

**In Search of “The Russian Path”  
Impact of the 2008 Crisis on Russia’s Economic Policy**

**Dasha Barannik**

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## INTRODUCTION

Between 2000 and 2008 Vladimir Putin presided over a dramatically changing Russia. During his tenure as President, the country enjoyed its strongest economic position since the end of Communism, characterized by booming average macroeconomic growth of 6.7 percent per year, modest inflation, budget surpluses, the eradication of foreign debt obligations and the accumulation of massive hard currency reserves (see Appendix A).<sup>1</sup> Between 1999 and 2008 Russia ranked among the world's fastest growing economies, also recording the highest per capita income in purchasing power parity terms (\$16,000) among the promising BRIC countries (Brazil, Russia, India, China).<sup>2</sup> Social order and stability returned after the fallout from the 1998 financial crisis; unemployment levels fell, real disposable income and consumer spending rose, and many were lifted out of poverty. In comparison to the fractious experiments with democracy of the 1990s, the average Russian citizen viewed himself as safer, more secure, and living better across a series of indicators under the leadership of Vladimir Putin.

Putin's rise also engendered the reemergence of autocratic rule and a gradual rollback of democracy. Centralization of political power at the federal level, enlargement of government resources, the marked absence of a true political opposition party, and an unprecedented intrusion of the state into economic affairs – all of these indicators attest to the Kremlin's zealous pursuit of control, which many commentators, both Western and Russian, believe cost Russia dearly in spite of the tremendous economic revival. In terms of public safety, civil society,

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<sup>1</sup> Michael McFaul and Kathryn Stoner-Weiss, "The Myth of the Authoritarian Model: How Putin's Crackdown Holds Russia Back." *Foreign Affairs*, January/February 2008.

<sup>2</sup> Anders Aslund and Peter Kuchins, *The Russia Balance Sheet*. Peter G. Peterson Institute for International Economic and the Center for Strategic International Studies. 2009. P 40

health, corruption, and the security of property rights, Russians were worse off in 2008 than they were a decade ago.<sup>3</sup>

The ideal of a strong and sovereign Russia permeated government rhetoric and policy during this time. Wishing to chart his country's unique political, economic and social course through history independent of dictates from foreign influences, Putin took an assertive stance on the global stage. Clashes with the WTO and the IMF, a nationalist foreign policy, and other seemingly anti-globalization instances, however, occurred just as Russia was becoming increasingly integrated with the international economy. Between 1999 and 2008 the country's exports grew 525 percent and imports rose almost 640 percent; in the same period, foreign investment flows grew to \$60 billion.<sup>4</sup> Foreign direct investment constituted twelve percent of gross domestic product (GDP) in 2008,<sup>5</sup> reflecting overseas investors' substantial interest in profiting from Russia's flourishing economy. By no means could one consider Russia to be a full-fledged market economy in 2008: the existence of state monopolies combined with a corrupt state apparatus and the lack of sufficient institutional underpinnings to support the enforcement of private property rights left a huge array of market-sustaining reforms unachieved. Kremlin plans for modernization produced in the last eight years met with skepticism on the part of Russian citizens and Western observers, who doubted the credibility of the state's commitment to facilitating economic competition via a strong rule of law and transparent policy environment. Wholesale adoption of Western capitalism has not occurred in Russia; instead, between 2000 and 2008 foreign financial intermediation occurred within a state-dominated economic system.

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<sup>3</sup> Ibid

<sup>4</sup> William Cooper, "Russia's Economic Performance and Policies and Their Implications for the United States." *Congressional Research Service*. Report for Congress, RL 34512.

<sup>5</sup> Ibid

Beginning with a severe decline in the Russian stock market in August 2008 and compounded by plummeting oil prices, the global financial crisis has initiated severe economic recession in Russia. As a result, myriad weaknesses in various aspects of its export-dependent economy, money markets and financial sector have been laid bare; gross domestic product fell 9.5 percent in the first quarter of 2009,<sup>6</sup> real incomes plunged 6.7 percent,<sup>7</sup> and foreign exchange reserves shrank by \$131 billion in 2008.<sup>8</sup> Initially adamant about Russia's strength and ability to withstand adverse economic impacts seen as originating in Western nations, the Kremlin reversed course in August 2009 when President Dmitry Medvedev admitted that misguided government policies had exacerbated his country's problems: "We cannot develop any longer like this....the crisis has put us under such conditions that we will have to take decisions about changing the structure of our economy,"<sup>9</sup> he acknowledged. This statement alone indicates a substantial break with nearly a decade of Putin-led assertions insisting on Russia's independent success in generating wealth in the global economy. The severity of the present downturn brings questions pertaining to state interference in economic affairs and diversification of the resource-dependent economy to the forefront of public and scholarly discourse. Yet, as renowned Russia scholar Dmitri Simes notes, "in Russia, hard times normally produce hard lines;"<sup>10</sup> future liberal reforms are by no means the expectation. In fact, the crisis may cause any burgeoning interest in such policies on the part of the government to be replaced by hardening of state control in the economic sphere.

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<sup>6</sup> "Russia and the Financial Crisis." The Association of Chartered Certified Accountants (ACCA) Russia. June 15, 2009.

<sup>7</sup> Ibid

<sup>8</sup> Ibid

<sup>9</sup> Stuart Williams, "Russian economy hitting dead end." *The Associated Foreign Press*. August 11, 2009.

<sup>10</sup> Dmitri Simes, "Uncertainty in Moscow." *The National Interest Online: Subjective Evaluation*. December 12, 2008.

Russia now unmistakably confronts the tradeoffs implied by the realities of unprecedented interdependence with the global economy. The economic devastation the country experienced in 1998 as a result of its first financial crisis followed several years of attempts at market-oriented reform strategies and interaction with the global economy. Instead of transforming the inefficient legacies of the Soviet economy into a modern competitive market, this so-called “neoliberal experiment”<sup>11</sup> resulted in narrowly focused policies that exposed Russia to international capital volatility and led to a collapse of the ruble. Yet today Russian policymakers face a vastly different political and economic situation than their counterparts who were forced to devalue the ruble and default on foreign obligations a decade ago. Since 1999 heightened exposure to foreign capital flows has occurred concurrently with the Putin-led channeling of windfall profits from commodities exports to a state-controlled network of domestic enterprise comprising banks, holding companies, and industrial leaders. During the oil boom of 2000-2008, this arrangement ensured economic and social stability, a hallmark of the Putin regime, but hinged precariously on favorable externally determined commodities prices and operated via a deficient and weak domestic mechanism. The implosion of the Western financial system in 2008 stopped the capital flows that had sustained this system. The resultant diminished financial capacity of the Russian state and indirect consequences for domestic politics affect the viability and attractiveness of available policies for recovery and future growth, elevating the urgency of determining how the Kremlin will attempt to balance preservation of its strong influence on the Russian economy and society with increased adherence to policies and conditions favorable to stability and security in internationally integrated goods and capital markets.

