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RUSSIA: ENTRENCHED ELITES RIDE OUT THE CRISIS

By Peter Rutland

The South East Asian crisis of 1997 had a delayed but substantial impact on Russia, triggering a devaluation and debt default in August 1998. This showed that Russia had come a long way from its Soviet past and was now an integral part of the global capitalist economy. It also confirmed that integration is a risky business, bringing increased exposure to fluctuations in world commodity and capital markets.

The crisis triggered much angst amongst Western governments, who woke up to the fact that all was not well with the Russian transition. But once the dust had settled the impact of the crisis on Russia's political and economic institutions was surprisingly muted. It caused some reshuffling within the political and financial elites, but did not change the basic trajectory of developments in the country since 1991.

Post-Soviet Russia has an authoritarian political system with formal democratic institutions, very strong presidential leadership, a fragmented party system, and a weak ideological framework. The economic policy pursued since 1991 has been generally forward-looking, but usually with a very short time horizon and often driven by the venal interests of a narrow circle of decision-makers and their cronies. Surprisingly radical steps were taken in the direction of market reform in the chaotic year of 1992, but since then progress towards further liberalization has been slow and episodic.

INTRODUCTION

The key contours of Russian political economy were shaped long before 1998: the crisis merely served to highlight the system's existing features. The August crisis was the most serious since the collapse of the ruble in October 1994 ("Black Tuesday"), but did not presage any fundamental systemic changes.

Politically, Boris Yeltsin had succeeded in creating a powerful presidential system of rule by the end of 1993. This gave the government a high degree of autonomy from political and economic groups in society, enabling them to ride out crises with a high degree of impunity. Some individual leaders were jettisoned, but the real levers of power did not change hands.

The numerous subsidy-seeking industrial and farm lobbies inherited from the Soviet system had already been bludgeoned into political powerlessness by the twin shocks of Soviet collapse in December 1991 and price liberalization in January 1992. Federal revenues fell to 10% of GDP, and these lobbies were scrambling for a share of a vanishing pie. Soft bank credits bought them some time in 1992-93, but tightening control over the money supply from 1994 left them high and dry.

The key new interests were the private banking groups which emerged out of the wreckage of the Soviet economy and became major players in Yeltsin's Russia. Although they thrived under market reform, they were still highly dependent on state favors. They grew rich from sweetheart deals as state assets were privatized, and from the granting of beneficial licenses to import highly-taxed goods like alcohol and tobacco. The big money was to be made through the export of metals, oil, and gas (with access to the state-owned export pipelines granted through a non-transparent quota system). The new bankers built up media empires, which they used to help Yeltsin win re-election in 1996.

The August crisis slowed the onward march of the oligarchs, and strengthened the hand of the state apparatus (especially the security structures: that is, the men with guns). Many of the financial oligarchs were weakened or ruined by the debt default and devaluation, while the energy lobby suffered from falling oil prices in the wake of the Asian crisis. However, oil prices soon rebounded, and the oligarchs likewise showed considerable staying power, rallying forces in the December 1999 parliamentary election behind the new Prime Minister Vladimir Putin.

In a pluralist democracy, one would have predicted that at some point the financial oligarchs would have had to cede political power to the Soviet-era industrial and agricultural interests whose workers made up a majority of the electorate. However, Yeltsin's super-presidential system and the tight control over the mass media prevented these anti-market social interests from coalescing at the ballot box.

Ideological factors should also be taken into account, especially among dispersed interest groups such as the urban middle classes and the expanding number of urban poor. People were voting not just on the basis of their economic interests, but also in keeping with their perceptions of what kind of political system they wanted to see in Russia. The majority of Russians wanted to live in a forward-looking, Western-style society, rather than trying to turn the clock back to the Soviet years.

The August crisis caused an inflationary surge and a steep decline in living standards, on the order of 20%.[1] Yet this did not cause an upsurge of popular protest. The main reason, probably, is that repeated crises and dashed hopes over the previous decade had numbed popular capacity for mobilization. If the August storm cloud had burst out of a clear sky, people would have run for cover. Having been drenched by daily downpours for a decade, the average Russian hardly bothered to open their umbrella.

The political will for a shift to a more centrist or statist economic policy was clearly present in Russian society – and certainly in the Russian parliament – in the immediate aftermath of August. But given the nature of Yeltsin's super-presidential regime, the Kremlin was able to keep proposals for constitutional reform at arm's length and simply sat out the post-crisis months with only modest course corrections in economic policy.

THE SOVIET LEGACY

The politics of post-Soviet Russia

By 1989, four years of abortive reform under the leadership of Mikhail Gorbachev had wrecked the control systems of the socialist economy without creating any effective new mechanism in its place. Russia saw open worker unrest for the first time in 80 years, as coal miners struck to protest empty store shelves. Nationalist unrest in the Baltic and Caucasus was another headache for Gorbachev. The country was held together by massive foreign loans (amounting to $80 billion) while Gorbachev pleased Western lenders by allowing the dissolution of the Soviet empire in Central and Eastern Europe. The Soviet budget collapsed as republic governments refused to pay taxes to the federal center. 1991 saw the collapse not only of the centrally-planned economy, but also of the communist political system and of the multinational empire which that system had sustained. Russia faced a triple transition – to market, to democracy, and to a nation-state.

Suddenly, the leaders of the 15 republics which made up the Soviet Union found themselves at the head of sovereign states, and faced the daunting task of building new political and economic systems from scratch. Most of them seized upon the idea of market reform: they had lost their ability to manage their economies, and had little choice but to embrace the market system being urged on them by the West. [2] Note, incidentally, that *choosing* a national leader was not an immediate problem: the republic leaders who were already in power when the Soviet Union collapsed stayed on as presidents of the newly-

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[1] Data on economic performance are taken from the quarterly and monthly reports of *Russian Economic Trends*, published by the Working Center for Economic Reform in Moscow.

[2] The only presidents who rejected radical market reform and proclaimed their own path were Islam Karimov (Uzbekistan), Saparmurad Niyazov (Turkmenistan), and Alyaksandr Lukashenko (Belarus).

independent states. They included Boris Yeltsin, who was elected president of the Russian Federation in June 1991.

