

# So What Changed? The 1998 Financial Crisis and Russia's Economic and Political Development

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**Abstract:** At the time, the August 1998 financial crisis was described as a watershed in Russia's development. This article looks at the reasons the crisis had a minimal effect on Russia's economy and argues that the political effect of the crisis was more marked. The growth that has occurred in the Russian economy since 1998 may mean that a reoccurrence of crisis will not be as benign as the 1998 crisis turned out to be.

**Keywords:** financial crisis, political economy, Russia, virtual economy

## Introduction

It is nearly a decade since the August 1998 financial crisis in Russia. At the time, the crisis marked a turning point in the development of Russia's economy. In its immediate aftermath there was some expectation that it would be the "prelude to what promises to be a long and painful period of insolvency and crisis,"<sup>1</sup> and would lead rapidly to another, more severe, financial crisis.<sup>2</sup> These predictions have not come true. Indeed, Russia's financial crisis experience would seem to be an enviable one: it has not caused a loss of economic sovereignty with international agencies asserting their influence over economic policy as a condition of alleviating the problems of currency collapse and debt default, nor did it presage a period of economic depression. Instead, the power of the Russian state has grown since 1998 and Russia has experienced a near uninterrupted economic recovery since 1999 with gross domestic product (GDP) growth averaging 6.8 percent per annum from 1999 to 2005, growth in industrial production averaging 7 percent per annum from 1999 to 2005, unemployment falling from 13.2 percent in 1998 to 7.7 percent in 2005, and average wages rising from \$108 to \$301 a month. If the 1998 crisis had an effect on Russia, it was positive.

Why was the impact of the August 1998 financial crisis so muted economically in Russia? Russia's economic success since 1998 is not because of any particular negative or positive economic effect of the crisis. The crisis of 1998 was not more devastating or

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influential because of the peculiarities of Russia's postcommunist economic system and the chief problem of this system, the lack of capital to reform industry and create a more competitive economy with a diversified export structure. This problem endures. This article argues that three factors shaped the influence of the August 1998 financial crisis on domestic forces and the subsequent development of Russia's political economy: the legacies of the USSR, the way that earlier reforms under President Boris Yeltsin benefited a small number of financiers and exporters, and the political fall out of 1998. Each of these was largely responsible for shaping one of the main segments of Russia's political economy: the "national" sectors of the economy—those branches of the economy that produce mainly for domestic consumption and do not receive a great level of foreign investment, the "transnationalized" sectors of the economy, and the government/state. Each of these segments of Russia's political economy has a peculiar relationship to the global economy. The national economy is isolated from it, receiving benefits indirectly from the general rise in national wealth from energy exports. Its role is passive; its character and structure in the 1990s meant limited foreign involvement in Russia's economy and little pressure to respond to the 1998 financial crisis in ways that would ensure continued capital inflows from abroad. The transnationalized economy and the state have more active relationships with the global economy and are in competition to facilitate Russia's relationship with the global economy. At the moment the state has the upper hand in this relationship. This might, if recovery carries on long enough, eventually turn into a successful response to Russia's problems. However, Russia's ability to grow depends on moving resources into the national economy to modernize it. If it does not, it will bear the cost of a large, unmodernized industrial sector, just as it did in the 1990s. This will perpetuate both its isolation from the global economy and its dependency on hydrocarbons, and might lead to further crisis.

### **Soviet Legacies, the National Economy, and Russia's Relative Economic Isolation**

Soviet legacies have shaped the national economy in two ways: high levels of negative value-added production (That is, the production of industrial goods whose value as manufactured items is less than the raw materials that went into their production. The value is subtracted from these materials during their transformation into a manufactured good.)<sup>3</sup> and capital deficiency in the Russian economy caused by high demand for investment during the Soviet period, when there were no constraints on borrowing because bankruptcy did not exist, and because high investment was needed to assuage the demands of planners and their political masters. Capital deficiency and negative value-added production are difficult to distinguish as causes of firm behavior and their effects were similar in the 1990s. They interacted with reform to create a "virtual economy." There is a long-running debate about the nature, source, and implications of "virtual economy," its relationship to such phenomena as tax and wage arrears, barter and monetary substitutes, and the extent to which virtual economy, as opposed to the political compromises that surrounded it, was responsible for Russia's economic slump in the 1990s.<sup>4</sup> This debate is ongoing. I use "virtual economy" as shorthand for a set of practices that provided a bridge between the end of the Soviet era and the present. These practices, with barter and tax and wage arrears prominent among them, created a "rampant 'bottom-up' return to central planning [without, of course, centralization or planning] that eliminate[d] the forces of free prices

and competition.”<sup>5</sup> This preserved the isolation of a large part of Russia’s economy from direct influence from the global economy.