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<sup>11</sup> Neil Robinson, “The global economy, reform and crisis in Russia.” *Review of International Political Economy* 6:4 Winter 1999. Pages 531-564

The formulation of a response to the crisis reflects the shifting balance between considerations of domestic policy goals and the constraints the powerful forces of globalization potentially impose on the Kremlin if it wishes to reap the benefits of international markets. The experience of the current crisis opens wider the door of opportunity to break Russia's historical legacy of an authoritarian state maintaining a resource-dependent economy; it may force far-reaching changes in the economy, society, and foreign policy. Furthermore, it offers a case study of how developing countries respond to the "trilemma"<sup>12</sup> confronting nation-states in the post-global crisis world: what is the price of deeper international economic integration in terms of foregone flexibility of the nation-state to prescribe policies driven by domestically-determined needs? Conclusions about Russia's shifting priorities and options carry implications for undemocratic regimes that rely on the global system for market-based financial intermediation, as well as for the prospects for international cooperation and leadership in the evolving global order. By tracing the interaction of external economic events and Russia's domestic economic framework this thesis will characterize the changing considerations and constraints presently faced by policymakers and the impact of such a shifting economic decision making climate on domestic regime stability. The financial crisis has forced significant reconfigurations in economic thinking within the Russian government, but the overall approach to economic diversification, modernization and liberalization will likely remain largely unchanged if Putin and those in his inner circle feel they retain a secure hold on political power.

## **LITERATURE REVIEW**

Since August 2008, the adverse impact of the global credit crisis on the Russian economy has precipitated a flurry of commentary, analysis and questions regarding the government policy

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<sup>12</sup> Dani Rodrik, *One Economics, Many Recipes*. Princeton University Press, Princeton. 2007.  
Penn Humanities Forum Mellon Undergraduate Research Fellowship, Final Paper April 2010  
Dasha Barannik, College '10,

response and prospects for long-term structural economic reform. In several cases, this scholarship has connected the current situation to broader political, economic and social issues both internal and external to Russia, creating a substantial body of observation and perspectives on which this thesis will draw.

Russia's increased interaction with global markets since encountering its first financial crisis in 1998 has created different conditions under which future policy will take shape; previous frameworks assessing factors influencing the sequence, timing and viability of economic liberalization in Russia must be tailored to fit the particular environment created by the recent global downturn. Theoretical perspectives on the opportunities and limitations inherent to the contemporary globalized economy offer basic frameworks for understanding the Russian manifestation of crisis and response.

### ***Globalization theory***

Theories of the impact of globalization, defined as increased international economic integration, generally agree on the existence of a tradeoff between benefits to domestic economic growth and limitations on government ability to pursue domestic policy goals that may be at odds with what is favorable for international economic activity. Dani Rodrik refers to a “trilemma”<sup>13</sup> confronting nation states, limiting them to the successful attainment of two out of three policy goals: independent monetary policy in pursuit of low unemployment and inflation levels, capital mobility, and a fixed exchange rate. Similarly, Thomas Friedman cites the necessity for today's nation-state to don the “golden straitjacket”<sup>14</sup> of privatizing enterprises, balancing budgets, lowering tariffs, removing restrictions on foreign investment, and eliminating

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<sup>13</sup> Dani Rodrik, *One Economics, Many Recipes*.

<sup>14</sup> Thomas Friedman, *The Lexus and the Olive Tree*. New York, NY. Anchor Books, 1999. P 110.

subsidies for state-owned firms if it wishes to attract international investors and profit from globalization.<sup>15</sup>

If the paths to economic prosperity available to states in the contemporary global economy are thus increasingly dictated by external actors, at least in some policy spheres, the sovereignty of the state itself, and political power bases, may be at threat. Rodrik argues that the weakened ability of national governments to sustain domestic social welfare arrangements in light of externally motivated obligations could prove politically destabilizing. The scaling back of Icelandic government expenditures on social welfare in order to repay external debt obligations and stabilize the krona serves as contemporary evidence of this dynamic. Citizens may increasingly criticize governments whose policies towards international markets they view as inadequate in ensuring social stability, prosperity, or other traditional mandates bestowed on the nation-state. Contrary to the suggestions of contemporary rhetoric, Garrett believes that global markets impose weaker constraints on national policy choices than presumed due to the “strengthened political incentives for governments to use the policy instruments of the state to mitigate market dislocations by redistributing wealth and risk.”<sup>16</sup> Thus, the creation by government of new agencies for the purpose of retraining workers or disbursing social security funds itself supports the notion that the state retains capacity to effect change aimed at counteracting the effects of globalization. Garrett argues that states have the tools to slow international economic integration; the degree to which they are used in this regard is a reflection of social and political factors.

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<sup>15</sup> Qtd in Barry Eichengreen, “One Economy, Ready or Not: Thomas Friedman’s Jaunt Through Globalization.” *Foreign Affairs*, May/June 1999.

<sup>16</sup> Geoffrey Garrett, “Global Markets and National Politics: Collision Course or Virtuous Circle?” *International Organization*, Vol. 52, No. 4, *International Organization at Fifty: Exploration and Contestation in the Study of World Politics* (Autumn, 1998), pp. 787-824



Integration with the global economy offers the potentially significant benefits to economic growth rates, but forces countries to bear risks that, if not addressed via properly tailored economic policy, may destabilize and bankrupt nations. Foreign direct investment and capital inflows, two indicators of international economic integration, have been shown to stimulate growth in developing countries such as Russia. Nevertheless, the lack of strong domestic institutions and regulatory frameworks, particularly in the banking sector, allowed waves of financial crisis to destabilize these regions in the 1990s.<sup>17</sup> International institutions and scholars advised developing country governments to increase economic cooperation with other countries, modernize the domestic financial sector and encourage transparency, competition, accountability, and protection of property rights; however, perceptions of globalization, political and other factors influence the timing and content of such reforms, and ultimately, their success in achieving lasting economic development. Specifically, governments in post-crisis emerging economies must balance expenditures on social welfare and pursuit of structural reforms increasing the state's propensity to profit in a globalized economy. Rogoff and others, in discussing how to best create a suitable domestic political and economic milieu for harnessing the benefits of global markets at minimal risk, suggest that insulation from the global economy through capital controls may have been a more promising strategy than complete openness to financial markets for economic growth post-2008.<sup>18</sup> Only developing countries with "stable macroeconomic policies as well as sufficiently strong financial and other institutions, regulation and governance...could benefit from being financially open;"<sup>19</sup> the divergent impact of the 2008 crisis on significantly "open" and relatively "closed" economies has prompted a reinvigorated

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<sup>17</sup> Ibid

<sup>18</sup> M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff and Shang-Jin Wei. "Financial Globalization: A Reappraisal." August 2006. IMF Staff Papers, Palgrave Macmillan Journals, vol. 56(1), P 8-62

<sup>19</sup> Ibid

research agenda on the components of a stable and prosperous interaction with foreign economies under increasing financial globalization. Scholars of Russian politics often cite the early 1990s as a period when Russia, under the heavy-handed influence of the West, unsuccessfully pursued the paradigm of globalization's positive promises.<sup>20</sup> With this historical background in mind, economic development strategy today must harmonize Russia's unique values, traditions and resources with the norms and processes of the global environment.

