The Current Economic Crisis in Russia is Neither

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The ruble's imminent plummet, amid increasing revenue shortages and foreign debt, has been the focus of international attention toward Russia and elite domestic strife within Russia for the past several months. In their desperate attempt to find a solution, as well as to avoid taking (their share of) the blame, both sides have cited separate causes. International lenders claim that the primary source of Russia's economic ills is the government's poor fiscal policies, while Russian leaders attribute their woes to the unexpected fall in international oil prices and the financial turmoil in Asia. Still others blame the International Monetary Fund (IMF) itself for insisting upon a monetary policy that was ultimately untenable given Russia's social and economic conditions.

This finger-pointing fails to capture the true nature of the current economic crisis in Russia. It portrays the crisis as the outcome of immediate causes that might have been prevented by better tax codes, a stable international economy, or better economic advice. Yet, in actuality, the crisis is neither current nor economic. Rather, it is the cumulative outcome of Russia's failure to build a viable modern state; that is, one with sufficient autonomy and capacity to formulate and implement economic goals beyond the parochial interests of dominant social groups. Russia's attempt to build a market economy has not coincided with efforts to construct key state institutions empowered to regulate it, but rather, with the invigoration of Soviet-era practices that undermine this role. This has contributed to the rise of alternative power bases which, in the absence of the rule of law, are allowed to govern themselves. Thus, they engage in self-interested behavior without regard for the immediate consequences or broader externalities. The result is a country on the verge of political and economic collapse thanks to a small number of individuals who have enriched themselves at the risk of both state disintegration and societal detachment.

That the roots of Russia's crisis are deep and essentially political in origin is crucial not only to understanding the nature of the crisis, but also to developing a workable solution. If Russia's crisis was truly current and economic, for example, this might mandate another set of IMF bailouts aimed at helping the state achieve macroeconomic stabilization. The true nature of the crisis, however, mandates a long-term policy directed toward (re-)building the Russian state itself, which can only be achieved from within. Contrary to the conventional wisdom that economic reform must proceed political reform if it is to succeed, in Russia's case the lesson is precisely the reverse. The solution, therefore, must be centered on political reform.

The Roots of Russia's Crisis

Two primary tenets have guided Russian policymaking since the election of Boris Yeltsin to the presidency in 1991: first, the prioritization of economic over political reform; and second, the sanctity of personal ties and informal networks over institutions. Their sum result was to concentrate economic, and ultimately political, power among a set of new and increasingly autonomous forces--e.g., financial-industrial groups (FIGs), regional leaders, and criminals. These forces have come together to pose a direct challenge to the central state's authority by inhibiting its ability to independently formulate and successfully implement a viable economic reform plan. Thus, ironically, the Russian state has undermined its own autonomy and capacity.

From the beginning, Russian reformers prioritized the introduction of a market over the establishment of legitimate, centralized political authority and rule of law necessary to govern this market. This is not surprising, considering that the majority of elites in the new government received their training in a system which emphasized the primacy of the economy over social and political relations. This Soviet-inspired ideology was actually invigorated by these elites' fervent belief in what once was considered its nemesis--capitalism and the power of the market. In essence, Russian reformers took neo-liberalism to the extreme, focusing their attention on the accumulation of private goods and capital by any means with the naïve expectation, it seems, that the necessary political reforms would somehow follow.

At the same time, the central government continued to rely upon personal ties and informal networks developed under the Soviet system to formulate and implement policy, rather than investing in institution-building. Yeltsin himself refused to institutionalize his popular authority in 1991, for example, by constructing a new political party or holding new elections to replace the Soviet-era parliament. He chose instead to depend upon the personalistic style of leadership that characterized Soviet rule, and hence, to centralize the policymaking process among a few select individuals who could easily utilize their political influence to further their own economic gain. In fact, those in the best position to take advantage of Mikhail Gorbachev's economic reform program (Perestroika) in the mid-to-late 1980s--such as Communist Party officials and factory directors--actually acquired their real wealth under Yeltsin's government.