The primary utility of market reform in 1991 was more political than economic. It provided a sense of purpose and direction. It gave the governments a policy agenda to follow, and a rhetoric of legitimation with which to appeal to their citizens for support. It also opened the door to potentially billions of dollars of Western aid, loans, and investment. Behind the rhetoric of a brighter future for all, marketization also gave the incumbent elites a chance to enrich themselves.

The main claim to legitimacy of the new post-socialist regimes in East Europe was the reclaiming of a suppressed national independence and identity. The situation in Russia was complicated because Russian national identity was closely intertwined with patriotic feelings for the now-deceased Soviet state. In 1990-91 Boris Yeltsin and the democrats started using the symbols of Russian nationalism against Gorbachev and the Soviet state. After 1991 the Communist Party of the Russian Federation tried to use Russian nationalism mixed with nostalgia for the Soviet Union to mobilize opposition to Yeltsin's reforms. However, Yeltsin was the man who had created the new sovereign Russian state by challenging the Soviet leadership. In contrast to the Communists' Soviet nostalgia, Yeltsin argued that he was building a forward-looking Russia, one that would join the international community of nations as a partner of the United States and as a democratic and capitalist country. Hence market reform was particularly important to Yeltsin's political image. The political advantages of a forward-looking economic strategy sustained Yeltsin in power despite the fact that GDP fell for seven straight years and reform produced few concrete benefits for the average Russian. Vladimir Lenin's dictum that "politics is the ABC of economics" seems to hold true also for the transition from socialism to capitalism.

The specificity of the Soviet economy

The Soviet economy of 1991 had a quite different structure from any other on the planet. For 75 years the Soviet economy had been built up according to the logic of central planning, where the objectives were national security and social transformation. It was heavily militarized, with from 25-40% of industry devoted to military production. Industrial location was based on the strategic decisions of central planners with scant regard to production costs. What would happen when such an economy was exposed to the forces of supply and demand? There was no such thing as a "world market price" for nuclear submarines or space stations – the items in which Russia had developed a "comparative advantage" during the Cold War.

When the Soviet Union broke up into 15 independent states many long-standing economic ties were severed.[3] From summer 1993 on Russia refused to supply rubles to the other republics, and trade between the new states collapsed since they lacked the cash or credit to finance transactions. Many of the interest groups of the Soviet economy clung to the hope that trade ties with the newly-independent states could be rebuilt. This view proved misguided, and helped to politically neutralize those groups in 1992-94. The reformers who seized on the notion of national sovereignty in the 15 new states were backing the right horse.

Russia's vast oil and gas reserves gave Moscow options that most other post-socialist states did not possess. Energy exports generated $40-50 billion a year, accounting for more than half Russia's export earnings and a quarter of federal revenues.[4] But this energy wealth was a mixed blessing. It encouraged myopic, rent-seeking behavior by Russian elites, and discouraged them from embracing full-

[3] Among the East Europeans only Yugoslavia and Czechoslovakia had to deal with the collapse of a multi-national state (and the Czechoslovaks managed to carry out a "velvet divorce" without disruption in 1992).

[4] Kazakhstan, Azerbaijan, and Turkmenistan also have substantial hydrocarbon reserves, but unlike Russia their fields were under-developed, and were physically isolated from world markets. Pending the completion of new export pipelines, the bulk of their energy exports still flow across Russia.

blown economic liberalization. They kept control of energy reserves out of the hands of foreign investors – not realizing that Western companies would simply look elsewhere (Nigeria, Venezuela, etc.) rather than accept the terms the Kremlin was prepared to offer. Inside Russia, the state gas monopoly Gazprom used export revenues to subsidize domestic consumers, creating a mini-planned economy. Gazprom used its subsidized deliveries as an excuse to avoid paying taxes and as an opportunity to build political alliances with regional elites.

In many countries, the concentration of wealth that comes with oil has bolstered authoritarian regimes and corrupt elites, and has stymied the development of competitive markets and civil societies. Post-1991 Russia fits this pattern, even though it inherited a more developed and diverse economy than these other petro-states.

THE POLITICAL CONTEXT FOR REFORM

In East-Central Europe, the democratic political systems that were introduced after 1989 were primarily parliamentary rather than presidential in character. In most of those countries (including Hungary and Czech Republic), the presidents are elected indirectly, by the parliament. Even where the presidents are directly elected (as in Poland and Croatia), they have only limited powers (to delay legislation, to call for referenda, and in some cases to dissolve parliament). Governments are formed by the parties that win parliamentary elections, and theys fall when they lose parliamentary support or are defeated in elections. In most countries broad democratic coalitions won the first wave of parliamentary elections in 1990, and set about market reform. There was a broad social consensus on the need to build a democracy and market economy, and there was no sharp polarization between the friends and foes of change. On the contrary, in Poland and Hungary when reformed ex-communist parties won power in elections in 1993 and 1995 they continued with the reform programs of their liberal predecessors.

In Russia, the political system evolved in quite a different direction, and displayed a lot more continuities with its socialist predecessor than was the case in East Europe.[5] In the Russian Republic the legislature (Congress of People's Deputies) and executive (President Boris Yeltsin) were elected before the collapse of the Soviet Union (in March 1990 and June 1991, respectively). Yeltsin and the Congress were united in opposition to Soviet President Mikhail Gorbachev and his efforts to hold together the Soviet Union. After the Soviet collapse, Yeltsin and the Congress disagreed over what sort of constitution Russia needed (presidential or parliamentary) and how fast to push the pace of economic reform.

President Yeltsin moved into the Kremlin, recently vacated by Gorbachev, and his administration swelled to more than 7,000 officials – more than in the old Soviet Communist Party Central Committee. There was no equivalent to this presidential bureaucracy in East Europe (although most of the other ex-Soviet republics developed similar institutions). Yeltsin refused to become the leader of a political party, claiming that as head of state he was "above" party politics. In following years the Russian legislature was treated not as source of laws and a vehicle for democratization, but as an annoyance that was to be ignored or avoided wherever possible. Governments and ministers were changed at the whim of the president. The central characteristic of Russia's post-communist political system was a debilitating stalemate between the president and parliament, a deadlock which hampered the government's ability to implement policies to build a functioning market economy and effective rule of law.