Soviet industry developed in isolation from global economic pressures and prices because of central control over foreign economic relations.<sup>6</sup> This meant that changes in global supply and demand and pressures to be competitive did not impact economic activity directly. Prices were set centrally and frequently for political reasons and often did not resemble costs. Soviet managers who could not break even did not face bankruptcy because they were judged by the ability to produce a set quantity of a good rather than by their profit margins. Planners wrote off losses and did not bar further investment. Low labor productivity and high levels of investment caused by the absence of self-restraint on employment or on demands for investment such as those in market economies further hampered controlling costs.<sup>7</sup> These factors combined at the end of the Soviet era to create an inefficient economy with high costs, high demand for investment, and low returns on it. The goods produced by this economy were “negative value added goods” in that they were unsaleable beyond the Soviet Union: by the late 1980s roughly 7 to 8 percent of Soviet production was of “world standard,” that is, exportable to countries outside the USSR’s trading bloc, the Council for Mutual Economic Assistance, which it dominated politically and in which it controlled prices.<sup>8</sup> For reformers in the Russian government a key task was exposing this situation as economically unsustainable by subjecting the economy to commercialization through subsidy cuts. However, for those engaged in negative value-added production or who received capital that they would not be able to access in a commercial environment, continuity was preferable to change because continuity meant the protection of livelihoods and managerial power. The latter began to resemble ownership as the power of the Soviet state declined.<sup>9</sup> Reform threatened this control/ownership directly by both redistribution and removing the subsidies that supported it. Industrial interests resisted reform. They did this by continuing to trade among themselves, building substantial interenterprise debts, or barter, failing to pay taxes or paying them in kind, and through subsidies provided by lobbying both central and local governments. The latter were a particularly good source of subsidies because they were a conduit to energy suppliers, which, under pressure from local authorities, began to accept payment in kind or maintained supply where no payment existed. The shortage of credit caused by radical economic reform, which cut the supply of money going to industry as the state’s budget was cut, and as banks found it more profitable to lend to the state and to finance arbitrage trading than to lend to industry compounded capital deficiency.

Between 1992 and 1994 these different means of resisting reform created a virtual economy, a form of economy in which value-subtracting production was protected and resource transfers to industry compensated for the lack of capital in the economy. The continued existence of value-subtracting production and the need of capital-deficient enterprises for a new source of credit led to the development of a “value pump,” a means of infusing production with a value that it could not create, or providing industry with capital that it could not get through the financial system.<sup>10</sup> The main sources of value pumped into the national economy were the energy sector and labor. Transferring value from labor in the form of nonpayment of wages, or payment in (overvalued) kind was both a transfer of value and a means of perpetuating the systems of power and welfare in the economy at the local level because it ensured that workers remained “dependent” on their enterprise. The transfer of

value from the energy sector to the rest of the economy was based mostly on Gazprom, the state-owned gas monopoly. By mid-1996, it had “practically replaced the [Central Bank] as the source of centralized credit” to industrial producers and was owed \$10 billion by its customers.<sup>11</sup> “Liquidity,” as Shleifer and Treisman put it, “was injected into illiquid parts of the economy not in the form of money but in the form of fuel.”<sup>12</sup>

The development of the virtual economy after 1992 acted as a survival mechanism for Russian industrial interests.<sup>13</sup> It also had two further related effects.

