

Though I'm not a hunter, my companions enjoyed the success of the hunt.

watching a vision fail. Perhaps I was bewitched by the magnitude of the opportunity. The possibility of being the first to establish investment relations with the new, emerging Russia seemed too great a dream to relinquish. Still the impediments mounted until the dacha lockout proved to be the last straw. Also, I may have been misled by sentiment. I had a special feeling for Russia, which, after half a century of enmity toward the United States, was now racing to embrace basic American principles.

I rooted for the Russians, something I could not do for the Chinese. Though they commanded my respect for many reasons, especially for their willingness to learn our business practices, the leadership displayed contempt for our ideals when their own young people espoused them in Tiananmen Square.

Aspects of China won my heart, but with the Chinese you still had to compartmentalize your relationships and distinguish between the people and the government, which was no longer necessary in post-Soviet Russia. And the Russians could be very winning. Under their stolid exterior, they were spontaneous, emotional, generous—Italians locked inside Swedes. My friendships with some of them have survived even my bitter disappointment.

At different times, I would host strategy sessions in Switzerland, with Evgeny Vitkovsky . . .

. . . and with Svetlana Kolupaeva (left), Alexander Kuznetsov (second left), and Natalia and Oleg Gapanovich (right). I value their friendship.

The bottom line, however, was that Batterymarch was unable to do business in Russia, where freedom had suddenly become more important than food. On the other hand, we were able to do business in China, where food was more important than freedom. The Chinese seemed to agree on the priority, from Deng in Beijing to Yafei on my porch.

I do not rule out the possibility of trying Russia again. For the immediate future, however, the turmoil there makes negotiations risky in several ways. I have continued to visit Moscow and St. Petersburg, and I maintain contact; but when I am there I feel discomfort of a sort that I have not experienced anywhere else. In Russia foreign executives are now routinely kidnapped for ransom; also, it is possible that my presence could evoke feelings of political animosity since I was associated with Gorbachev's faction at the end. Russia lacks effective government and law, and though the people have a saying that the fishing is best in troubled waters, it probably does not apply to today's turbulent whirlpools, where rod, reel, and fisherman could all be lost.

A military takeover in Russia remained, for a time, a strong possibility. The army, the one institution that always functioned well in the Soviet Union, retained some of its traditional prestige. Perhaps Russia would do well under a just and efficient military rule. Russians may be politically revolutionary, but they are socially conservative. Always a communal society, they do not mind observing old-fashioned mores and rules. In fact, they will actively try to encourage others to adhere to the rules. They had not, however, developed any experience, or taste, for the rule of law. Released from the restraints that bound it for centuries, including serfdom under the tsars and the terror of the Communists, Russia is, at least in part, without principles, ideology, or mission, which makes it a potentially very dangerous wild card in the game of international poker.

Visiting the new Russia was alarming in any number of ways. Gangsters in expensive zoot suits were everywhere and walked around as if they owned the country, which apparently wasn't (and still isn't) far from the truth. (One estimate by Yeltsin's government placed mob control of the economy at 40 percent.) Foreign visitors were discouraged from visiting certain fashionable restaurants. You may be told, "The food and decor are very good, but a while back someone rolled in a hand grenade in a *mafiya* hit. When the grenade didn't go off, they came back with machine guns."

At the other end of the spectrum were the shamefaced beggars, usually widows on pensions that did not provide enough to keep body and soul together. Begging was their only chance and last resort. Knowing that what they did was out of necessity has not saved them from feeling intense shame. Some Russians say that they give money only to the beggars who look ashamed.

But shame and stupidity are two different things. Some beggar women have the good sense to position themselves near the hotels and restaurants where people tend to have money and feel generous. Compassion is part of Russian tradition, and people do give money to beggars. The so-called "new Russians," the mostly young people who have adapted well to the new economic realities, will contribute a ruble note that, given the inflation rate, is losing value as it changes hands. The old Russia begs from the new.