The first major rift between Yeltsin and Congress came in January 1992 when the acting prime minister, the liberal economist Yegor Gaidar, abolished most controls on consumer prices, triggering an inflationary surge that hit 1,600% by year's end. Most of the economic liberalization measures were introduced by presidential decree – a power which Congress had voted the president on an emergency basis for one year in November 1991. In June 1992 Congress did vote into law the voucher privatization program crafted by the energetic young reformer Anatolii Chubais. Chubais watered down the privatization program to accommodate the interests of the directors' lobby, allowing workers and

[5] Lilia Shevtsova, *Yeltsin's Russia: Myths and Reality* (Washington, DC: Carnegie Endowment, 1999).

managers to buy a controlling block of shares in their own firm. In December 1992 when Yeltsin's emergency presidential powers expired, the Congress refused to renew Gaidar as prime minister. Instead they endorsed Yeltsin's compromise choice, Viktor Chernomyrdin, a bland bureaucrat who had headed the Soviet gas industry.

While some reform programs were passed into law, most were introduced by presidential decree (most notoriously, the 1995 loans-for-shares privatization scheme). Implementation was in the hands of bureaucratic institutions such as the Central Bank or the State Privatization Committee which were insulated from parliamentary scrutiny. They were run by cliques operating out of the presidential administration, with minimal legal or public accountability. This environment was fertile ground for corruption.

Yeltsin called a referendum in April 1993, in which he won a narrow majority in support of his policies. Given the privations of the preceding year, the vote in favor of continued market reform was a triumph of hope over experience. Over the summer of 1993 Yeltsin tried to engineer passage of a new constitution which would grant him broader powers. Congress resisted, and in September 1993 Yeltsin ordered the parliament to disband. This was an act that was beyond his constitutional powers (so he disbanded the Constitutional Court too). The Congress refused to go, and recalcitrant deputies were dislodged by a full-scale army assault on the parliament building – the very White House that Yeltsin had defended against the hard-liner coup attempt in August 1991.

After the bloody events of October, parliamentary elections were held in December 1993. The voters delivered a rebuke to Yeltsin, by voting in a majority of communists and nationalists. A simultaneous referendum on the new constitution passed by a narrow majority (amidst allegations of vote-rigging). It gave more powers to the president, creating in effect a super-presidential system. A new bicameral parliament consisted of the State Duma and the Federation Council (composed of two officials from each of Russia's 89 provinces). The president has the right to nominate the prime minister, subject to Duma approval. If the nominee is rejected three times, the president can dismiss the Duma and call fresh elections – a powerful incentive for the Duma to accept his nominee. The president issues decrees over areas where no law has been passed, and has the power to veto legislation. (The veto can be overridden by a two-thirds majority of each house).

In the Duma elections in December 1995 the Communist Party emerged as the strongest force and was able to block Yeltsin's legislative initiatives. Each fall, for example, there was a confrontation over the next year's budget. The government proposed spending cuts and a smaller deficit, while the Duma insisted on passing a budget with higher spending. In practice the government simply ignored the budget and held actual spending below the target levels.

At the beginning of 1996, with the economy shrinking for the seventh year in a row and an unresolved war in Chechnya, Yeltsin's popularity ratings were in single digits. And yet in July 1996 Yeltsin returned from political oblivion to win re-election as president over Communist challenger Gennadii Zyuganov. His remarkable political recovery was due to a combination of a vigorous anti-communism campaign in the state- and privately-owned media and lavish pork-barrel spending, helped by a $10.1 billion, three-year loan approved by the IMF in March 1996. The Communists could rely on the support of some 25-30% of the electorate, but their reactionary policies (the Duma foolishly passed a resolution calling for the restoration of the Soviet Union) lost them the support of centrist voters. Yeltsin's campaign managers painted the election as a stark choice between a Communist past and a democratic future. A prominent role was played by the self-styled "seven bankers," magnates such as Boris Berezovskii who had created huge and lucrative business empires out of the Soviet collapse.[6] The seven leading oligarchs agreed to pool their financial and media resources to engineer a Yeltsin victory.

The main threat to Yeltsin's re-election was his poor health, but the media withheld from voters the fact that Yeltsin suffered a mayor heart attack four days before the second round of the presidential election. Yeltsin's illnesses meant he unable to work for eight of the 12 months after the election. The image of a strong reformist leader was largely an illusion.

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[6] Dmitrii Dokuchaev, "The Big Seven of Russian business are named," *Izvestiya,* 5 January 1997.

Some see the 1996 election as proof that democracy was consolidated in Russia, since Russians had the chance to choose their head of state for the first time in their 1,000-year history.[7] Others suggest that the election was a travesty of democracy, and showed the consolidation of an oligarchic elite who had learned to stay in power through manipulating the rules of the democratic game.

It had been assumed that the main barrier to reform would be opposition from groups with a vested interest in the pre-1991 system, such as communist bureaucrats and workers in state-subsidized industries and farms. However, these backward-looking elites were politically disemboweled by the rapid collapse of communism and proved totally unable to defend their interests in the transition economy. The workers in these sectors also proved politically inert despite (or perhaps because of) shattering social changes, a massive fall in living standards, and tremendous uncertainty about their future.

By 1996 it was clear that the main threat to the Russian transition came not from communist reactionaries or irate workers, but from some of the very elites who were leading the charge towards the market economy. These elites hijacked the market transition and only tolerated liberalization to the extent that it lined their own pockets.[8] The emergence of the oligarchs slowed the development of other interest groups with a stronger commitment to genuine market reform. Their antics also discredited the reform cause and hence weakened its dispersed interest group base.