### ***Comparison with 1998 financial crisis***

In recent Russian history, crisis preceded periods of substantial economic change in 1991-1993 and 1998-2002.<sup>21</sup> Thus, in an attempt to describe the impact of the 2008 credit crunch on Russia, scholars have examined what its differences in nature and context from the 1998 financial crisis may imply for the future. Whereas 1998 involved a national public sector and currency crisis, excessive borrowing by the private sector due to major triple shocks—terms of trade, capital outflows, and tight external borrowing – incited the crisis of 2008.<sup>22</sup> As Bogetic notes, global linkages in place by 2008 meant that the drastic deterioration of the foreign market situation with respect to raw material prices and financial markets made a Russian economic downturn inevitable.<sup>23</sup> Most notably, the 2008 crisis has spread to the real sector of the economy (i.e. the downturn is evident in wages and industrial production), adding broader uncertainty over macroeconomic growth to problems in the financial sector. Consequently, academic literature has broadly segmented potential government responses to the 2008 crisis into short-term

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<sup>20</sup> Paul Saunders, "Why 'Globalization' Didn't Rescue Russia." *Policy Review*, Hoover Institution, Stanford University. February & March 2001.

<sup>21</sup> "Russia's Road Back." Interview with Anders Aslund. *Peterson Institute for International Economics*. April 22, 2009.

<sup>22</sup> Zeljko Bogetic, "Russia: Recent Economic Developments and Medium-Term Prospects." March 31, 2008. Moscow.

<sup>23</sup> Ibid

recovery measures and longer-term structural reforms aimed at diversifying the economy and furthering economic liberalization by reducing state control over economic activity.

It is important to note that a weak government ruled Russia in the post-1998 period.<sup>24</sup> Some structural reforms were introduced during this time, but were eclipsed by the reestablishment of state control over key sectors of the economy beginning in 2002.<sup>25</sup> According to Neil Robinson, between 1999 and 2003 the Russian state emphasized the use of energy revenues as a source of patronage instead of strengthening state administrative capacity, a legal basis for economic activity and the rule of law; as a result, the state could not stimulate homegrown finance and growth, nor harness the “transformative powers of global markets.”<sup>26</sup> Scholars agree that the Russian economic development policy depended on revenues from oil and gas exports in the 2000s, encouraged by high commodity prices. This created vulnerability to international downturns while limiting the scope for institutional and regulatory reforms that could free the country from the structural legacy of communism. Today, the strength of the “more sophisticated”<sup>27</sup> Russian state is strikingly higher and its reach decidedly broader, although it is precisely the 2008 crisis that may serve as the critical juncture initiating a descent from this apex of potency.

In contrast to the inability of the Russian state to control widespread social disturbances accompanying the 1998 fall-out, particularly the upheaval of the “balance” established among oligarchs and the public distress caused by economic depression, the Kremlin has succeeded in preserving social stability since the start of the 2008 crisis. In assessing the significance of popular opinion and activity for periods of crisis, Volkov and others emphasize the absence of a

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<sup>24</sup> Vladimir Mau, “The Global Crisis As Seen from Russia.” *Russia in Global Affairs*, vol. 1, January – March 2009.

<sup>25</sup> William Cooper, “Russia’s Economic Performance and Policies and Their Implications for the United States.”

<sup>26</sup> Neil Robinson, “The global economy, reform and crisis in Russia.”

<sup>27</sup> Andrew Wilson, “Russia’s economic crisis – no cue for ‘Perestroika 2.0.’” openDemocracy Online. September 4, 2009.

tradition of mass democratic protest inciting a shift in the power balance of the Russian ruling elite, attributing this to the “famous passivity”<sup>28</sup> of the Russian people that is often described as the flip-side of “an unrivalled ability to survive adversity.”<sup>29</sup> Today, some argue, unlimited powers, especially in the realm of media, and sufficient financial resources allow the Kremlin to exploit this dynamic and mitigate instances of social unrest much more swiftly and effectively than a decade ago.<sup>30</sup> Acknowledging that the Kremlin’s approach has so far not significantly resulted in societal upheaval, Aslund and Kuchins believe that the government has poorly managed the crisis by ignoring its root causes.<sup>31</sup> In their view, such a policy will yield results that are “politically and socially untenable.”<sup>32</sup> Perhaps, then, the time horizon for mobilization of notable societal opposition is much longer than the average length of economic crisis.

### ***Putin’s economic policy and the social contract***

Literature related to the 2008 financial crisis devotes substantial attention to the economic development agenda during Putin’s presidency (2000 – 2008). Examination of the economic preferences of Putin and his closest government advisors has been inextricably linked to discussions pertaining to his conceptions of state power, state-society relations, democratic freedom, and other notions. Understanding the formulation of Putin’s brand of leadership has fuelled scholarly debate, with the only point of agreement among top academics and researchers being the conclusion that the Russian state is an enigma. Though scholars and pundits disagree

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<sup>28</sup> Vadim Volkov, “Will the Financial Crisis Lead to Political Change in Russia?” PONARS Eurasia Policy Memo No. 81. *Eurasian Strategy Project, Walsh School of Foreign Service*, September 2009.

<sup>29</sup> Ibid

<sup>30</sup> Ibid

<sup>31</sup> *The Russia Balance Sheet* p 55

<sup>32</sup> Ibid

about the degree and sustainability of Putin's monopoly on Russian political resources, he undoubtedly carries substantial weight in economic policymaking today.

Clifford G. Gaddy and Barry W. Ickes believe President Putin held financial stability and independence of his country as his primary objectives, which he achieved and sustained through rapid accumulation of money into the oil-stabilization fund and into foreign exchange reserves.<sup>33</sup> Broadly speaking, they believe four ideological principles guide the Putin administration's economic agenda: 1) the economy is Russia's key strength in the world; 2) the economy should be as strong and as efficient as possible; 3) the economy should ensure the priority of the state; 4) the economy must be robust to crisis.<sup>34</sup> Most of these objectives are often described as stemming from "never again" lessons learned after the 1998 crisis; different interpretations of this link highlight Putin's personal desire never to again allow Russia to suffer from humiliation on the international stage, and the belief that pursuit of these objectives constitutes the basis for Putin's domestic popular and political support.

Based on this framework, Gaddy and Ickes posit that Putin relied on the global system to intermediate the financial flows from Russia's own oil and gas export earnings into the domestic corporate sector, simultaneously providing state wealth and affording control over domestic private enterprise through a "protection racket."<sup>35</sup> The owners of Russia's most powerful companies (oligarchs) were allowed to conduct business free from government appropriation as long as they did not oppose Putin's tax regime, whose primary function was to channel more resources to the federal government.<sup>36</sup> This mechanism operated via the deficient financial sector, which had shifted from financing government deficits in the 1990s to expanding lending

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<sup>33</sup> Clifford G. Gaddy and Barry W. Ickes, "Putin's Third Way." *The National Interest*. January 21, 2009.

<sup>34</sup> Ibid

<sup>35</sup> Ibid

<sup>36</sup> Ibid

to households and corporations in the Putin years,<sup>37</sup> and therefore hinged heavily on international economic developments. Gaddy and Ickes posit that Putin will seek to maintain financial sovereignty, that is, autonomy from foreign influence in economic decision making, at all costs.<sup>38</sup> Steven Halliwell, like many others, points out that the crisis threatens Putin's "grand bargain" with Russian society – the exchange of basic freedoms for economic stability.<sup>39</sup>

### *Domestic politics*

The present domestic political arrangement serves as both a determinant of policy response to the crisis and a variable shaped by the economic implications of the crisis itself. Mobilization of the political will for reform, a matter of political leadership influenced by its ability to sustain economic growth, is frequently cited as the key factor in the implementation of reforms.<sup>40</sup> The preoccupation of the world's preeminent scholars of Russian politics with the tandem of power at the federal level has raised a number of questions in the wake of the crisis. President Dmitry Medvedev and Prime Minister Putin and their respective inner circles hold allegiance to different groups and espouse differing conceptions of Russia's economic development. Sestanovich and others suggest that the presence of "liberal reformers" in the Russian administration may shape the reform agenda, highlighting Medvedev's emphasis on the importance of further reform and on cooperation with other countries. Have the policies of Putin's clan been discredited, creating the potential for more liberal economic policymaking? Would Putin seek to take ownership of such measures, or step back and permit Medvedev to

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<sup>37</sup> Eric Berglof and A. Lehmann, "Sustaining Russia's Growth: The Role of Financial Reform," *Journal of Comparative Economics*, Volume 37, Issue 2, June 2009, P 198-206.