First, barter and interenterprise debt made it hard for outside interests to see whether an investment in an enterprise would yield a return. As a result, and in tandem with the other political and social problems that Russia faced during these years, the inflow of foreign direct investment (FDI) to Russia before 1998 was very low. From 1989 to 1997, postcommunist states in the former USSR and Eastern Europe received \$187 per capita in FDI, and in Eastern Europe (all postcommunist states including the Baltic states minus the rest of the former USSR), the average was \$439 per capita. Russia received just \$63 per capita. In 1997, the year before the crash, the ratio of FDI to GDP as a percentage was on average 1.8 percent for all postcommunist states and 2.5 percent in Eastern Europe. For Russia it was 0.8 percent.<sup>14</sup> Most of this investment was concentrated in a few regions and the energy sector. The bulk of the Russian economy did not receive foreign capital. This limited the impact that foreign demands for restructuring could have post-1998. Corresponding calls for reform from the bulk of Russian industry, which did not require governmental action to assuage foreign investors and maintain the inward flow of capital, did not match foreign demands.

Second, virtual economy resulted in the demonetization of the Russian economy. This demonetization took the form of payments in kind to workers (wages and welfare) and the state (tax), or nonpayment of such, barter between enterprises, and debt build-up. These actions forced the state to look for money elsewhere and after 1994 it increasingly began to raise revenue through the sale of short-term debt. This encouraged the banking sector to continue neglecting the industrial economy and concentrate on speculative behavior. Before 1994 the banks engaged in currency speculation and loans to fund short-term commodity trades and arbitrage rather than in loans to industrial producers. These actions generated very high profits because of inflation. As inflation fell after 1994 due to increasing demonetization of the economy, these profits came from the new government debt market so that loans to industrial producers remained small. Before August 1998 loans by banks to business were worth only 11 percent of GDP in Russia (compared with 82 percent of GDP in the Czech Republic). Most of these bank to business loans were short term, with only about 1 percent of loans to business being for longer than one year.<sup>15</sup>

The result of this was that the financial crisis that hit the banking sector in August 1998 did not have any great impact on many Russian businesses, which made them vulnerable to opportunistic outside investors. Crisis in the financial sector affected the government, but it did not affect the rest of the economy, cause bankruptcies, or cause changes in lending because financial intermediation in the real economy was very small. The crisis' economic impact was nasty but short. In nontransitional emerging market economies, banking crises have depressed growth by one percentage point in the first year after the crisis and three the next before recovery on average.<sup>16</sup> In Russia, GDP dipped by slightly more than 5 percent in 1998, but this was immediately followed by growth in 1999 and thereafter.<sup>17</sup>

Russian industry survived the 1998 crash without being exposed to outside interference or having to respond to outside interests. In the short term it even profited from the crisis. The weakness of the ruble meant that consumers turned back to Russian producers because they could not afford foreign goods: the value of imports decreased by \$17 billion in 1999 and continued to be relatively low in 2000–02. Growth in demand for Russian goods boosted sales and the use of money rather than payment in kind. The amount of barter in industrial sales fell from 46 percent to 33 percent between January 1999 and January 2000 and continued to decline as the economy remonetized.

Ironically, then, the financial crisis made money more stable and usable because of the weakness of money before the crisis. Remonetization is not the same as restructuring. Some labor has been shed from industry and moved to the tertiary sector. However, industry has not yet recovered or reached a point where it is integrated into the global economy via external ownership or trade. Recovery has certainly not been based on foreign capital coming

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in and taking advantage of Russian weakness. There were net outflows of foreign capital in 2000, 2002, and 2003. There were high inflows in 2004 and 2005, but, again, relative to other states the amount was miniscule (\$15 per capita in 2004 in Russia compared with an average of \$97 for all postcommunist economies).<sup>18</sup> Moreover, these inflows were concentrated on the energy sector, which has taken the majority of industrial FDI and, since 1999 (and before), has regularly accounted for about two-thirds of any increase in industrial FDI (and domestic industrial investment), and on trade and catering.<sup>19</sup> Russia’s export structure is also unchanged. It still depends on hydrocarbon exports to generate its balance of payments surplus and fund imports (which have grown massively since 2002), and has not been able to diversify exports. This shows a fundamental weakness in the national economy. The terms of trade are beneficial to Russia because of high state spending to keep the ruble relatively undervalued. Despite the positive terms of trade, Russian industry is still uncompetitive and is perhaps likely to remain so as any comparative advantages that it has in terms of developing as a knowledge economy are eroded by developments in other emerging economies.<sup>20</sup> In effect, and despite growth, the Russian economy is still as capital deficient after 1998 as it was throughout the 1990s.