BUILDING A MARKET ECONOMY

In late 1991, with the Soviet Union disintegrating and its economic system in chaos, President Yeltsin decided to adopt the same strategy for rapid market liberalization that had been introduced in Poland in 1990.[9] The strategy (known by its critics as "shock therapy" and more generally as the "Washington Consensus") consisted of trinity of policies: monetary stabilization, liberalization, and privatization. Most of these policies are sensible and have proved their effectiveness in a variety of circumstances.[10] In Russia, however, they proved inadequate to the task at hand: building a prosperous market economy out of the ruins of the Soviet system.

Stabilization meant introducing a stable currency and preventing hyperinflation (inflation of more than 50% per month). The easiest way to do this is to make the currency convertible and use the exchange rate as the "nominal anchor" of the stabilization program. **Liberalization** meant lifting restrictions on business activity, domestic and international. Price controls and subsidies should be ended. Quotas and duties on exports should be eliminated and import tariffs lowered. Import competition would force the producers inherited from the Soviet economy to become competitive or go out of business. Free trade would reveal Russia's comparative advantage and draw foreign investment into the sectors with growth potential. **Privatization** meant the sale of state-owned firms in order to unleash entrepreneurship and create competitive markets.[11] Subsidies should stop for the remaining state enterprises (the "hard budget constraint") and loss-making firms should be forced into bankruptcy.

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[7] When elected in 1991, Yeltsin was running to the head the Russian Federal Republic, while Gorbachev was still president of the Soviet Union.

[8] Jeffrey Sachs and Katarina Pistor (eds.) *The Rule of Law and Economic Reform in Russia* (Boulder: Westview Press, 1997); Stephen Handelman, *Comrade Criminal: Russia's New Mafiya* (New Haven: Yale University Press, 1997)

[9] Poland even won a 50% cut in its foreign debts in return for the launch of market reform (unlike Hungary, which grimly paid its bills.) Jeffrey Sachs, *Poland's Jump to the Market Economy* (Cambridge, MA: MIT Press, 1993).

[10] *World Bank Development Report 1996: From Plan to Market* (Washington DC: World Bank, 1996); John Williamson, "Democracy and the 'Washington Consensus,'" *World Development*, vol. 21, no. 8, pp. 1329-1337.

[11] Roman Frydman, Andrzej Rapaczynski, et al.,. *The Privatization Process in Russia, Ukraine, and the Baltic States* (Budapest: Central European University Press, 1993); Lynn Nelson and

The reforms in East-Central Europe brought inflation down and GDP growth restarted after a "transition recession" of about two years' duration. Privatization policies varied within East Europe. While Hungary sold many state firms to foreign buyers Czechoslovakia opted for a crash program of voucher privatization, in which shares were given away to citizens who bid for them with special coupons, distributed at nominal cost to the adult population. The scheme led to dispersed share ownership and weak corporate governance, creating many opportunities for corruption by unscrupulous entrepreneurs. But it enabled the reformist government of Prime Minister Vaclav Klaus to win re-election in May 1992. Political utility overrode economic efficiency. Russia was to adopt a version of the Czech voucher scheme – with similar results.

The operation succeeds, but the patient sickens

After 1991 Russia made some remarkable steps in the direction of a market economy, leading many international observers to proclaim that capitalism had taken firm root in Russia.[12] But inflation fell more slowly than in East Europe, and the transition recession never really ended. The cumulative fall in GDP was greater than 40% – higher than during the Great Depression in the US. (Living standards also fell, to a lesser extent.) Recovery only began in 1997, and then with an anemic GDP growth of 0.8%.

Liberalization had the most dramatic initial effect. Most price controls were lifted on 2 January 1992, and store shelves quickly filled up. Controls on energy prices continued for several years, and housing and utilities remain price-controlled to this day. Trade liberalization led to a flood of imports, which soon accounted for about half of all consumer spending. There was an export boom, as producers switched their sales of oil and metals from the ex-Soviet republics to hard-currency markets.[13] Among the disappointments was the slow growth in small businesses and foreign investment (below $6 billion). Both these failings were rooted in the evils of crime, corruption, and bureaucratic regulation

Stabilization remained elusive for some years. The ruble was made convertible into dollars, but inflation clocked 1,600% in 1992, wiping out people's hard-earned savings. It took three years of political infighting before the government was able to bring the money supply and budget deficit under control, with inflation falling to 130% (annual) by the end of 1995. From then on the ruble held its value against the dollar within the corridor announced by the Central Bank. However, the ruble stabilization was accompanied by the dollarization and de-monetization of much of the economy. Many firms resorted to barter, which accounted for more than half of all industrial transactions by 1997. Arrears became a money-substitute: arrears in paying suppliers, tax authorities, and workers. The rise of this hidden economy – something not really seen in East Europe – was largely ignored by the international community until 1998.[14] Another disturbing trend was the slump in federal tax revenues, which fell from 25-30% of GDP in 1989 to 10-12% by 1997, while federal spending was still running at 15-18% of GDP.

Irina Kuzes, *Property to the People: The Struggle for Radical Economic Reform in Russia* (Armonk: ME Sharpe, 1994).

[12] Andrei Shleifer, Maxim Boycko and Robert Vishny, *Privatizing Russia* (Cambridge, Mass: MIT Press, 1995); Anders Aslund, *How Russia Became a Market Economy*, (Washington, DC: Brookings Institution, 1995); Richard Layard and John Parker, *The Coming Russian Boom,* (New York: The Free Press, 1996).

[13] David G. Tarr and Constantine Michalopoulos, *Trade Performance and Policy in the New Independent States* (Washington DC: World Bank, 1996); Oleg Davydov, *Inside Out: The Radical Transformation of Russian Foreign Trade, 1992-1997* (New York: Fordham University Press, 1998).

[14] Gaddy and Ickes refer to the barter system as a "virtual economy" since it was based on subsidized, value-destroying enterprises. But one can equally argue that it was the financial sector which was the "virtual" economy –particularly in light of the collapse of the banking system's in August 1998. Clifford Gaddy and Barry Ickes, "Beyond the Bailout: Time to face reality about Russia's 'virtual economy,'" *Foreign Affairs,* no. 77, pp. 53-67, 1998.