<sup>38</sup> Ibid

<sup>39</sup> Steven Halliwell, "Russia and the Global Crisis: Consequences of Delayed Reform." *Strategic Asia 2009–10: Economic Meltdown and Geopolitical Stability*. National Bureau of Asian Research: 2009.

<sup>40</sup> Anders Aslund and Andrew Kuchins, *The Russia Balance Sheet*.

assume a leading role? To what extent is Medvedev more liberal than Putin, and would economic policy under his rule differ dramatically from that of the past eight years? Although these are undeniably interesting areas of inquiry, especially in light of Putin's indications that he will seek a return to the presidency in 2012, this thesis will primary focus on the observable impacts of the 2008 crisis on policy choices available to the Russian government to argue that it has shifted the composition of economic policymaking to allow for new or altered considerations regarding the global economy and its relationship to the Russian economic condition. Awareness that the crisis likely contributes to the evolution of fundamental aspects of Russian politics will contribute to a nuanced analysis of its effects on viable policy choices.

Noting that elites and special interests would suffer from the economic reforms necessary for Russia to overcome the recession, Hough analyzes potential responses through the lens of incentives generated by potential economic reform. According to Robinson, short-term political gain, buying off lobbies, and the protection of vested economic interests constituted government objectives that hindered reform in the wake of the 1998 crash. Greene argues that evidence of this dynamic in response to the 2008 crisis already exists: the government has tacitly allowed various private and public sector interests to gain control of companies, including Aeroflot and large banks, in order to satisfy the ruling elite.<sup>41</sup>

### ***Scenarios for the future course of economic policy***

Recent literature attempts to predict the future course of economic policy and the development agenda by employing event-driven scenario frameworks differing across the factors influencing the sequence and extent of reform. Erik Berglof and Alexander Lehmann focus on the overall macroeconomic position as a driver of economic liberalization; in their view, “the

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<sup>41</sup> Sam Greene, “Domesticating Russia’s Economic Crisis.” *International Economic Bulletin*, June 2009.  
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prospect of several years of weak if not negative economic growth will likely weaken popular support for further economic reforms” since rising inflation and a slowdown in credit expansion may command the Kremlin’s attention.<sup>42</sup> Nicolay Petrov predicts that authoritarianism, not economic liberalization, will rise in the near future, as the government does not yet appreciate the seriousness of crisis impacts but will revert to traditional methods of control in attempt to preserve political power. This prediction is consistent with the findings of Pitilk that “an institutionalized system of conflict management in constitutional democracies”<sup>43</sup> provides a higher likelihood of successful responsive policy changes than does an authoritarian state like Russia. Another perspective, led by Anders Aslund, posits three scenarios for the future: a) a continuation of the Putin approach: low growth rate, living on energy resources, and maintaining hard authoritarianism; b) a liberalization both of economics and politics, and opening up to the West, the world, and increased globalization, and c) a serious crisis scenario.<sup>44</sup> Putin’s desire to prevent the third scenario prompted him to let the more plausible policies recommended by government liberals proceed; this is the driver of policy shifts. Similarly, Halliwell presents three varying scenarios for duration of global recession and outlines policy implications on this basis.<sup>45</sup>

### ***Scope for further research***

As the country stands at a crossroads in the economic sphere, several facets of the 2008 crash impact on Russia have not yet been adequately addressed by existing literature. The global nature of the crisis will certainly continue to have domestic implications. Medvedev and Putin must work to facilitate recovery and cultivate a business-friendly, institutionally-sound

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<sup>42</sup> Eric Berglof, “Sustaining Russia’s Growth.”

<sup>43</sup> Hans Pitlik and S. Wirth, “Do crises promote the extent of economic liberalization?: an empirical test.” *European Journal of Political Economy*, Volume 19, Issue 3, September 2003, P 565-581.

<sup>44</sup> “Russia’s Road Back.” Interview with Anders Aslund.

<sup>45</sup> Halliwell, “Russia and the Global Crisis.”



environment in the long run; the policies available can cater to both domestic and international constituencies, and the tradeoffs in seeking such a balance have yet to be studied in depth. Increased social welfare and heightened international credibility might be obtainable in tandem, not necessarily at one another's expense. Additionally, while the relatively small body of literature pertaining to the recent crisis in Russia addresses political implications for Putin's regime, there has been little work suggesting how such concerns will percolate through policymaking channels into economic measures.

The unprecedented global scale of recession associated with this crisis offers the possibility of exploring how shared negative experiences shape policy responses. To what extent will considerations about cooperation for international economic recovery, for example, coordination of central bank policies and limits on protectionism, factor into Russian policy options? There is mixed evidence on whether banking crises encourage reforms in developing countries; how do predictions change based on the presence of macroeconomic risk stemming from global recession, length of recession, and impact on certain sectors of the real economy? Important conclusions for other emerging markets or authoritarian states may be drawn from the Russian experience thus far as to what constitutes a desirable balance between economic policies promoting stability and those promoting international openness and efficiency. Finally, it will be important to evaluate the broader implications of various economic reform scenarios for Russia's foreign policy, and for the world economy.

## METHODOLOGY

In analyzing the effects of the 2008 global credit crisis on the Russian government policy response, it is essential to first characterize the economic and political landscape prior to the downturn, to identify key features of policymaking in this environment, and to understand the channels through which external forces altered Russia's economy before and during the crisis itself. The research question fundamentally pertains to tradeoffs facing policymakers seeking to sustain economic growth: between adaptation and control, broadly speaking, and in particular between the importance of considering the economic implications of external forces in policymaking and responding to internally-driven policy needs. This, in turn, could imply "tighter control over the economy, more constraints on the big businesses and less impetus toward integration into the global economy"<sup>46</sup> on one hand, or a greater inclination to participate openly in the global marketplace and relax state controls.

Scholars largely agree on the basic characteristics of the balance determined during Vladimir Putin's tenure as President (2000-2008): in order to restore Russia's status as a strong and sovereign nation and, by extension, to sustain political power, Putin believed in the necessity of accumulating wealth for the country. This ensured social stability characterized by a fairly consistent price level, job security, and other features that translated into a population largely uncritical of the government.<sup>47</sup> The desire to promote social stability came as a result of the disastrous societal effects of the 1998 financial crisis, which left Russian citizens critical of the government and fuelled years of short-lived and unstable governments. To Putin, this suggested that a wealthy state could provide for its citizens in dire circumstances and withstand crisis with a higher likelihood, ensuring political continuity and power. Thus, the pursuit of such "financial

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<sup>46</sup> Clifford G. Gaddy and Barry W. Ickes, "Putin's Third Way."