### **Russia’s Transnationalized Economy and the State: Shifting Balances of Power before and after 1998**

If the relative isolation of much of Russia’s economy and its largely “national” focus is continuous from the Soviet era, so is the transnationalized sector of the economy. Russia’s trade with the rest of the world is mainly through the sale of energy products, particularly oil and gas, coupled with sales of metals and other raw materials. This pattern of trade developed in the 1960s and became ensconced in the 1970s because the USSR



enjoyed high returns on its energy trade with the West after the OPEC oil price rises of the early 1970s and because the rest of Soviet industry began to lag technologically and competitively.<sup>21</sup>

The difference between the Soviet era and the present is that control over hydrocarbons and other major exporting sectors are divided between the state and private business. This division occurred in the mid-1990s in response to the failure of reform in 1992–93. This failure placed severe constraints on the state's ability to raise revenue. Government fiscal difficulties contributed to a change of privatization policy as well as to the sale of aforementioned government debt. The first rounds of privatization in 1992–93 were supposed to make citizens stockholders; people were given vouchers to swap for shares, and enterprises were to be privatized in such a way as to allow their managers and workers to gain control of them.<sup>22</sup> This form of privatization did not earn the state any revenue; property was transferred to “new” owners (generally existing managers), rather than sold to them, by the state.

After 1994 the state hoped to raise revenue from privatization as well as to transfer it to efficient managers. It did this through auctions (including the infamous share for loans auctions). Russia's commercial banks dominated these auctions (sometimes with the assistance of foreign investors), especially in the early share for loans auctions. The banks used these auctions to turn some of the vast profits made through currency speculation and arbitrage into property and industrial holdings. This created large financial-industrial groups (FIGs).<sup>23</sup> The leaders of these FIGs are often called oligarchs, although their ability to construct an oligarchy was never great, as some of their fates after 2000 show.

Only enterprises with export potential and that were attractive to foreign investors (oil producers, major producers of metals, telecommunication firms) were auctioned to banks to create FIGs. These firms integrated into the global economy mainly through trade. On average, slightly less than 50 percent of Russia's exports in the 1990s were hydrocarbons, and slightly more than 20 percent were metals.<sup>24</sup> Foreign investment went into these sectors, but low levels of investment, legal limits (until 1997 foreign ownership in oil firms was capped at 15 percent), and nefarious corporate governance often limited its impact. As a result, although foreign investment was larger in sectors such as oil and was necessary for modernization, only 4.1 percent of enterprises in the energy sector received foreign investment by 1998; in ferrous and non-ferrous metals the figures were 1.5 percent and 2.9 percent of enterprises, respectively. These exceeded the industrial average of 0.7 percent foreign involvement, but foreign capital was lacking in the sectors that dominated Russia's export trade.<sup>25</sup>

The transnational sector of Russia's economy was thus largely formed as a response to the failures of the first wave of reform. Political actors protected this formation of the transnational sector of the Russian economy both nationally and regionally and, in turn, were granted support for their tenure from the banks and FIGs that made up the transnational sector of the Russian economy. This mutually beneficial relationship lasted from 1994 to 1997. The relationship between the FIGs and their owners and the state began to change after 1997 because the cost of financing the state's deficit through the sale of short-term debt was too expensive (especially because privatization for cash had not been lucrative and because FIGs did not pay their taxes). The government tried to increase its revenue by lowering the cost of its borrowing through opening up the government debt market to

foreigners and by improving tax collection. Both of these policies threatened FIGs' profits. Their banking sectors would be hit if government debt returns fell; their industrial wings would be less profitable if they had to pay their taxes on time instead of using unpaid taxes to buy government debt.

These actions were part of a general call by Yeltsin for the state to be independent of particular social interests and able to act in the general interest of the state as articulated, for example, in his 1997 state of the union address. The push for more secure state finances did not work and was partially responsible for the August 1998 financial crisis.<sup>26</sup> The drive to isolate political power from particular social interests—in this case the interest of the FIGs—was successful to the extent that any semblance of a group interest between the FIGs disappeared as competition between them for property became vitriolic under pressure from the state, and their relations with politicians became more conflicted.<sup>27</sup> This also contributed to the build-up to the August 1998 financial crisis, because it led to government turnover and weakened credibility so that securing crisis prevention measures from parliament and from outside agencies such as the IMF became harder.