The pervasiveness of these two tendencies in Russian policymaking (and the consequences) are clearly illustrated by three integrally related processes geared toward the establishment of a "market economy" in Russia: price liberalization, privatization and monetarization.

Price Liberalization

The first concrete step taken by the new Russian government toward establishing a market economy was the liberalization of prices in January 1992. As predicted, this led almost immediately to hyperinflation; prices rose at an unprecedented rate--300-400 times over the next 10 months--and most Russian citizens lost their entire savings. Yet, while ordinary Russians were becoming impoverished, those with close connections to the preceding Soviet and current Russian government used their access to benefit personally from spiraling inflation. One

common method was through access to foreign trade, which only a handful of individuals (and their relatives) attained as part of Gorbachev's attempts to stimulate the stagnant Soviet economy. These individuals organized cooperatives, which purchased foreign goods with Communist Party (i.e. state) money and sold them to domestic consumers for a profit. They then repaid their debts to the state in rubles and used the remaining foreign currency to create commercial banks. These commercial banks were then well-positioned to provide the state with much needed capital in the wake of inflation-generated shortages. Some credits were issued to Russian enterprises to cover their production costs (particularly wages), but most were deposited in commercial banks at market rates instead. Another common method was to confiscate state assets and resell them to the state as one's own property. This practice also has its origins in the system of cooperatives, and was especially popular among factory directors, given the abundant resources at their disposal. It continued, and in fact was invigorated by the ensuing privatization of Russian enterprises (discussed below).

The Russian government continued to allow certain individuals and groups privileged access to foreign trade and state-owned assets. The energy sector is a case in point. Gazprom, the state monopoly on the production, transportation, and distribution of Russia's natural gas, remained intact thanks to the lobbying efforts of its highest-ranking patron, then Prime Minister Viktor Chenomyrdin. It has continued to provide natural gas to domestic consumers at subsidized prices while selling a certain percentage abroad for hard currency at world market rates. The key difference is that the profits are now accrued directly by the company's board of directors rather than the Communist Party. In the oil sector, the state monopoly was replaced by several vertically-integrated companies that essentially "compete" for the right to export oil abroad. Over the past several years, companies have won and lost export licenses based on their ability to pay large bribes to the bureaucrats in government agencies responsible for issuing these licenses. This pertains to other natural resources as well, such as iron, steel, and non-ferrous metals. Government officials, in this case usually at the regional-level, would either extract large bribes in order to grant licenses or insist on becoming a business partner. Because domestic prices have been, and continue to be, much lower than the international price for most natural resources, "entrepreneurial" Russians learned quickly that buying them up cheap at home and selling them abroad was an extremely quick way of amassing great personal wealth without incurring costs.

Meanwhile, to ease the social burden of the market transition the Russian government also continued to subsidize imports, which could then be resold to the population at domestic market prices. With the breakdown of the state distribution system, a system of commodity exchanges and a burgeoning network of private traders emerged to seize this opportunity. They, too, had strong links to Soviet and Russian officialdom, as well as to criminal elements who engaged in private trade under the Soviet system.

Privatization

The de facto privatization of state property that took place from the late-1980s through mid-1992 served as a precursor to the government privatization program launched in October 1992. This "official" privatization consisted of two main parts. The first included the transfer of state ownership of large-scale enterprises through a voucher system. Vouchers worth 10,000 rubles

were distributed to Russian workers, who could then exchange them for shares in industry. Most Russian workers, however, failed to see the value in acquiring industrial shares because they did not equate them, as we do in the West, either with receiving monthly stock dividends or exerting some influence on the managerial process. Those Russians who did consider the vouchers valuable were already well-entrenched in the expanding commercial and criminal structures. They accumulated the majority of vouchers either by purchasing them from ill-informed citizens for nominal fees or guaranteeing high dividends (which, by the way, never materialized) in return for investing the vouchers in a collective fund. The second phase was money privatization. In theory, this involved setting a price for each enterprise, based on its current infrastructure and productive potential, and then choosing among competitive bids. In practice, it consisted of selling Russian industry at undervalued prices to favored "insiders" through the manipulation of documents and auctioning procedures at all levels of government.