For the most part, intellectuals, scientists, writers, artists, and filmmakers are not doing well. During the Soviet era they were vulnerable to censorship by the state, but they were also funded by the state. Those funds have largely disappeared. It appears that there is not even enough money to complete improvements to the Bolshoi Theater.

Many of the intelligentsia worried about the soul of the country. Russia has not yet established a new identity for itself, and this is reflected in the language. Usually so vivid, it has suddenly become loose and diffuse. Now that anything can be published, few people read anymore. Publishers struggle to function in a free market at this time, and usually don't

Renovations at Moscow's world-famous Bolshoi Theater would be ongoing for many years.

succeed. This, of course, could change. For now, they seek sponsors among the newly rich.

Russian television, now vivid and dynamic, is one reason people read less, but there is another perhaps more important reason. People must act. Initiative has been forced upon, rather than granted to, the Russians. Their capitalism, "stick capitalism," is driven by the horrible spectre of poverty amidst plenty—begging at the banquet—rather than the availability of goods.

The stability of the new Russia will depend on how quickly it can create a middle class. A society with Armanis at one end and raggedy kerchiefs at the other, with a huge void in between, cannot maintain that precarious balance very long. Yet for many good reasons I am optimistic. In addition to those I have discussed here, two revealing little details that I noticed on my most recent trip make me even more confident.

Something was different about Pushkin Square in the heart of downtown Moscow, but I couldn't identify exactly what it was. Yes, people were better dressed, the stores were certainly stocked with goods, and I saw so many Mercedes I could have been in Beverly Hills. Finally I recognized it. It was the familiar beeping sound of electronic car door openers.

Despite funding problems for the arts, attending ballet at the Bolshoi was always a special event.

And the other detail concerned, of all things, refills for PEZ dispensers. PEZ is a rectangular candy dispensed by holders with cartoon characters' heads for tops. The head lifts up and out pops the candy. A frequent traveler to Russia told me the following story: "In New York I bought some PEZ dispensers and a couple of refills for the children of some friends of mine in Moscow. But then I felt bad for the kids; the refills would get used up and then what would they do? Was it better to let them have fun for a little while even though they might be unhappy later? Anyway, all my fancy worries were meaningless because I looked in the window of a kiosk near the Kremlin and they're selling PEZ refills!"

In other words, the markets of technological automotive gadgetry and highly specialized candy items had penetrated deeply into Russia. My prediction is that the laws of the market will influence the society more, pulling it in the direction of political stability, and will do so by creating a middle class. It is clear that the greater the stability, the greater the prosperity.

Regardless of its future political system, Russia will remain a land rich in natural and intellectual resources. Apple Computer and other U.S. companies have started to tap the rich pool of Russian software specialists who will work for a tenth of what their Western counterparts are paid. For the time being, the melancholy joke still applies:

"Do you know how to make a small fortune?"

"How?"

"Bring a large fortune to Russia."

China is a completely different story. Batterymarch was able to succeed there because China, as a nation, succeeded.

Deng did what leaders are supposed to do: He envisioned, then implemented a better future for his country. He carried China beyond Mao's grandiose ambitions and wanton violence to a prosperous stability. Deng did not accomplish this without his own ruthlessness, which was indeed deplorable. But in sheer number and brutality, his crimes were far fewer than Mao's.

The post-Mao Chinese took a series of small, calculated risks that added up to nothing less than a genuine revolution. In Marxist doctrine, the state is supposed to fade away. In China, ideology diminished while the state remained. However, it voluntarily relinquished control of much of the economy while retaining some key sectors. In the Soviet Union, the press of circumstances ultimately forced the Communist Party to dissolve itself; in China, events forced the party to surrender control and ideology, but not power. In fact, the Chinese Communist Party invented a new identity for itself, thus establishing a new role and a new basis for legitimacy. In so doing, it demonstrated that it could create conditions conducive to prosperity. Now the country sought to develop these conditions further to eliminate gross inequities in economic distribution and to maintain social equilibrium—not an easy task in a nation of well over a billion people. Since employment would no longer be the state's highest priority, tens of millions of workers would have to be discharged from jobs that served the purpose of social welfare. Great migrations of workers had already begun.