The impact of the August 1998 financial crisis was interpreted with these pre-crisis developments and events in mind. The linkage of banks to industry meant that although there were some casualties in the banking sector, many of the big banks, or at least their owners and the holding companies that they controlled, survived in one way or another. FIGs were hit by the losses they sustained when the government defaulted on some of its debt and devalued the ruble, but they could fall back on the funds that continued to flow into their coffers from their industrial operations, in particular from their holdings in the oil sector as prices began to rise after 1998. Indeed, the weakness of the ruble in the immediate aftermath of the crisis made the export producing firms controlled by the banks even more profitable. Control over these assets and the profit that could be squeezed from them were secured by diluting the minority stockholders' holdings and transferring pricing operations that created rent for holding companies in which outside stockholders had no stake. Such actions were not new. In some cases their use both pre- and post-dated the 1998 crisis. Nor were they confined to the oil industry.<sup>28</sup> However, they gathered momentum in 1999, partly due to the financial crisis and the need to tighten control over oil firms acquired in the 1990s. Control of the oil industries was directly threatened in early 1999 when the government of Yevgeny Primakov, which was less committed to market solutions and less liberal in its political and economic orientation than pre-August 1998 governments, eliminated the possibility of creating a new state oil company that would include those firms in which the state still had an interest and several that had been privatized.<sup>29</sup>

The form of privatization undertaken after 1994 thus shaped who was involved in the transnational sector and meant that the effects of the 1998 financial crisis were ameliorated for some of the banks. One result of this was that the gates were not opened to an influx of foreign banks as has been the case following other financial crises in post-communist states, and as was expected in some quarters at the time of the 1998 crash. The number of foreign-owned banks has grown from 30 out of 1476 in 1998 to 41 out of 1329 in 2003. However, this growth mostly took place after 2000–01, and the asset share of foreign-owned banks has fallen since 1999 from 10.6 to 7.4 percent. This is a very different picture than Eastern Europe. In 2003, Slovakia, for example, 16 out of 21 banks were foreign-owned with 96.3 percent asset share; in the Czech Republic the

figures were 26 out of 35 banks with 86.3 percent asset share; Hungary had 29 out of 38 banks with 83.5 percent asset share; and even in Serbia and Montenegro, 16 out of 47 banks were foreign-owned with 38.4 percent asset share.<sup>30</sup>

If the impact of the 1998 financial crisis on Russia's FIGs was muted because of their particular mixture of financial and industrial operations, the impact on the state was more immediate. The crisis weakened Yeltsin's authority, his ability to command loyalty from regional leaders and some economic leaders, and threw open the question of his succession. Several elite groups began mobilizing early in 1999 with an eye on capturing support, competing in the December 1999 elections, and building a bandwagon that would last through the 2000 presidential election. Ironically, the political impact of economic crisis allowed for an even more complete reassertion of state autonomy than Yeltsin called for in 1997. By weakening Yeltsin and dividing the Russian political elite, particularly regional leaders from the center, the 1998 crisis helped to separate the politics of succession from social interests. The divide between government and business and the weakening of the center's control over the regions made them competitors in the succession struggle rather than negotiating parties as they had been for Yeltsin's 1996 reelection. Yeltsin was forced to find a successor from within his administration—Vladimir Putin—and use the extensive formal powers of the presidency to reclaim some degree of control over the political process. Yeltsin and Putin were lucky in that Putin's appointment as prime minister in August 1999, and Yeltsin's ceding of authority to him, created a bandwagon effect in late 1999 that overtook the efforts of his rivals. Putin's hard-line toward Chechnya when war recommenced at the end of September 1999 helped, as did the recovery of the national economy, because of the shallow impact of the 1998 financial crisis.<sup>31</sup> The net effect of these changes was that Putin won the presidency in 2000 in what turned out to be a noncontest—the only real question was whether Putin would secure a first round victory, and he did—in which Putin made no promises to any group, voter, or vested interest, to win. Once Putin had won the presidency in 2000 the effect of the 1998 crisis on politics reached its conclusion: he used his mandate to re-create central political authority.