Privatization was hailed as a major victory for the reformers. Some 70% of productive assets were transferred out of state ownership. First, in 1990-92 many state firms were turned into private corporations at the stroke of a pen, with their shares held by federal and regional governments or other firms. Most of Russia's 2,000 commercial banks were created in this manner, as was the gas monopoly Gazprom. Second, in 1992 citizens were given vouchers to bid for shares in state enterprises. Unlike the Czech model, workers and managers could acquire a majority of the shares in their own firm. More than 70% of firms chose the buyout, and in these cases control was typically concentrated in the directors' hands. Third, privatization through cash sales began in 1994. The government did not want to sell to foreign investors, but Russian buyers lacked capital. So in 1995 the privatization tsar Anatolii Chubais decided to swap shares in a dozen leading oil and metals companies in return for loans from Russian banks. The transactions reeked of corruption: the firms were sold at bargain prices to bidders chosen in advance. The loans-for-shares scheme enabled the Moscow-based banks to take control of some of the major revenue-generating assets of the economy, such as the Norilsk Nickel mine.

On the brink of success?

By 1997 the rudiments of a capitalist economy were in place in Russia, and Yeltsin's re-election victory seemed to show that the reform leadership was firmly in control. In spring 1997 Yeltsin tried to restart the reform momentum which had faltered during Yeltsin's electioneering in the first half of 1996 and ill-health in the second. He appointed Anatolii Chubais and Boris Nemtsov, the youthful governor of Nizhnii Novgorod, as first deputy prime ministers and they launched a "second liberal revolution."

However, their efforts to cut spending to close the yawning budget deficit were blocked by the barons who controlled the energy industries, and who resisted the proposed increases in taxes and utility prices. Meanwhile, the oligarchs vied for control over the remaining spoils in the state sector, such as the telecom company Svyazinvest and the last state-owned oil companies. The reformers also faced a recalcitrant State Duma, which blocked the new laws needed to move forward with market reform: laws to revise the tax system and introduce a new civil code; to allow lands sales; and to permit production-sharing for foreign investors.

Liberal hopes were raised in March 1998, when Yeltsin fired Viktor Chernomyrdin, premier since December 1992, fearing that he was developing presidential aspirations. Yeltsin replaced him with Sergei Kirienko, a 35-year old political unknown and ally of the liberal Nemtsov. Kirienko was soon overwhelmed by the daunting task of dealing with the delayed after-effects of the South-East Asian financial meltdown – and with a domestic financial crisis of Russia's own making.

A HOT AUGUST

During one intense week in August 1998, the shaky edifice of financial stabilization in Russia was shattered. On Monday 17th August, payments on most categories of international and domestic government debt were suspended, and the exchange rate floor was lowered from 6 to 9 rubles to the dollar. Panicked individuals tried to change all their rubles for dollars, and the financial system froze up. Imports plunged and domestic prices surged by 40% within a month. By 7th September the ruble had fallen from 6 to 21 rubles to the dollar.

The August crisis was due partly to the contagion effects of the 1997 Asian crisis, and partly to policy errors by the Russian government. Chief among these were the decision to fix the exchange rate at too high a level, and the government's resolve to finance the budget deficit through international borrowing.

An over-valued ruble

In July 1995 the Russian government committed itself to maintaining the ruble within a "corridor" of 4,300-4,900 rubles/dollar.[15] Inflation ran at 130% in 1995, causing the ruble to appreciate against the dollar by 30%.[16] But tighter monetary policy meant inflation fell to 22% in 1996 and 11% in 1997.

The exchange rate was set at a rather high level - 50% of the dollar purchasing power parity, rising to 70% of PPP by 1998.[17] (In contrast the Chinese yuan is set at about 20% of PPP.) The "strong" ruble made for cheaper imports and fueled the emergence of a consumer middle class. But it priced Russian manufacturers out of export markets and exposed them to fierce import competition. Russia was not competitive in finished goods like autos at any price. But her semi-finished industries such as steel, paper, and chemicals were potentially competitive.

The IMF thought that the exchange rate was defensible, given that Russia was running a current account surplus of about $15 billion each year, thanks to its oil and gas earnings. The ratios of external debt to GDP and of annual repayments to export earnings (each around 15-25%) were also manageable. However, signs of trouble began to appear even before the Asian crisis broke. In July 1997, for the first time in a decade, Russia's current account slipped into deficit, due to a leveling off in export earnings. Some economists, not to mention exporters, issued increasingly strident calls for a devaluation of the ruble.

Neither a borrower nor a lender be

The second error which led to the August crash was the 1995 decision to finance the federal deficit through borrowing – at the urging of the IMF, who extolled the virtues of "non-inflationary deficit financing" over printing more money.[18] But by 1997 the federal government was collecting a mere 10% of GDP in taxes, while spending about 15% of GDP. The Achilles heel of Russia's "crony capitalism" was tax collection. Liberalization made it easier for firms to hide earnings from the taxman – especially export earnings. As a result even after monetary stabilization was achieved, fiscal balance remained elusive. The "fat" had already been cut from the budget (procurement of new arms had dropped to almost zero, for example) so spending could only be cut through delaying payments in federally-funded wages and social benefits. This was politically risky, since the recipients had the right to vote and to protest.

The deficit was financed through the sale of treasury bills (in Russian called GKOs). About half of GKOs were bought by foreigners, attracted by the high rates of return.
GKO nominal rates averaged 63% in 1996, falling to a low of 26% in mid-1997. There was concern at the mounting pile of GKO debt, which reached 50% of GDP. Tax collection had still not improved, so new GKOs were issued to pay off previous bonds, in what critics called a "pyramid scheme."