The Chinese had certain advantages over Russia. Despite the fact that Tibet and some of the Turkic-speaking regions in the West desire independence, China does not have to confront the problems of empire that beset the Soviet Union in its final days. Ninety-three percent of the country's population is Han Chinese.

Also, China was less directly involved in the Cold War than was the Soviet Union, which meant far fewer of its resources were invested in the arms and space races and other expenses necessary for maintaining the status of superpower. Since the revolution in Russia preceded that in China by 32 years, the latter country had the advantage of being in an earlier stage of socialism; the Chinese were a generation closer to the prerevolutionary past and may remember more about how to conduct business.

When Deng took over, the Chinese were still in the "great leader" phase of socialism. Mao, who combined traits of Lenin and Stalin, both made and ruined the revolution. Through violent excess, Stalin and Mao inflicted great damage upon their societies in many ways, including the destruction of large numbers of intellectuals. The Cultural Revolution disrupted education for a decade; students marauded while scientists were sent to pig farms for closer contact with the laboring masses. Stalin was constantly summoning scientists back from the Gulag where he had exiled them. Infinitely crafty when it came to the seizing and holding of power, he was stupid when it came to understanding certain branches of science. For example, by supporting T. D. Lysenko, a biologist who believed that acquired characteristics could be transmitted genetically, he wreaked havoc on Soviet agriculture. In addition, he had a tremendous aversion to computers, which he considered "bourgeois"—by far the worst insult in the Soviet lexicon. The repercussions of his Luddite-like attitude are still being felt. The Soviet, and now the Russian, computer industry was very limited and very focused, and computers have yet to penetrate that society as they have in technologically more advanced societies. From his own perspective, Stalin was probably right in his contempt for computers. After all, they have led to the information explosion, which has transformed the world and, fortunately, made life harder for tyrants who rule through propaganda and thought control.

After Stalin's death, the Soviets made great strides. They superseded the United States in space by sending up the first satellite, Sputnik; the first man in space, Yuri Gagarin; and the first woman, Valentina Tereshkova. The Chinese, too, made rapid progress after Mao's death but wisely confined it to productive areas.

Other secrets of China's success lie in the nation's history and the people's character. It had reasons as strong as Russia's to be anti-Western. In the nineteenth century, Western powers flooded China with opium, which led to the Opium Wars. In defeat, China, humiliated and violated, was forced to concede land, including Hong Kong, to the British. That those events were in the more distant past may account for why China was able to learn from and adopt Western ways. Russia, still smarting from its loss of superpower status, appeared obsessed with asserting its individuality: a bad mistake.

In the end, perhaps nothing is more important than character. Nothing is as revealing, both in personal relationships and in global politics, as the way a person or an entire nation—I'm referring here to China and Russia—reacts to the success of others. The Russians feel envious, the Chinese ambitious. Exposing a critical aspect of its national personality, the Russians like to relate the story about the peasant who had only one cow, while his neighbor had two. A fairy appeared and offered to grant the peasant any wish his heart desired. "Kill one of my neighbor's cows," he said.

Travelers to China report on the glut of success stories: people rising from abject poverty to wealth with astonishing speed. They feed off these stories and are inspired by them. My own observations accord with those of the writer Paul Theroux, who, in an article "Going to See the Dragon" (*Harper's*, October 1993, 33–56), quoted several Chinese:

> This remark led to a discussion about envy among a number of Chinese around me. Several of them maintained that there was very little envy in the new China.
>
> "If a person gets rich, the attitude is 'Good luck to him,' " one Chinese said. "If I work hard I'll get rich too."
>
> "You don't burn a man's house down because he has a better one than you," another Chinese said. "There is even a sense that the rich man might help you."