This reassertion of central state control took two forms in the first months of Putin's presidency: it exerted central power over regional leadership by curtailing the rights of regional leaders and weakening their tenure and voice in central decision making and it launched an attack on major business actors who had media interests, particularly Vladimir Gusinsky and his Media-Most group and Boris Berezovsky, who had a 49 percent stake in ORT, the main Russian TV channel. The opening of investigations into the privatization and tax payments of several other FIGs and businessmen accompanied action against the media interests of big banks and powerful business interests. Together the investigations and the takeovers of business media interests were a strong signal to FIGs that the political situation had changed and not in their favor. Putin made this signal even more explicit in a meeting that he held with business leaders in July 2000. At this meeting business leaders pressed for an end to the investigations and for guarantees that there would be no redistribution of privatized state property. Although Putin made some concessions on property redistribution he warned the oligarchs that interference in politics would no longer be tolerated.

Putin's meeting with business leaders only marked a temporary ceasefire. The reassertion of central executive political authority soon involved closer regulation of the strategic sectors of the economy to make the state the arbiter of the terms and condition on which



major enterprises could link to the global economy. There was limited capacity to expand Russian energy production, or at least limited capacity to expand production without major outlay in the future.<sup>32</sup> This outlay was not forthcoming following Putin's election because the oligarchs expanded production to deplete the resources without investing in future production, or they looked to foreign investors without taking account of the state. The problem with foreign investment (besides arguments about economic security) is that it potentially creates more stable property rights in the energy sector. For the state this is a trade-off. Although it welcomes the investment, the reinforcement of property rights in the oil industry gives it less control over the amount of oil pumped and the amount of rent received.<sup>33</sup> This problem was an acute one in the early years of Putin's administration. Between 1998 and 2002 the export value of minerals (of which about 98 percent are oil and related products) nearly doubled in dollar terms. Growth was particularly marked in 2000, when exports were 171.5 percent of what they had been in 1999.<sup>34</sup> Six major private oil firms did the bulk of this exporting, with firms under state control barely expanding production.<sup>35</sup> At the same time many of these firms began to reposition themselves to facilitate inward investment. Companies such as Yukos, which had been one of the worst offenders against minority shareholders, did an about face and announced that they would be adopting international accounting standards. This was the beginning of a wave of reengagement with international financial institutions by major Russian companies, with IPO launches on the London Stock Exchange a favored method of expanding foreign participation. Action against firms such as Yukos, which began in 2003, were attempts to stop this process, which the center saw as uncontrollable. The attack on Yukos fit with the style of political management that had already begun to develop and had been displayed in the attacks on Media-Most and Berezovsky. Besides tax evasion, Khodorkovsky's "crimes" were political (support for civil society and opposition parties) as well as economic, championing a break-up of the state's oil transport monopoly (a major source of rent) and seeking to isolate his firm from state influence by establishing international linkages.

This development of state intervention has prompted some analysts to describe Russia under Putin as heading toward a form of state capitalism.<sup>36</sup> Yukos marked a turning point, but whether it brought about the establishment of a new state capitalist order remains to be seen. The Yukos affair has been followed by moves to curtail foreign investment through legislation, blocking the sale of companies such as *Siloviye Mashiny* (Power Machines, which produces equipment for the fuel-and-energy and the nuclear power sectors) to foreign firms (in this case Siemens; it was subsequently sold to UES, the state-owned electricity monopoly), attempts to place state representatives on more company boards such as the board of *Avtovaz* (cars), the sale of *Sibneft* (Abramovich's oil firm) to Gazprom, the state increasing its holdings and control of Gazprom, and the rolling back of privatization of major industrial units such as *Kamaz* (trucks). Yet, although these and other actions support the view that there is a centralization of economic power in Russia and might be taken to indicate that intervention has developed a logic of its own, they have been tempered by the fact that the acquisition of firms such as Yukos and *Sibneft* by state companies has seen them expand their foreign debts considerably to fund their respective purchases. Gazprom had to borrow \$7.3 billion to buy *Sibneft*, for example, and Rosneft began to privatize, which included offering 13 percent of its shares to international investors in July 2006 to pay for its takeover of Yukos. Increased political control has thus changed the way that the

state manages the transnationalization of the Russian economy rather than rolling it back to some form of autarkic, state-led development.