The impact of the Asian crisis

The effects of the Asian financial meltdown on Russia were twofold. First, it caused a flight from emerging markets (including Russia) by international investors. Partly this was driven by fear, and partly by the desire to cash out gains in Russia to compensate for losses in South East Asia. Second, the global recession that followed the Asian crisis caused a slump in commodity prices. Oil fell from $18 a barrel in

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[15] In January 1998 the ruble was redenominated: 1,000 old rubles became one new ruble.
[16] The Central Bank switched to a more flexible "inclined corridor" (akin to a crawling peg) in July 1996.
[17] Vladimir Popov, "Will Russia achieve fast economic growth*?" Communist Economies and Economic Transformatio*n, vol. 10, no. 4, 1998, pp. 421-49.
[18] Daniel S. Treisman "Fighting inflation in a transitional regime – Russia's anomalous stabilization," *World Politics*, vol. 50, no. 2, 1998.

December 1997 to $11 a barrel by the end of 1998.[19] This was a severe blow to Russia, which relied on oil for nearly half its export earnings. Each $1 per barrel fall in the oil price cost the government an estimated $1 billion in lost revenue (out of annual receipts of $30 billion).

Increasing uncertainty caused GKO rates to rise. By June the stock of GKOs was about $40 billion, of which half were held by foreigners or by Russian banks with money borrowed abroad. Interest payments accounted for 30% of federal expenditure, and the government found it hard to sell GKOs even at rates in excess of 100 percent. In July 1998 to reduce exposure to a possible ruble devaluation the government converted $6.4 billion of GKOs into Eurobonds at 15 percent interest, denominated in dollars. However that still left $11 billion of GKOs falling due by the end of September.

Fearful that a ruble devaluation would cause panic, the IMF approved a $22.6 billion aid package on 20 July, including $4.8 billion in cash. The IMF insisted on emergency spending cuts and tax increases to bring the deficit below 3% of GDP. The IMF loan did not calm investor fears (although it did enable most Western banks to liquidate their GKO holdings). Then came the fateful letter from George Soros to *the Financial Times* of 13th August, saying that devaluation was inevitable, and the ruble crashed.

AFTER AUGUST

In the wake of the ruble devaluation and debt default alarmists predicted complete economic collapse – hyperinflation, the breakdown of food supplies, the introduction of rationing – which could trigger anything from a fascist coup to the resurrection of communism. Even sober observers foresaw efforts to reintroduce more state planning such as price controls, the suspension of ruble convertibility, and the re-nationalization of enterprises.

In the end, none of these dire scenarios played out. The overall effect of the crisis was to cause a long-overdue correction in the ruble exchange rate, to puncture the power of the bank oligarchs, and to cause a revival of demand for Russian products.

The ruble slipped from 6.2 to the dollar on 16 August to 22 to the dollar at year's end, where it stabilized. The financial freeze caused a sudden drop in imports and the effective collapse of the commercial banking sector. Russian banks had borrowed about $10 billion to finance GKO purchases: the crash plunging them into insolvency.[20] People with accounts in commercial banks that folded lost all their deposits. 75% of savings were in the state-owned Sberbank, but even those lost three-quarters of their value due to inflation. Most people kept a large proportion of their savings in dollars under the mattress, and these canny savers were unaffected by the crisis.

Imports fell by about half in the four months following August. Consumers switched to domestic products, causing industrial production rising 10% in the fourth quarter. Exports were expected to rise after the deep devaluation of the ruble. Inflation hit 38% in September, but fell to 4.5% in October, 5.7% in November and 11.6% in December – showing that Moscow did not turn on the printing presses. Inflation eased to 8.5% in January and 3.8% in February.

By September 1999 industrial production had risen 18% above the September 1998 trough (and 7% above the same month in 1997).[21] In the first seven months of 1999 Russia ran a $15.6 billion foreign trade surplus. GDP growth for 1999 was 1.8%, the best since the collapse of the Soviet Union. The government was even able to cut the backlog of state wage arrears from 2.1 months average delay in January to 1.3 months in April.[22] The stock exchange (RTS) plunged 85% in dollar terms in 1998, but rose 27% in the first two months of 1999 and 85% by the year's end, reversing the loss of the previous year.

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[19] Most of Russia's natural gas is sold at fixed prices under 20 year take-or-pay contracts, so gas earnings were not seriously affected.
[20] Menatep Bank for example lost control over Yukos, the second largest oil company, when it defaulted on a $236 million loan backed with Yukos shares. *Wall Street Journal*, 31 May 1999.
[21] *Russian Economic Trends*, October 1999.
[22] Itar-Tass, 25 May 1999.

The crisis altered the relationship between Moscow and the international financial community – ironically strengthening the former at the expense of the latter. The devaluation punctured the illusion that the IMF's previous policies had been working. The Russian government felt emboldened to reintroduce export tariffs on oil, which they had reluctantly abolished at the IMF's behest in 1996. The debt default bought time and increased Russia's bargaining leverage. Russia had $17 billion in interest and principal falling due on its international loans in 1999: a sum which they would not pay. As Russia was "too big and too nuclear" to allow a formal default, the IMF agreed a new $4.5 billion loan in June 1999 (to be used solely to repay IMF loans falling due in 1999). Negotiations with the Western banks holding frozen GKOs dragged on for months. Some banks settled for the meager terms that Moscow was offering – equivalent to less than 5 cents on the dollar – in the hope of winning more Russian business in the future.

Russia's recovery was helped by the rebound in the world oil price, which doubled by the end of 1999. The new oil export tariff raised $1.5 billion (6% of federal revenues) in the first half of 1999, enabling the government to run a primary budget surplus of 3% of GDP by the summer of 1999. This was a radical turnaround from the fiscal crisis of the previous summer.

Political fallout muted

The August crash forced the resignation of premier Kirienko and his replacement by former spy-chief Yevgennii Primakov. Initial fears of a radical transformation in the political system, with social upheaval and perhaps even an attempted return to communism, proved unfounded. In fact, the overall impact of the crisis was to reinforce rather than undermine Russia's basic political institutions. Some individual careers were damaged or boosted by the crisis, and some financial circles rose while others fell. But the crisis did not open the political system to any significant new political actors. One January 1999 poll indicated that "as a result of the crisis [Russia's] political regime, strange as it may be, not only did not grow weaker but even grew stronger."[23] While 49% of poll respondents reported a "very significant" fall in living standards, very few took part in any political activity, and most still supported the idea of a market economy (by 47 to 39%).