The Chinese learned from the Great Leap Forward to take small and steady steps. The Russians were addicted to grand gestures, which have ultimately led to epic ruin. Now the questions are: What will rise out of Russia's ruin? Where will China's small but rapid steps lead?

If there is any dominant theme in Russia's history, it is that the country can survive anything. It has outlasted the Mongols, tsars, Nazi invaders, and Communist tyrants. Either Russia will remain a disaster in all 11 of its time zones or it will return to life and power. I remember the question posed by Robert Strauss, former U.S. ambassador in Moscow: What do we in the United States want—a strong hostile Russia or a powerful friendly Russia? Because either way Russia will be strong again one day.

Though I agree about Russia's resurgence, I can't help wondering how far into the future it will be. As someone with a bent for guessing the future, I take the long view.

Investment, however, moves in shorter cycles than history. The time will come when Russia again becomes a viable investment opportunity. It may be that the Russians will take a lesson from the Chinese and compromise with a similar blend of capitalism, social freedom, and authoritarian rule. Russia is more likely to have a nationalist party that monopolizes power rather than revert back to communism. Unlike Russia, China has preserved its commitment to communism during its economic metamorphosis; thus it has the sanction of continuity. Having broken its ties with communism, Russia will most likely include some communist rhetoric and policies in its nationalist program but will base its legitimacy on other foundations.

Karl Marx predicted that all societies would move from capitalism to communism. He was right that there would be a transformation, but he had its direction backward. What we are witnessing now is the unprecedented spectacle of two countries—one the largest in size, the other in population—making the perilous but exciting leap from communism to capitalism. The people involved have no guidelines or precedents. Both nations have enormous problems; if they are solved, new and vibrant societies will emerge.

It is not clear which of the two, in the long run, will be more successful. For a time, Russia will remain the Sick Man of the World, dangerous because it is weak, disoriented, subject to spasm. Russia's painful ruin, however, may prove an advantage later because it has freed the country from communist rule. The Chinese have postponed this step, which, given their situation, is probably wise. One of the great unknowns is the extent to which the Chinese desire human rights and political liberty now, and how much that desire will increase with their rising prosperity. The Chinese may adopt democracy so gradually that no one will notice. Or they may find that the final distance to freedom is long and perilous. As Winston Churchill once said, you can't leap an abyss in two jumps.

There is no question now that the Chinese have regained their appetite for greatness. Nothing is modest about their ambitions. Their desire to be the site of the Olympics, as well as their having hosted the International Women's Conference in 1995 (although marred by excess control) exemplify this. China seeks a standing consistent with its history, a standing it has earned again in its proven ability to deliver what it promises.

The period of upheaval and turmoil Russia has experienced qualifies as a revolution as profound as the one that took place in 1917. The Bolshevik seizure of power had serious consequences for the international community because it meant that Russia would withdraw from the war against Germany. But this latest revolution has the potential to result in the gravest consequences, because Russia's nuclear arsenal, albeit reduced, is still immense. It would be the irony of ironies if nuclear terrorism, or a nuclear "event" of any sort, were to mark and mar the new world order that has supposedly emerged after the West's victory in the Cold War. One great worry is that nuclear materials could be stolen. This is unquestionably a realistic concern since the facilities that house the materials have no elaborate security, having been built in the bad old days when no sane Soviet would even approach such a building. During the Cold War the most fearsome objects were the huge ICBMs that could streak halfway around the globe and destroy an entire city. In the post–Cold War period the most fearsome object is the smallest, the grapefruit-sized device that can be carried in a suitcase. Of course, this does not mean that no attention should be paid to the remainder of Russia's nuclear arsenal, part of which might be used in a civil or secessionist war or in a conflict with one or more former members of the U.S.S.R.