<sup>47</sup> Ibid

sovereignty”<sup>48</sup> conditioned Putin’s choice of economic policy. The state maintained tight control over domestic private enterprise, and employed the Russian financial sector to intermediate profits from commodities exports into state reserves. Scholars refer to the acceptance of this economic arrangement in return for domestic price stability and employment levels as the implicit “social contract.”<sup>49</sup>

The Putin economic development agenda hinged on international economic activity in a particular manner: oil prices determined government revenues, and, accordingly, the state budget. In its approach, the Kremlin believed the internal system it constructed could control and direct external flows to enrich the nation. The young body of scholarship pertaining to the effects of the recent crisis on Russia’s economy demonstrates the severity of impacts on multiple dimensions; this analysis seeks to strengthen the understanding of how these effects translate into recovery measures and contribute to the formulation of long-term economic development strategy. In doing so, it will contribute to the study of how economic crises encourage (or discourage) economic reform and how easily governments may align domestic goals to productively and reliably sustain growth and promote wealth under present levels of globalization.

Essentially, I argue that the effects of the 2008 crisis have caused the Russian government, led by Putin, who remains the chief policymaker, to put forth policies and take actions that would not have been pursued in the absence of such a cataclysmic event. It is precisely the newest expression of risk originating abroad that drives this shifting mindset. There was little incentive to deviate from the economic structures put in place by Putin before the crisis; despite allowing for swift and appropriate actions in the immediate post-crisis period, the

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<sup>48</sup> Ibid

<sup>49</sup> Ibid

system failed to protect fully against a downturn and limited financial capacity of the state. The Kremlin now looks for cues regarding global recovery as it formulates economic policy for recovery and long-term growth. Struggling to balance preservation of political power, financial sovereignty, and social stability, it has begun to formulate an economic policy that demonstrates the tradeoffs between policies favoring domestic priorities and those conducive to stability in an internationally integrated economy. To be sure, Putin and Medvedev aim to project confidence in Russia's propensity to navigate the economic storm in pursuit of sustaining the social contract and maintaining similar domestic objectives as before. Individual preferences of government officials, social unrest, and other factors may explain the state's recovery policies. Yet the features of the crisis response that have already emerged suggest a mounting appreciation for the inevitable need for policies to respond to the present vulnerability of the Russian system to external forces. Given the difficulty of predicting the path of global recovery, the analysis will refer to three exogenously determined scenarios with varying levels of energy prices and length of recession in the rest of the world: 1) long and deep global recession and energy prices sink near historic lows; 2) brief recession and strong rebound of energy prices; 3) moderate recovery, and energy prices stay at historically elevated levels. Though the hypothesis posits that the Russian state now formulates policy to a greater degree by attempting to discern which of these scenarios will occur, the tempered growth forecasts at the end of December 2008 renders it likely that a quick recovery has been ruled out. A scenario between 1) and 3), that is, moderate recovery and gradual rebound of oil prices (though not to previously record high levels) now seems to be the most likely.

Process tracing allows the most effective illumination of the links between globalization, defined as international economic integration, the 2008 financial crisis, and economic strategy

formulation. First, it is necessary to determine the pillars of Putin's economic policy during the boom years, as well as what particular structures characterized Russian integration into the global financial economy since 1998. Policies on economic growth, inflation, the ruble exchange rate, state budgetary plans, the evolution of the financial sector, foreign direct investment, capital flows and state ownership of assets will be examined. Based on this initial scenario, it will become possible to envision a picture of what reform would entail and construct a counterfactual understanding of what Russia's trajectory could have been had the financial crisis not occurred. WTO accession, the introduction of transparent procurement processes for major investments, and a halt or reversal in nationalization projects are all examples of positive orientation towards global economic integration, as they demonstrate willingness to adhere to international norms of transparency, competition and unobstructed flows of goods and capital across borders. The relative weight of alternate explanatory factors, including personal preferences of leaders and societal demands, will be gauged by exploring whether they may be causally linked to significant policy decisions. To the extent reliable information is available through Western media, I will identify "core interests" for individuals and government agencies participating in economic policymaking between 2000 and 2008; these may comprise specific policy preferences, broader ideological tendencies, or considerations about political power or social standing of tangential relation to formulation of preferences for economic policy. This section of the analysis will be limited by the restricted ability of Western media provide a thorough description of the actions and perspectives of these actors as a result of limitations to access imposed by the Russian state. As there are a multitude of approaches to describing personal preferences of Russian policymakers, I will consult the top scholars of Russian politics to sketch the basic contours of individual motivations and tendencies; for a data point in which a given actor is significant, I will

consult the relevant core preference to examine whether the action taken showed consistency with this preference. If it did not, I will examine other independent variables. If it did, which I expect to be the case in the majority of instances, a more nuanced analysis of the degree of continuity between preferences and actions taken will be required.

Scholarly consensus on the preferences of Russian citizens will determine the basis for societal demands, an alternate explanatory factor for the economic policy chosen by the Russian government thus far. Based on public opinion survey data from the period 2000 – 2008 indicating satisfaction with economic indicators such as wages, employment levels and prices, I will identify the chief areas of concern for the Russian public. Given Russia's authoritarian tradition, I expect to find that societal demands carry relatively less weight in policymaking, as they are seldom articulated aggressively and pointedly enough to significantly steer leaders against their personal preferences. In the particular case of my research question, I expect that in the short-term, societal demands have prompted the Russian government to formulate recovery measures addressing first and foremost these needs. The tension lies between popular demands, that is, democracy, and the interests of individual leaders – autocracy. Importantly, the financial crisis and the external factors it injects into policymaking affects both these actors and, by extension, their preferences for future economic policy.

The 2008 financial crisis may be viewed as a “critical juncture”<sup>50</sup> in Russian economic policymaking, inviting the possibility of a dramatic shift in the direction of the nation's long-term economic development. Four major shocks transmitted the global crisis in Russia:

- 1) The intensification of the global crisis caused a sudden stop and then a reversal in capital flows out of Russia.

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<sup>50</sup> Giovanni Capoccia and R. Daniel Kelemen, “The Study of Critical Junctures: Theory, Narrative and Counterfactuals in Historical Institutionalism.” *World Politics* 59, April 2007. P 347  
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- 2) The global credit crunch and tightening external borrowing conditions exacerbated liquidity problems in Russia's banking system.
- 3) A sharp drop in the price of oil began to erode Russia's fiscal and external account surpluses and its huge international currency reserves.
- 4) Russia's stock market experienced a massive decline—largely reflecting the global loss of confidence and the precipitous drop in the price of oil.<sup>51</sup>

Using process tracing, the analysis will explain how the external factors listed above affected the Russian economy, for example, reducing the balance sheets in three sectors (government, corporations and households). The first causal mechanism will thus be established between the externally determined variables (e.g. commodities prices, capital inflows), the choice of domestic institutions and policies, and resulting economic circumstances. The actions of the Kremlin since August 2008 in response to the specific externally-driven economic circumstances identified will subsequently be compared to pre-crisis policies and linked back to externally driven occurrences by rigorous and systematic reconstruction of each step of the decision-making process;<sup>52</sup> this will form the second causal mechanism. Government decisions pertaining to exchange rate dynamics, stimulus spending, lending to corporations and other entities, and messages regarding the crisis and recovery measures offer unique data points which may have occurred following precise events in the global economy impacting particular aspects of the Russian economy.