After Kirienko resigned the Duma twice rejected Yeltsin's initial nominee to replace him, Viktor Chernomyrdin. On 11 September Yeltsin appointed Foreign Minister Yevgennii Primakov as prime minister, a choice which was eagerly approved by the Duma. Primakov appointed some former communist apparatchiki: Viktor Gerashchenko returned to head the Central Bank and former planning chief Yurii Maslyukov became first deputy prime minister for economic policy. But young reformers still occupied about half the ministries, and there was no reversal in government policies with respect to stabilization and market reform.

The August crisis and subsequent change of government served to reinforce constitutional procedures and weakened President Yeltsin vis-à-vis the parliament. But the Communists were not able to exploit the crisis to dislodge Yeltsin from power. The crisis shifted the balance of power within the executive branch, weakening the oligarchs and strengthening the "power ministries" (defense, interior, and Federal Security Service). This seems to be the most lasting political consequence of the August crisis. Not only Primakov but also both his successors as premier came from the security organs. Yeltsin fired Primakov in April 1999, fearing that the wily ex-diplomat was becoming too popular, and that he might launch anti-corruption investigations aimed at Yeltsin's inner circle.[24] Yeltsin replaced Primakov with interior minister Sergei Stepashin. Stepashin in turn was fired in August 1999, for failing to stop Chechen attacks on Dagestan. Yeltsin replaced Stepashin with the 47-year old Vladimir Putin, the head of

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[23] Leontii Byzov and Vladimir Petukhov, "August shook pockets but not heads," *Obshchaya gazeta*, no. 7, 18-24 February 1999.

[24] Yeltsin's son-in-law is a director of Aeroflot and according to press reports was implicated in the laundering of the airline's foreign earnings through Swiss bank accounts.

the Federal Security Service and a 15-year KGB veteran who had never been elected to public office. Putin was enthusiastically confirmed by the Duma.

The three post-crisis prime ministers did not reverse the course of economic and domestic policy pursued by their predecessors. The main change came in foreign policy: they hardened their rhetoric towards the United States. But this had more to do with NATO's air war against Yugoslavia than the 1998 financial crisis. Another possible consequence of the resurgence of the security apparatus was the launching of offensive operations against Chechnya in August 1999. However, the immediate cause of the Russian assault was attacks by Chechen militants on neighboring Dagestan.

The August crisis seemed to reinforce the shift in the power from federal to regional leaders. This trend began with the declarations of sovereignty by ethnic republics in 1991-92, and was strengthened once regional governors started to be directly elected (from 1996 on). In summer 1997 the Federation Council (composed of the heads of the executive and legislative branches in each of Russia's 89 provinces) refused to allow Yeltsin dismiss the controversial governor of Primorskii krai in the far east. Another important victory for regional interests came in April 1998, when parliament passed – over Yeltsin's veto – a law transferring 33% of the stock in the electricity monopoly UES to regional governments.

Some governors tried to use the August crisis as an excuse to introduce price controls and restrictions on the export of goods from their region. Within a few weeks such efforts proved unwise and unnecessary. Some regional bosses also managed to re-nationalize local enterprises which became insolvent after the crisis. The Primakov government tried to reach out to regional leaders: eight governors were invited to join the national cabinet. The new budget for 1999 gave regions the option to levy a regional sales tax of up to 5%.[25] But these changes were incremental rather than revolutionary, and the decentralizing trend pre-dated the August crisis. Also, in contrast to Primakov premier Putin has taken a tougher line on regional autonomy, so some of the post-August gains may be rolled back.

THE RUSSIAN CASE IN COMPARATIVE PERSPECTIVE

There are some interesting parallels between Russia and other countries which have experienced financial crises in the wake of market liberalization, from Asia to Latin America. But Russia also has distinctive features: a strong pro-reform presidency, undertaking a historic social transformation and faced by weak and disoriented opposition groups.

In Russia the political consensus for reform was weak but positive. The bureaucratic capacity to implement reform was weaker still, leading to much frustration. Surprisingly, many potentially powerful interest groups inherited from the Soviet system failed to prevent the adoption of reform policies – partly because the president felt able to ignore, bribe, or threaten the parliament. However these interests were often able to block the implementation of reforms. Relatively simple policies that were easy to execute at national level were successfully adopted, while more complex or demanding reforms failed to take root. Reforms that required doing less of something (such as printing money, or controlling prices) were easier than reforms that required doing something positive (such as building effective corporate governance or a reliable court system).

One might have expected the Asian crisis to have greater impact in Russia than in East Europe – given that the political consensus for reform was weaker in Russia; and given Russia's dependence on price-sensitive energy exports. Despite the dramatic collapse of the ruble in August 1998, the aftershocks of the Asian crisis did not cause fundamental changes in either the course of economic policy or the exercise of political power in Russia.

Interest coalitions and the reform process

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[25] Radoslav Petkov and Natan Shklyar, "Regional responses to the August crisis," *Transitions* (Prague) March 1999.

Experience in other countries suggests that the urban middle classes can be a significant factor magnifying the impact of international financial crises. Sharing diverse and dispersed interests (as opposed to the concentrated interests associated with specific industrial lobbies) they are usually politically quiescent and poorly organized. However, an exogenously-induced crisis, such as an exchange rate collapse, may trigger their political mobilization. A loyal urban middle class is key to the building of a successful pro-reform coalition.

In Russia the middle class were politically passive before and after the August 1998 – despite the fact that the crisis dealt a serious blow to their current living standard and confidence about the future. One of the most puzzling features of Russian politics since 1991 has been the political apathy of the middle class, and of the Russian people in general. Eight years of falling GDP has generated a small number of "winners" from the market transition and a large number of "losers." There are perhaps 1-2 million "New Russians" earning more than $2,000 a month; a precarious middle class of 5-10 million earning more than $500 a month; and a sea of more than 80 million poor making ends meet as best they can, spending more than half of their income on food. Most of the middle class have remained supportive of the market reforms, voting for Yeltsin in the 1993 referendum and 1996 election. The Communists are supported by a solid 25% of the electorate. [26] But other discontented voters are just as wary of the Communists as they are of the government. In elections they either abstain or register a protest vote for one the charismatic nationalists, such as Vladimir Zhirinovsky or Aleksandr Lebed.