If any of those scenarios were enacted, the result would be the crisis of the age. Yet this possibility is rarely, if ever, mentioned in the ongoing public dialogue on nuclear war. In part this is because we are tired of thinking about nuclear crises. On this subject, we operate in a massive state of denial. Also, we tend to deny what we can't control. Worse, our excessive crowing over victory in the Cold War and our refusal to be of significant assistance to Russia have alienated that country, which now, understandably, may be quite reluctant to share any information it does possess regarding the state of its own nuclear arsenal.

Still, it is fairly certain that if tomorrow the Russians announced a public auction of five nuclear weapons, the world's attention would be immediately drawn. The world would be awakened to a new danger posed by those nuclear weapons, which will have become symbols of a nation's importance or status—a ticket into the Big Shots' Club. And the prestige of membership will be marked by plutonium, as currency was once by gold.

If the first phase of the political/economic transformation was Gorbachev's attempt to consumerize the Soviet economy within the structure of the Soviet Union, the second started in August 1991—with the failed coup attempt and ultimate dissolution of the Soviet Union—and lasted nearly a decade, through the 1990s.

This second phase was a period marked by confusion, looting of assets, and emergence of an openly expressive society. My most recent trips to the "new Russia" only confirmed the dire reports I had read in the press or heard from friends. The fear of crime and chaos is pervasive. Russia has become a world center for the narcotics trade and money laundering. Banks devoted exclusively to that purpose were springing up everywhere and were cheaper to buy than a Mercedes. Uncooperative bankers were routinely murdered. Observers of Russia see crime as endangering both the country's fragile democracy and its newly born free market. Yet, paradoxically, the various *mafiyas* have enjoyed a modicum of respect among the citizenry because they imposed and maintained a semblance of order. If this offers some reassurance to beleaguered Russians, it offers none to the foreign investor.

It may be incorrect to view the government and the *mafiyas* as two distinct entities. Russian politics always had a criminal aspect—tsardom was once defined as absolute tyranny tempered by assassination—and Stalin was certainly a criminal by any legal standard. In the mid-1990s, neither the people in the government who had something to hide nor the *mafiyas* wanted a stable political climate. Steady, reliable governments will not tolerate this level of corruption and criminality. An unbalanced power structure means political instability, the enemy of genuine prosperity.

Gross domestic product, as best one can determine from figures, steadily declined. The term "bandit capitalism" seemed to fit. Economics was modeled more after that on the docks of Hoboken, New Jersey, than on mid-American free enterprise. Security meant paying for protection. And still no one tried to do anything for the people on the street, who would stay on the street. We know the result of the bandit capitalism. It is estimated that hundreds of billions of dollars' worth of state assets have moved into a few private hands, with the acquiescence of Western officials.

For Russia, capital flight has been a dominant feature of the decade of the 1990s, perhaps in the tens of billions of dollars each year. One can assume that almost none of it was entirely legally obtained; money laundering, false accounting statements, and tax evasion are rarely prosecuted as crimes in the Russian systems. Curiously, the present atmosphere of stability seems accompanied by a continuation of money outflow, perhaps even an increase. But foreign investments are a counterbalancing inflow.

Very little of the privatization—the giveaway—of Russian enterprises went to ordinary people. But privatization often benefited a new class of entrepreneurs, the oligarchs, who got very rich on the spoils.

And this money made in these gray, if not black, markets moved out of Russia in total amounts estimated to be between $25 billion and $50 billion.

The Russian public, normally passive and tolerant, and especially the free press ultimately could not reconcile the bandit capitalism—and the speeding private limousines, the bodyguards in chase vehicles, the contract killings—with the poverty on the streets. By late 1999, after nearly a decade of free politics and free economics, this second phase of Russian transformation was over. A quest for a strong hand and pride in one's country set the stage for a turn to former KGB colonel Vladimir Putin.

We have just entered the new phase. Now there is an elected government, rumored to have been selected by some of the oligarchs, which appears determined to reinstate pride in central control. The young reformers are still present with their economic plans, but press critique of the government is curbed. The military is offered more support. And the oligarchs who may have helped select President Vladimir Putin (who may have been a member of that same oligarch circle) may get a little slap on the wrist. In other words, the new scheme will run the country on tight politics and easy economics.