It is important to note that both a tightening of state control and a more global orientation are compatible with a state more acutely aware of its economy's exposure to external shocks. If the Kremlin did not respond to exogenous incidents that negatively impacted its pre-crisis economic agenda, such as reductions in stabilization fund reserves, the argument that policy is

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<sup>51</sup> Zieljko Bogetic, "Anatomy of Russia's Financial Crisis." *World Bank Quarterly Monitor No. 15*, October – December 2008.

<sup>52</sup> Ibid

becoming increasingly responsive to global events is undermined. As Capoccia and Kelemen note, counterfactual analysis of the plausible consequences of other, viable choices that were not taken is necessary for a deeper understanding of the driving forces.<sup>53</sup> Data pertaining to government discussions and policies ultimately not chosen may be difficult to access and limited due to the still-evolving nature of the crisis response; furthermore, the government censors Russian media coverage of the crisis and has begun conducting discussions regarding economic policy in closed sessions. Limited access to reliable sources of information, however, will not detract from the power of the causal linkages outlined in this section to provide a deep understanding of the key decisions made thus far and their immediate context.<sup>54</sup>

To explore whether the Kremlin is in fact responding to alternative independent variables more so than to external forces, episodes of social unrest, like the January 2009 protests in Vladivostok, will be similarly examined in search of connected policy responses. Russia has a number of “company-towns” whose livelihood depends largely on industrial production in factories of one or a few large enterprises. Federal policies and actions towards these regions have received much attention during the crisis, as these areas, which were adversely affected by the crisis, are viewed as potential hot spots for social unrest. Social stability is itself a variable affected by the economic crisis, as it has led to declining incomes and employment and abrupt reductions in social services.<sup>55</sup> Here the analysis will proceed from data points of social instability, identified primarily through reputable media outlets, to government responses. Policies determined as responding primarily to domestic constituencies may or may not be in line with those “advocated” by the global economy, that is, those policies that the first stage of

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<sup>53</sup> Ibid, 369

<sup>54</sup> Ibid

<sup>55</sup> Evgeny Levkin, “Slump and the city: Company towns and the crisis in Russia.” *Development & Transition: The Regional Impact of the Global Economic Crisis*.



analysis will identify as components of a globally-oriented reform agenda. To separate the influence of the economic crisis from the variable of social stability, I will assess government economic policy responses to episodes of social unrest unconnected with the global factors of the present downturn. There may be instances when the government has acted preemptively or responded in a manner uncharacteristic of its prior relationship with society, indicating a shift in the approach to this relationship. Most instances of social unrest occurring after August 2008 will likely be linked indirectly to the external effects of the financial crisis, though some episodes may be decoupled from a direct relationship.

Additionally, no analysis of decision-making within the Russian state can ignore the complex interplay among Kremlin factions and individuals in power. Though financial policy is not a traditional responsibility of the Russian president, in October 2008 Medvedev created a “Council for the Development of the Financial Markets of the Russian Federation under the auspices of the President of the Russian Federation” which assigned his administration several responsibilities in this domain.<sup>56</sup> Later, he criticized the government, though not Putin directly, for a slow crisis response.<sup>57</sup> President Dmitri Medvedev, Prime Minister Vladimir Putin, Medvedev’s Deputy Chief of Staff Vladislav Surkov, Deputy Prime Minister Igor Sechin and others harbor individual political ambitions, and so-called “liberal reformers”<sup>58</sup> in the Medvedev and Putin administrations in the post-crisis period also exert influence on economic policymaking; however, this thesis will proceed from the assumption that the liberal clan advocating economic liberalization and market-promoting structural reforms held a much smaller share of economic decision making up to 2008. The degree of this influence varies, however,

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<sup>56</sup> Eberhard Schneider, “Split in the Russian Political Tandem Putin-Medvedev?” *Caucasian Review of International Affairs*, Vol. 3 (2), Spring 2009.

<sup>57</sup> Guy Faulconbridge, “Putin to defend handling of Russian crisis.” *Reuters*. April 5, 2009.

<sup>58</sup> Michael Stott, “Russian tanks crush hopes of Moscow liberal agenda.” *Reuters*. August 22, 2008.

with the relative importance Putin assigns to the economic policy recommendations of this group. I will seek anecdotal evidence from news articles, interviews and secondary sources to assess the implications shifting balances of power have on the economic agenda. If Putin will seek to maintain the existing political equilibrium, domestic politics suggest he should continue to suppress liberal challengers. Support for these individuals and their policies may prove politically destabilizing and hence undesirable. However, if my argument is correct, the Putin economic plan will prove unsustainable in the future due to the vulnerability it creates for the Russian economy. It would be irrational to assume that Russian officials are completely blind to this idea; therefore, the process of economic policymaking occurring today is closely linked with Putin's reformulation of a strategy to ensure his political survival. How different the resulting policies and economic landscape will be remains to be seen.

While outside the particular lens through which this thesis approaches the government response to the Russian financial crisis, my hypothesis assumes that given Russia's authoritarian decision-making regime and lack of historical precedence for democratic political activism, a turn towards or away from globalization will be marginally influenced by popular demand for change, especially in the long term. Traditionally, the Russian population has harbored a high threshold for authoritarianism,<sup>59</sup> seemingly preferring societal stability to disruption caused by democratic opposition. This supposition justifies the focus on government responses to the 2008 crisis. On this dimension, a critical comparison of recent social unrest with responses to instances of social disruption following the 1998 crisis will be especially illuminating. Thus far, the accumulated financial resources have allowed the government to stem potential points of popular

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<sup>59</sup> Dmitry Badovsky, "Russia's Modernization: At Another Fork in the Road." *Russia in Global Affairs*, Vol. 3. July – September 2009.

discontent; for instance, \$1 billion was pledged to support the ailing automobile industry<sup>60</sup> and four regional governors removed on the basis of their alleged failure to fight the crisis.<sup>61</sup> Whereas after 1998 the government lacked the political and fiscal resources to mitigate detriment to society, leading to the introduction of a series of economic reforms, the strengthened capacity of the state today allows it to act more effectively towards this end. I will attempt to show that to the extent it is possible to contain this source of instability, the state will sense less of a need to carry out reform. Prolonged global recovery, however, will continue to spark potential instances of political insecurity; greater appreciation for this dynamic will prompt a reengineering of policy.

The Russian economic situation created by the 2008 crisis differs markedly from the 1998 post-crisis conditions across several dimensions that illustrate increased global economic integration. Increased capital flows and implied economic, consumption and income risk, for example, suggest that if the Russian government wanted to maintain certain domestic employment and price levels, it should increase spending on programs aimed at mitigating risk to these factors. There is disagreement within existing scholarship over the degree to which the Kremlin underestimated the risk external forces posed to internal stability when constructing economic policy in the period 2000-2008. In any case, the 2008 crisis exposed the weaknesses of the system. The acute effects of Russia's two financial crises, despite their differences, and scholarship by Williamson, Drazen and Easterly indicating the existence of a link between crisis and economic reform<sup>62</sup> justifies the use of this comparison and the choice of 2000 – 2008 as the

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<sup>60</sup> "Russia Promises Auto Aid -- Kremlin Pledges Over \$1 Billion in Bid to Avoid Layoffs." *Wall Street Journal*. March 31, 2009.

<sup>61</sup> Dmitri Sidorov, "Russia Should Open to Foreign Investment." *Forbes*. March 12, 2009.

<sup>62</sup> John Williamson (Ed.), "The political economy of policy reform." *Peterson Institute for International Economics*, January 1994

“pre-crisis” time frame during which the social contract to be assessed (antecedent condition) came into being.