The urban poor includes many members of the Soviet-era middle class (educated, urban white-collar employees) Their lifetime savings were wiped out by the 1992 hyperinflation, and many of them work in the public sector (education, health, defense) which was decimated by budget cuts. Despite paying a heavy price in lost income and jobs, these people have not mobilized against market reform. Some would say this shows the persistence of an authoritarian political culture under which the Russian people – and especially the "service classes" employed by the state – dutifully obey their rulers. Optimists would say it is because they have a long-term, forward-looking perspective, similar to the ideology of "national renewal" which helped forge reform coalitions in East-Central Europe. Recognizing the failure of the Soviet system, they want to build a better Russia for the sake of their children. Despite the slump, there were some improvements in the life of the middle class since 1991, such as increased personal freedom, including the freedom to travel abroad, and the right to buy their state-owned apartment at a bargain price. The experience of 1992 planted in the middle classes a deep fear of hyperinflation, something which could explain their willingness to support Yeltsin's reform policies. The events of August 1998 can also be seen as validation of the inflation-phobia hypothesis, since the post-crash government maintained fairly tight monetary policy.

After the surprises and shocks of the past decade, the Russian people, poor and middle class alike, have developed their own urban survival economy and seem to have been able to ride out the August crisis with relative impunity. Perhaps they have become so disillusioned by the criminalization of the Russian political elite and the artificial polarization between Yeltsin's government and the communist Duma that they have simply abandoned hope in collective, political solutions to their problems.

Foreign trade coalitions

Foreign trade liberalization was a crucial component of the Russian transition. Since 1992 foreign trade as a proportion of GDP has more than doubled. In 1998, exports stood at around $70 billion and imports $60 billion, making up one third of GDP (valued at $450 billion). This trade boom was partly due to the dismantling of most barriers to imports and exports, but also to the sharp decline in domestic GDP, which automatically increased the proportion accounted for by a (more or less static) level of trade. A fall in trade with East Europe and the ex-Soviet republics was balanced by an increase in trade with the West.

[26] Stephen White, Richard Rose, and Ian McAllister, *How Russia Votes* (London: Chatham House, 1997).

Export-oriented industries clearly benefited greatly from trade liberalization of trade (and from the slackness of tax collection). Most of the benefits were siphoned off by the corporate elites: few of the proceeds from exports found their way back to the communities which produced them. Even the oil sector was not immune to the arrears in wage payments which plagued Russian industry after 1994, for example. So it is hard to find evidence of broad coalitions of interests based around export industries.

Restrictions on imports were also radically reduced, with the average tariff barrier falling to around 12-15% by 1994 – relatively low by international standards.[27] Russian producers were damaged by the opening to imports – which were more competitive in terms of quality, price, and general attractiveness. This applied to all sorts of goods, from food to tractors to airplanes. Just about the only sector which was able through political lobbying to maintain high tariff barriers was automobiles, where tariffs stayed at the 40-50% level even until 1999. Domestic auto production maintained its 1991 level, although truck sales fell by two-thirds as their mainstay clients (farmers and the army) ran out of cash.

Despite suffering from trade liberalization, these domestic manufacturers were unable to mobilize politically to reverse the policy. This is testimony to the centralized, authoritarian character of the post-1991 political system, and the closed nature of the policy-making elites. The industrialists were still able to exert influence at regional level, but the trade and exchange rate regime was a nationally-determined policy.

Most of the politically-tough issues regarding trade liberalization had been settled long before the August crisis. One puzzle is why the exporters were not more successful in pushing for an earlier devaluation of the ruble, rather than waiting for the crisis to force this change. It seems that the wealthy and powerful energy lobby was insulated from monetary policy. This was jealously guarded by the autonomous Central Bank and finance ministry, who listened more to the IMF than any domestic actors. These financial agencies lost some autonomy after August, having been held responsible for the mismanagement which brought about the crisis.

Slim pickings for subsidy seekers

Th entire Soviet economy was built around the principle of state subsidies, creating a giant, nation-wide constituency for hand-outs after 1991. The very fact that there were so many claimants made it easier for the government to say no: the cupboard really was bare. It was cold turkey for the military industry complex, which accounted for about 25% of the Soviet-era economy. State orders for their products fell by 90%. True, many sectors benefited from indirect subsidies in the form of tolerated arrears in taxes and energy bills. But only farmers and coal miners had any success in winning direct subsidies (if not from the budget, then soft bank credits, or a share of international loans). The miners won some concessions because they were still able to mount effective protests – blocking train lines in May-June 1998, for example. The farm lobby was able to mobilize rural voters, and was the only economic sector to have their own party in the Duma (the Agrarians). But subsidies to farmers fell from 10% of GDP in Soviet times to less than 2% after 1992.

CONCLUSION

The August crisis exposed the deep institutional flaws of Yeltsin’s Russia: the centralization of political power, its potential for instability, and the continued presence of a powerful security apparatus. It challenged naïve assumptions about Russia’s progress towards a prosperous and stable market economy. However the crisis did not usher in any radical structural changes in Russia’s political economy. It forced a severe but overdue devaluation of the ruble, which helped to revive domestic manufacturing industry. It weaned the government off their previous over-reliance on borrowing to plug the gaps in the budget. But it did not shift policy in the direction of protectionism. It caused the government to fall, and strengthened

[27] Despite the openness of the Russian economy, the World Trade Organization has refused entry to Russia, citing concerns about legal and bureaucratic capacity.

the influence of the security ministries while weakening the power of the financial oligarchs. But it did not dislodge Boris Yeltsin from the Kremlin, nor did it lead to any fundamental shift in the presidential system of government which he had fashioned.