There seems to be little doubt that Putin was placed in the offices of prime minister and later as president to forestall something that would be worse for these oligarchs—a military coup that was not of their initiation. His charge was, most likely, to restore national pride and leave the economy free to function on global rules under the direction of the leading business forces already in place.

While Russia plunges toward an autocratic, single-theme model—restore pride in the central state—Western governments look for active dissent as a requisite for signs that democratic leanings have not been stifled. It would be consistent with the multistrategy Russian mind to provide evidence of some dissent but in a carefully controlled manner. So it is possible to detect the move of a seemingly nongovernment party under the direction of Boris Berezovsky, who might be principally responsible for appointing Putin to the leadership in the first place. Thus, evidence of dissent could be found but orchestrated behind the scenes. And real dissent in the form of press freedoms would continue to be curbed.

Under the new Putin regime, the thirst for prosperity continues as one of the megatrends of our times. People have always sought wealth, but never in history have so many been so thwarted from attaining any degree of prosperity and then, suddenly, liberated to pursue it. The value of prosperity is not only in the economic well-being it provides. It also makes healthy political stability possible. The dangers posed by Russia's potentially errant nuclear arsenal, its crime, and its fragmentation are all problems solved best through prosperity. The successful resolution of Russia's current crisis lies more with the marketplace than the ballot box.

China's crises will occur down the line. Its success or failure depends on how it deals with a growth in population and a decrease in arable land. Aside from the land lost to erosion and pollution, the countryside is being used for industry, housing, and even golf courses at an alarming rate. Optimists among the Chinese opine that the land is more valuable when put to industrial or other income-producing use than when farmed. Food can be bought more cheaply on the open world market. That may be economically smart but politically naive, because any major power dependent on an outside source for food may be in a fix if the international climate turns stormy.

China, a nation of over a billion people, is stirred up and on the move. During three visits over the past few years, I could discern the influence of technology, allowing access by the Chinese to the information highway that has proven so infectious in our times. There is no way to compute how that information will synthesize in those billion minds. China's very size makes it mysterious to others and to itself. Hu Yaobang, the party official and reformer who died in 1989 (and the mourning for whom evolved into the Tiananmen Square demonstrations), once noted: "Marx never saw a lightbulb; Engels never saw an airplane; and neither of them ever saw China." But there remain plenty of questions about the wisdom of China's own leaders who, though they have seen lightbulbs and airplanes, may still be misjudging their own nation. To a significant degree, China's future depends on how well the leaders read the lessons of its immediate past. For example, in May 1994, China's president and party chief, Jiang Zemin, drew a direct line between the suppression of the demonstrators at Tiananmen Square in June 1989 and China's current stability. "History shows that anything conducive to our national stability is good. . . . Without the resolute measures taken then, China would not have enjoyed today's stability. In the past five years, China has enjoyed economic development, social stability, and improved livelihood of the people, thanks to our consistent efforts to take stability as an overriding priority." This self-congratulatory justification for brutality is false.

Many believe that the economic forces already loosed in China have reached a point of no return and have gathered momentum. Single-party rule may still be the most efficient way to deal with the economy, now and for the foreseeable future. A delicate balance must be maintained: keeping control over the populace but not so tightly that people are alienated and rebel.

In fact, what happened in China and, to some extent, in Russia represents another of the newly emerging megatrends—dual systems/dual societies. Under the old system, in both countries, politics and economics were yoked. Now there is a sort of overlap, a bipolar system: those who enjoy wealth, freedom, and power and those who do not. Scarce resources are allocated by centralized control, as they are in wartime, while at the same time the market must be allowed to grow robust. Those beneath the poverty line in any society will live in a planned economy and a socialistic welfare state. Those with the ability to produce will live in an entirely different economy and body politic.