Since the start of the crisis, the state demonstrated an evolution of interpretation of the length of recovery, at first devoting minimal attention to crisis and its effects on Russia, then acquiescing to the incontestable reality that much more elaborate involvement would be required on the part of the state. In this respect, policymakers have already ruled out the possibility of Russia escaping global crisis unscathed. Stephen Halliwell’s three varying scenarios for the duration of global recession<sup>63</sup> will provide a framework for an analysis of the future impact external forces will have on Russian balance sheets in three sectors and on social stability, a core component of the social contract. Conclusions regarding the tradeoffs between domestically oriented and externally driven policies inherent to each scenario will be made and compared to the policy choices made thus far by the Kremlin. In this manner, this analysis will provide insight into the importance of external scenario planning for the Russian government in the aftermath of the financial crisis.

This thesis seeks to explain the effects of the crisis on the Russian social contract, that is, the particular balance of domestic spending and welfare provision with international economic integration sustained over the past eight years. The chosen analytical framework holds constant the Kremlin’s desire to maintain its current level of political power in order to focus the analysis on the effects of globalization, as exacerbated by the financial crisis, as the primary causal mechanism in operation to limit the scope of viable policy choices. The purpose of this constant is to remove from consideration the possibility that Putin wishes to radically reduce his power for reasons unconnected to the crisis, altogether another field of inquiry; this is consistent with the hypothesis that the crisis will serve as a factor making the pursuit of this constant more

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<sup>63</sup> Steven Halliwell, “Russia and the Global Crisis: Consequences of Delayed Reform.”  
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challenging. Though other authoritarian states and emerging economies undoubtedly also inject considerations about the global economy into policymaking, there are simply too many variables that must be controlled for in such comparative case studies; conversely, attempting to operationalize complex societal and political-economic arrangements would lessen the certainty with which any conclusions could be applied to Russia. The subjective nature of certain elements of the Kremlin “response,” in particular, messaging, and the uniqueness of their expression to Russia’s particular political and societal landscape render an event-driven process tracing analysis over several components of the crisis impact the most useful analytical approach. The next section will develop a full depiction of economic policy and its evolution in parallel with Russia’s global economic integration since 1999 with the goal of illustrating the systemic points of greatest openness and vulnerability to external forces and the policies that created and sustained them. A comprehensive assessment of other determinants of economic policy, such as popular support and the preferences of policymaking clans, will provide the basis for evaluating the channels through which policymakers interpret the crisis and any changes in relative importance of the independent variables that have come about as a result.

Having outlined a roadmap by which the analysis will proceed and noting the limitations of such an approach, the next chapter will identify a sequence of events that have occurred as part of the crisis since 2008. Process tracing will subsequently be carried out from each external event to actions taken by the Russian state. Alternative options will be identified by referencing scholarly works and commentary on the subject. In this examination it will be important to be mindful of the connections between external events, their impact through Russia’s institutions/domestic setting, and features of the crisis that are primarily domestically-rooted.

## **EXTERNAL EVENTS**

The 2008 global financial crisis hit Russia swiftly and severely, validating the assertion made in 2007 by experts Andrew Kuchins and Thomas Graham that, “the state of the global economy is the most important external driver for Russia’s future... If we experience a major recession or even more serious economic downturn in the next decade, Russia will be adversely affected.”<sup>64</sup> In this section I will first construct an understanding of the drivers and main components of economic policy during the Putin presidency, as well as an outline of the major policies and government actions that would constitute a departure from the route set forth during this period. The relative importance of popular demands and social unrest in economic policymaking will be considered. In the first section of this chapter I will use process tracing to follow how incidents originating in foreign economies transmitted the economic crisis to Russia and what impact this had on government actions. Next, I will use events exemplifying the social dimension of the economic crisis as data points for analysis of the government’s response. Given the exceptional magnitude and nature of the economic crisis, as well as the historical political apathy and tolerance for authoritarianism of the Russian population, I expect to find evidence that the government predicated its actions on the impact of the crisis and its future course, limited in its viable policy options as a result of external forces. The state likely continued to seek maintenance of the political status quo, but faced new challenges in doing so as a result of the crisis.

### ***Putin’s economic policy and its trajectory***

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<sup>64</sup> Andrew Kuchins, *Alternative Futures for Russia to 2017*. Center for Strategic and International Studies, December 2007.

In the words of Clifford Gaddy and Barry Ickes, Putin pursued “dual policy objectives of optimal efficiency and maximum robustness to short-term shocks”<sup>65</sup> during his tenure as president (2000-2008). This comprised the establishment of firm federal government control over the economy and a symbiotic relationship with major players in the business sector. Making the Russian economy robust to crisis constituted a guiding principle for Putin’s economic policymaking; based on the radical onset of economic depression in connection with the 1998 financial crisis, the priority was “not to invest in long-term growth but to invest in enhancing Russia’s resiliency to short-term shocks.”<sup>66</sup> Repayment of foreign debt and accumulation of vast financial reserves demonstrated a commitment to establishing so-called Russian financial sovereignty, whereby the state would not have loan obligations to international organizations or foreign governments and would have the financial resources to cushion its internal prices and economy from unexpected economic shocks. Reserves of foreign-denominated currency are needed to cover critical imports, repayment schedules of foreign debt, and to defend the national currency to maintain a stable exchange rate.

According to Anders Aslund, “Putin’s economic policy contains two constant, positive features: a strong emphasis on macroeconomic stability and high economic growth;”<sup>67</sup> there is agreement among experts that the Putin administration adhered to a conservative and responsible macroeconomic policy. Until October 2007, the government maintained fiscal discipline with budget surpluses every year from 2000 (ranging from 2.4 percent of GDP in 2001<sup>68</sup> to 5.4

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<sup>65</sup> Clifford G. Gaddy and Barry W. Ickes, “Putin's Third Way.”

<sup>66</sup> Ibid

<sup>67</sup> Anders Aslund, “Combatting Inflation with WTO Membership.” *The St. Petersburg Times*. November 6, 2007.

<sup>68</sup> *Russian Economic Report*. The World Bank Moscow Office – Economic Unit. January 2002.

[siteresources.worldbank.org/INTRUSSIANFEDERATION/.../RER\\_2\\_eng.pdf](http://siteresources.worldbank.org/INTRUSSIANFEDERATION/.../RER_2_eng.pdf)

percent of GDP in 2007.<sup>69</sup> When inflation began to rise, government expenditures increased. Prudent financial planning did occur during the latter half of Putin's presidency: the accumulation of oil-export duties and taxes for the extraction of natural resources into a National Stabilization Fund, set up in 2004, indicated Putin's desire to maintain budgetary surpluses and a cushion of foreign reserves in case of currency shocks. Concurrently, the federal government managed a relatively small budget constituting 21-22 percent of GDP, of which only a very limited portion was dedicated to development of infrastructure, education, technology and other areas. As a consequence, fiscal austerity caused the government to avoid large expenditures on "national projects" of proclaimed importance, such as health, education, housing and infrastructure. Inflation proved to be Putin's greatest challenge; a 40 percent jump in government spending and record net capital inflow of \$82.3 billion in 2007 spurred price growth,<sup>70</sup> which the Russian Central Bank struggled to manage concurrently with the exchange rate. By using ample foreign currency reserves to manage the ruble, the Central Bank effectively injected money into the domestic economy to weaken the currency, thereby fuelling inflation.