This second phase of privatization also allowed investors to acquire ownership in Russian industries through a "loans for shares" agreement between the central government and several newly-formed banks with close ties to the executive branch. Attempting to meet pressure from international financial institutions to cut inflation and balance the budget, the Russian government was forced to borrow money from commercial banks to meet its obligations. Beginning in late-1994, they used shares in state-owned enterprises as collateral. When they failed to repay the loans, the ownership transferred directly to the banks. Banks acquired some of Russia's largest and most valuable enterprises in this manner, including Norilsk Nickel, the largest nickel exporter in the world, and several of the newly formed vertically-integrated oil companies mentioned above (e.g. Sidanko and Yukos Oil). This then formed the basis for the emergence of financial-industrial groups (FIGs), uniquely positioned to exert pressure on Russian policymakers.

Not surprisingly, the Russian privatization program had two detrimental effects. First, it served to legitimize the prior process of "unofficial" privatization in which well-connected elites, namely Communist Party officials and factory managers, acquired vast wealth through claiming state property as their own. Second, it reinforced growing ties between government officials, financial institutions, and the criminal world.

Monetarization

The Russian banking system developed alongside the privatization process, and in a similar manner. Faced with the need to bolster the ruble and finance its budget, the government entrusted emergent banks to manage its accounts. These banks were selected based on their personal ties to government officials, in particular the degree to which they supported Yeltsin during his confrontation with the Russian parliament in October 1993. Initially, they were able to use this privileged role in the Russian economy primarily for economic gain. Their strategy was to delay payments on government obligations (in particular, wages) and instead to issue credits at exorbitant interest rates. They also engaged in other domestic money-making schemes, such as paying state debts to regional governments in exchange for a large percentage of the promissory notes' face value, while investing the bulk of their capital in more stable markets abroad. It is

important to note that commercial banks rarely used their surplus funds to pay wage arrears, even once they became the actual owners of some of Russia's most profitable industries.

Yet, in a rather short period of time, they used their position for political gain as well. The "loans for shares" program mentioned above provided one venue for influence over government policy, while their acquisition of major media outlets and private security forces created still others. One particular issue-area in which the banks have exerted influence is monetary policy. Their stubborn refusal to allow devaluation of the ruble was arguably behind the continued use of increasingly scarce capital to prop-up Russia's currency. Although the IMF's insistence on currency stabilization of course also contributed to this short-sighted policy, the domestic roots are often overlooked. Financial support from banking tycoons was also crucial to the success of Yeltsin's re-election campaign in June 1996.

The consequences of these developments are severe, both for the Russian economy and the Russian state.

- A "normal" banking system failed to emerge in Russia. Thus far, banks have failed to perform their intended role in a market economy: to take in deposits, maintain some in reserve, and use the rest to loan money (with interest) to credit-worthy individuals and commercial entities. Instead, they have functioned primarily to redistribute public funds to enterprises and to profit from foreign exchange and government bonds. (When commercial banks did lend money, therefore, the borrower was often unable to pay. Many banks then enlisted the services of what has emerged as a growing criminal sector to help them collect debts.)
- The government is heavily indebted to and dependent upon these banks.
- Despite its increasing debt, the central government is still unable to pay back wages because it cannot effectively monitor the very channels it depends upon to do this: commercial banks, regional governments, and enterprise directors.

Failure to pay wages leads, in turn, to loss in tax revenues, which creates the government's need for more loans to sustain itself. The failure to collect taxes is thus an additional and related problem. The banking system certainly did not create Russia's taxation problem. Tax evasion has been a pervasive feature of the Russian economy since 1991, with enterprises leading the way. Yet it did exacerbate the incapacity of the Russian state to tax by continually financing, and thus perpetuating, its deficit. Beginning in June 1994, this was achieved primarily by issuing government bonds (GKOs). Rather than solving the problem, this created another impetus for corporate tax evasion. For example, even if enterprises possessed the funds to pay their taxes, they would prefer instead to use the money to buy short-term GKOs and earn interest.