The picture will be complicated by another megatrend—connectivity. The profusion of information technology will make it nearly impossible to prevent those who are living in the marginal stratum from knowing about life in the upper reaches of that same nation. The main conflict will be between the equalizing force of information and the strict laws of global competition, which make a very sharp distinction between winners and losers among and within societies.

China and Russia are alike in defining themselves anew and standing as examples for most of the world. The rest of the developing world looks to them as models if only because they are closer to them in economic level. Some of those countries may prefer to emulate the United States or Germany, but they do not have that luxury. Aspirations must be gauged to be achievable or else disillusionment will set in—imitate the Joneses, not the Rockefellers or the Gateses.

Russia's problem is that it has to create a new identity for itself while still accommodating a rich variety of ethnic groups, some of which do not want to be part of the new Russia, as the war in Chechnya demonstrated. China's problem takes a different form. There are five Chinas, and slowly, but surely, they are reuniting in one way or another. Besides the mainland, there is Hong Kong, which reverted in 1997, and Macao, which did so in 1999. There is Taiwan, whose political future is uncertain, to say the least. And there is the diffuse world community of overseas Chinese who number approximately 40 million. Their attitudes toward China have changed considerably over the past several years. The country has transformed from one with which people felt it impossible to identify to one which is a source of pride.

China, as a country, has been undergoing a major reformation. It is in the process of reforming its identity, and we still don't know what the new China will be like or what place it will want at the table.

Through the centuries, the Chinese frame of mind was formed around the idea of balance—a dynamic equilibrium, not a static state. China knows what must be balanced: the rich and the poor; efficiency and unemployment; growth and inflation; stability and liberty. If the Chinese can synthesize these oppositions, they will have accomplished one of the great feats of modern history. For now, my money is on China.

Yet I must admit to feeling some misgivings about China. The whole world continues to watch that country where a great experiment in human society is progressing. We live in a time of globalization, when East and West have finally begun to blend. We all live in the same world. To take an amusing but instructive example, the mainland Chinese have gone wild for Christmas. Santa, who sometimes looks Western and sometimes oriental, is known as Old Man Christmas. He fits in with the Chinese tradition of the good old bearded wise man dispensing not wisdom, in this case, but gifts. In an article entitled "Colour of Revolution Beaten by a Nose," the *South China Morning Post* writes of Santa:

> From Beijing to Shanghai and Guangzhou, his bearded face is popping up in cities all over China. Where once red stood for revolution, at this time of year it's red for Rudolph.
>
> In Shanghai's swanky Isetan department store he's promoting everything from Triumph-brand brassieres to Estee Lauder soap-and-perfume packs. And with him have come all the other trappings of the season. Bing Crosby croons "White Christmas" over Isetan's public address system.
>
> Santa is clearly the star of China's Christmas. Jesus, Joseph, Mary and the angels hardly figure.

A cynic might say the Chinese have absorbed Christmas as it is now practiced in the West, long on commerce but gutted of spirituality. But that would be a shortsighted view. The historic role of Christianity as an ideology that shapes ethics and values—particularly its emphasis on the worth of the individual, the fate of whose soul is of cosmic importance—is directly related to the West's democratic values. In Europe and America the freedom of the individual and the free market are closely related concepts.

Paradoxically, just as democracy seems to be triumphing in the world, it is also in danger of losing its vigor and appeal. It will be very bad, indeed, if a free market thrives in an unfree China. It would, in fact, mean an acceptance of Western science and economics, but a rejection of the Western view that a person has no meaning or dignity without a strong measure of individual liberty. The great tragedy may yet be that the Western view of democracy as the most equitable and most constructive way for a society to organize itself—since it maximally utilizes the potential of its citizenry—is correct but will nevertheless be rejected for the far foreseeable future.

But no one knows the future. That's what makes life a gamble, a puzzle. Capitalism, whether it brings bitter wisdom or sweet wealth, is an adventure that never fails to exhilarate.

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