### Crisis and the Future

The limited impact of the August 1998 financial crisis on the national economy and the shift in the state's power over the transnationalized economy leaves open the issue of how far the crisis actually changed Russia's ability to develop as a part of the global economy. Specifically, Russia still has to cope with the fact that its national economy is still capital deficient. Does it transfer wealth from the transnationalized sector of the economy to the capital deficient sector? If so, how?

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So far there has not been an answer to these questions and few clues have been proposed as to what the answer might be. Pressure to transfer resources from the transnationalized sector to the national sector of the economy is muted, which is not surprising because there is a general rise in living standards caused by rising real wages. There are also transfers already in place. Domestic energy prices are charged at rates lower than international prices so that a subsidy can be maintained from Gaz-

prom and other energy firms. This is backed up by a “competitiveness” subsidy: the Central Bank's interventions in the currency market have held down the appreciation of the ruble and hence the volume of imports. Foreign currency reserves have risen dramatically from \$12 billion in 1998 to \$188.5 billion at the end of January 2006 and will top \$250 billion by the end of 2006. Purchases of foreign exchange were equal to 8–9 percent of GDP in 2003–2005 and are equal to 70 percent of domestic money supply. If the Central Bank had not heavily intervened in the foreign exchange market the ruble would have already appreciated beyond its 1998 level.

The second reason that there has not been a move to transfer resources to the national economy and alleviate its capital deficiency is organizational. Putin believes that growth is possible and that there should be a strategy for a more activist use of Russia's natural resources to achieve this growth. Hence the role of the state should grow in certain key sectors. This belief dates back to his PhD thesis<sup>37</sup> and has been expressed several times in his calls for doubling the GDP within the decade. However, although there has been a growth in the power of the central executive, the overall efficacy of public administration remains low. The effectiveness and competence of many state agencies is poor, with corruption still a major problem. Indeed, corruption seems to be growing, and despite efforts to control the growth of the state, the number of bureaucrats continues to rise, having grown by a quarter since Putin took office. A more activist state approach is perhaps on hold while state reform takes place. This is likely to be a long process.

Finally, the strength of the central executive has meant that calls for resource transfers are not politically effective. Demanding more resource transfers would require channels

through which demands could be made and actors willing to concede to those demands. In the 1990s there was a willingness to make concessions and demands flowed through business associations and regional leaders. But Putin has curtailed regional leaders' influence and business associations have, over time, become more market-oriented. The principle association has become dominated by representatives from the transnationalized sector of the economy—that is, from the group from whom resources would be transferred.<sup>38</sup> Consequently, only moderate sums were made available to a new Federal Investment Fund and for the completion of “national priority projects” at the end of 2005. These do not represent major increases in state spending and fall short of demands to spend some of the funds in the Stabilization Fund.<sup>39</sup> There are, however, politically and administratively manageable amounts and projects.

The lack of pressure to transfer resources, combined with prudent management of the state budget, has meant that the state has built up a large Stabilization Fund, some of which it now intends to invest abroad. This should act as a cushion for the state budget when the price of oil falls. Not planning for major expenditures has also meant that the state can still run a surplus if the price of oil falls. However, although this means that falling oil revenues will not hit the state hard in their first instance there are still problems ensuring that growth continues even if the price of oil remains high. Further growth depends on either ever-higher oil prices, greater volume of oil production, or diversification. Even if Russia could pump more oil it would then have to get it to the areas where demand is high, particularly in Asia. It is not certain that Russia can pump much more oil and even if it does it has to develop its pipeline network to Asian customers. These pipelines will take several years to build. To depend on oil for growth therefore leaves Russia vulnerable at the very least to problems of maintaining consistent growth. Price fluctuations might lead to temporary, short depressions of growth rates at the very least. Although these may not affect the state so much in the future because of the Stabilization Fund, they will encourage capital flight and undermine business confidence, which will affect investment and perpetuate the problem of capital deficiency. The degree to which changing oil prices affects GDP is hard to identify because of hidden effects such as transfer pricing and the impact of oil production volumes rather than price. However, the general view is that the impact is significant. Ruatava estimates that a 10 percent rise or fall in oil prices leads to a 2.2 percent rise or fall in GDP.<sup>40</sup> Moreover, industrial growth is generally heavily dependent on the oil industry; 80 percent of the variation and increase in industrial production in the first few years after 1998, when the effects of ruble devaluation of the economy were strongest, can be explained by the strengthened price of oil.<sup>41</sup> The steel industry in Russia is heavily dependent on the hydrocarbon extraction industries for orders.