The Failure of Russian Institution-Building

All three processes described above transpired in the absence of an attempt to construct and empower an independent source of regulation. There was little attempt on the part of the Russian government to build institutions consistent with the rule of law, such as a viable court system or

a legitimate police force. Nor were domestic efforts directed at the institutionalization of a legal system to protect property rights, enforce contracts, and govern bankruptcy procedures. Instead, the Russian government relied upon the self-discipline of its own rent-seeking officials, factory directors, and commercial bankers to execute its policies. The result was that everything was "for sale," including the state itself.

Indeed, the primacy of economic over political reform and the emphasis on personal ties that characterized the Russian transition's earliest stages reinforced one another to such an extent that they undermined any subsequent attempts to build central state institutions. The most important of these was the 1993 Constitution, which established both a "super-presidential" and a federal system in Russia. The rationale behind these major legal changes was to strengthen the presidency and to appease renegade regions while maintaining territorial integrity, respectively. In practice, however, they had the reverse effect. The super-presidential system made the presidency more susceptible to private group interests because they now had a much easier target to "capture." Thus, it only served to bolster the effectiveness of the FIGs' personalistic lobbying style. Chapter III was supposedly designed to encode central-peripheral relations as symmetrical, or equal among regions, but its ambiguity allows this relationship to be determined via bilateral agreements between the center and the regions. This further legitimated trends toward asymmetrical federalism, manifested in regional governments' adoption of laws, policies, and even constitutions in direct contradiction with federal laws, policies, and the Russian Constitution. In response to Russia's recent financial turmoil, some regions have re-instituted Soviet-style price controls and called for the re-nationalization of local industry.

Possible Solutions to the Crisis

In short, Russia's crisis is political, rather than economic in nature because it stems from Russia's attempt to establish a so-called "market economy" in the absence of a strong state. Rather than bolstering its authority by building institutions designed to regulate the market transition, the Russian government actively eroded its ability to play a constructive and decisive role in this process. Ironically, it has made itself increasingly irrelevant with respect to FIGs, regional leaders, and criminals.

Russia is experiencing a crisis of the state itself: it cannot be solved by funneling more money into a black hole at the central level, nor by contributing to the country's de facto decentralization of authority by channeling loans directly to the regions. A state incapable of making or implementing its own policies cannot execute the prescriptions of other countries. Thus, the international community can do little if anything to improve the situation in Russia (short of armed occupation, that is) given the weakness of Russia's political institutions--even with the Russian government's full support. For example, the IMF and World Bank can make future loans contingent upon myriad "economically sound" recommendations and requirements, but the Russian government must have both the collective will and the administrative capacity to fulfill these directives. The IMF has defended past bailouts by arguing that Russia was committed to structural reform. Whether the government is committed or not is hard to tell, but the bottom line is that it has not followed through with its promises because it lacks the autonomy or capacity to do so. One could even argue that Russian budgets have never represented more than a statement

of good intentions aimed at appeasing their creditors with little basis in reality. Year after year, for example, the Russian government has pledged to increase its tax collection rates despite the fact that this was (and remains) a political impossibility.

Russia's predicament requires a solution aimed at long-term institution building--a solution that, for better or for worse, depends primarily upon internal actors. International efforts thus far have been aimed at boosting foreign investors' confidence in the Russian economy. Yet, these efforts are futile if they do not boost confidence at home. The rent-seeking business/government elites in Russia will only become law-abiding citizens when they believe that their economic future lies within Russia. They will only believe in this future, however, once a competent state begins to form--that is, one that controls for the "ills" of the market rather than one that is controlled by these ills. Thus, the central task ahead for Russian policymakers is to convince rule-evaders that the rule of law is a necessary public good and that the state is the most efficient provider of this public good. The best thing that Western governments and international organizations can do to help in this endeavor is make future aid and loans contingent upon political rather than economic reform--and really mean it.

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