To balance out the effects that rising and falling oil prices and production levels might cause requires Russia to develop its other industrial sectors. This does not appear to be happening. Capital investment has increased since 1998, reversing the trend of the 1990s when there was a massive reduction of investment. However, the share of the oil and gas industries in this investment has risen at a rate that accounts for virtually the entire percentage rise in industrial investment.<sup>42</sup> Overall, investment is low in Russia in comparison to other fast growing economies in Eastern Europe and Asia.<sup>43</sup> In official surveys the main factor reported as limiting business activity by industry has consistently been insufficient monetary instruments—capital and credit—both before and after the 1998 financial crisis,

although the remonetization of the economy has lowered the overall number of respondents seeing it as a problem, as might be expected.<sup>44</sup>

Although these problems remain and growth over time is uncertain, Russia is still progressing. It has not resolved the issue of what kind of capitalist economy it has after 1998, and has remained permanently on the cusp of being something else. If it can develop state capacity, this something else may be some form of developmental state; resources could be tied to state capacity to produce growth. This growth would probably be different from that witnessed in other developmental states because Russia's starting point would be different, as would some of the problems that it faces because of geography and geopolitics. However, it would be a radical break with the past if development promoted a wider engagement with the global economy than only through the energy sector.

If Russia cannot achieve this change, it runs the risk of developing in fits and starts according to the price of energy. Alternatively, if energy prices fall for a longer period of time, it may find itself back in the position that it was in pre-August 1998, having to support the national economy in some way by resource transfers when money is scarce. If the latter is Russia's path the question becomes: has the state accumulated enough power to bear depression without transferring resources from the transnationalized sector of the economy to the national? In other words, can a political regime survive a contraction of the national economy and restructuring via unemployment without using its new power in the economy to try to hide depression through subsidies? Neither the prospect of a more powerful Russian state controlling depression and unemployment nor its allowing an unmodernized national economy to continue indefinitely is a very attractive proposition. The first option would marry Russia's devalued democracy to national poverty, the second would see Russia store up its problems and make their eventual resolution harder. If the former is Russia's future, developing in fits and starts according to the price of energy, it might just carry on muddling through much the same as it is now, depleting its Stabilization Fund when oil revenues are low, topping it up when they are high. It requires political will to be financially disciplined in good times and in bad, and such will might not outlast Putin. The danger would be that Russia has to borrow again to cover downturns and leaves itself open to another crisis, one that would be more destructive than 1998 because of the remonetization of the economy, and which would have the depressive effects that have characterized crisis in other parts of the world.

### **Conclusion**

The impact of the 1998 financial crisis was filtered through the developments of the 1990s in Russia, in particular the failure to develop a financial structure that was supportive and engaged with most of the industrial economy, the maintenance of negative value-added production and capital deficiency in the national economy, and the linkage of banks to those few sectors of the economy that were capable of exporting or attractive to foreign capital. In the first instance this meant that the economy recovered rapidly after the crisis and that the most dramatic changes caused by crisis were in politics. These political changes have since influenced the way in which the transnationalized sector can link to the global economy. Thus, Russia's weaknesses as a capitalist economy protected it from financial crisis effects. Its crisis experience, even the way and reasons for its being able to resist increased foreign pressure after crisis, might be relatively unique as a result. This

might not be the case in the future because this most recent crisis led to the remonetization of the Russian economy. The 1998 financial crisis might turn out to be a transitional one for Russia in more than one sense. It was a part of Russia's early political and economic transition, and coming together with an economic boom caused by high oil prices might lead to growth that could expose Russia to a depression-inducing crisis in the future.

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