Putin's conception of the relationship between the state and big business hinged on a desire "to set up a system that could maximally exploit the advantages of the market economy while ensuring that the interests of private business owners would always remain subordinate to the strategic interests of the state."<sup>71</sup> Importantly, Putin recognized and sought an efficient, modern economy, recognizing that it is a means to achievement of full sovereignty and the ability to shape Russia's destiny. In 2005, he described this condition by stating, "Russia will decide itself how it can implement the principles of freedom and democracy, taking into account its historical,

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<sup>69</sup> "Prospects for the Global Economy: Recent Developments." The World Bank – Global Development Finance 2009: Europe and Central Asia. June 22, 2009.

<sup>70</sup> Maria Levitov, "Putin Makes Medvedev Suffer Russian Inflation Jolt." *Bloomberg Online*. February 28, 2008.

<sup>71</sup> Clifford G. Gaddy and Barry W. Ickes, "Putin's Third Way."



geopolitical and other specificities. As a sovereign state, Russia can and will independently establish for itself the timeframe and conditions for moving along this path.”<sup>72</sup> For the purposes of this thesis, Putin’s conception of sovereignty comprised financial sovereignty (freedom from outstanding foreign debts and substantial financial resources to counteract currency shocks) as well as international political sovereignty (including freedom from Western incursions into the former Soviet Union).<sup>73</sup> Between 2000 and 2002 he augmented the market reforms initiated under Boris Yeltsin. A radical new flat income tax was introduced; registration, licensing and standardization for small and medium enterprises were simplified; and the sale of agricultural land became legal.<sup>74</sup> Putin regularly spoke in favor of private ownership and the development of a robust, competitive economy. Concurrently, however, regular off-budget, so-called “voluntary contributions,” by some of the country’s largest and wealthiest companies to local and regional governments created a system of informal taxation by the state.<sup>75</sup> The Yukos affair in 2003, during which Putin confiscated the successful company of Mikhail Khodorkovsky, a big businessman and vocal critic of the Putin regime who controlled a large proportion of the private sector, ushered in an era of renationalization. As oil prices rose in 2004, all economic reform halted; the correlation between slowing reform and rising oil prices is evident here. By 2008, corruption, inefficient state enterprises, and arbitrary interpretation of tax codes plagued the economy in addition to a high dependency on commodity exports. As Andrew Kuchins notes, “It would be wrong, however, simply to categorize Russia as a petro-state with a non-diversified economy. Microeconomic enterprise restructuring has also contributed to the Russian economic

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<sup>72</sup> Viktor Ryzhkov, “Sovereignty vs. Democracy?” *Russia in Global Affairs*. Volume 4, October – December 2005.

<sup>73</sup> Clifford Gaddy and Andrew Kuchins, “Putin’s Plan.” *Washington Quarterly*, Volume 31, Number 2, Spring 2008. P 117-129.

<sup>74</sup> Anders Aslund, *An Assessment of Putin’s Economic Policy*. The Peterson Institute of International Economics. Article published in *CESifo Forum*, February 2008.

<sup>75</sup> *Ibid*

boom, and other sectors of the economy...including consumer goods, construction, and telecommunications, are experiencing tremendous growth” which fuelled GDP expansion in 2007 despite slumping oil prices.<sup>76</sup> While progress did occur in these other sectors, the vast dominance of oil exports in economic growth overshadowed alternative channels in the government agenda.

The Russian government demonstrated a firm commitment to market methods and openness to the global economy. Whereas Prime Minister Vladimir Putin did not devote significant attention to Russian accession to the World Trade Organization during his last term as president, President Dmitry Medvedev made many remarks about the benefits of joining for the Russian economy.<sup>77</sup> In addition to encouraging international trade beginning in the early reform period and creating an environment receptive to foreign direct investment, the Russian government presided over the development of an internationally engaged financial sector. Russian firms held initial public offerings in New York and London, Western firms financed Russian companies’ expansion, and foreigners actively traded shares on the Russian stock market. The country enjoyed \$4.2 billion of portfolio foreign investment and nearly \$500 billion in private credits from foreigners in 2007.<sup>78</sup> The combination of the firm reliance on natural resources as a driver of the economy and an underdeveloped financial sector motivated the emergence of the following arrangement to redistribute wealth from energy production back into the economy, a mechanism that “remains key to understanding the country’s political economy.”<sup>79</sup> Russian companies exported oil to the West; the Russian government taxed the export earnings; the Russian government lent this money to Western governments; and then, given the collateral represented

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<sup>76</sup> Andrew Kuchins, *Alternative Futures for Russia*

<sup>77</sup> Anders Aslund, “WTO Can Place Russia on the Right Track.” *The Moscow Times*. July 31, 2008.

<sup>78</sup> Andrew Kuchins, *Economic Whiplash in Russia*. Center for Strategic and International Studies. February 19, 2009.

<sup>79</sup> Clifford G. Gaddy, *Russia’s Economic Policy at a Crossroads*. The Brookings Institution. February 18, 2009.

by Russian holdings of Western debt, Western banks lent the funds back to Russian companies, including those that had earned them in the first place.<sup>80</sup> In effect, Western banks rolled over Russian corporate debts throughout the 2000s, providing financial intermediation that could not be obtained domestically. During this time, major Russian firms prospered financially and expanded globally, all while accumulating extensive foreign debts; this development received little attention amidst the country's booming economic growth.

In September 2007 the Ministry of Economic Development and Trade published the "Concept of Long-term Socioeconomic Development of the Russian Federation," which outlined a development plan through 2020 (also referred to as the Russia 2020 Plan). The ultimate goal of the Concept is for Russia to become one of the world's top five economies and establish itself as a leader in technological innovation and global energy infrastructure, as well as a major international financial center. Though much energy is devoted to outlining this vision of Russia as a center of innovation, scholars doubt that the plan's ambitious growth targets will be achieved due to the unwillingness of the government to address the root threats to growth. Kuchins, Aslund and others point out that since the introduction of this document little action has been taken in the sectors identified; according to these experts, the government's inaction regarding the Russia 2020 plan exemplifies the lack of credibility associated with such commitments.

Centralization of economic policymaking at the federal government level occurred during Putin's presidency, leading to what some scholars identify as a top structural challenge: a hypertrophied, inert and corrupt state bureaucracy. Michael McFaul notes that the 1998 financial

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<sup>80</sup> Clifford G. Gaddy and Barry W. Ickes, "Putin's Third Way."

crisis “put an end to major debate over economic policy in Russia,”<sup>81</sup> referring to the consensus for fiscal austerity which existed at the time between society and its rulers. Putin’s rise to power coincided with a strengthening of authoritarianism and a rollback of democracy. Early in his tenure, Putin concentrated on consolidating political power in the Duma and Federation Council, and among regional governors. Having amassed substantial political capital (Putin’s approval ratings stood at 70 percent in 2002<sup>82</sup>), he cleared the way for economic policy to be formulated at the top. McFaul notes that, “with so much money from oil windfalls in the Kremlin’s coffers, Putin could crack down on or co-opt independent sources of political power.”<sup>83</sup> The government maintained the social contract existing prior to the crisis with relatively minimal social dissent, and certainly without large-scale threats to the existing order. In 2005, Putin responded to weeklong protests by pensioners by doubling increases in pension payments and reintroducing free public transport for these individuals.<sup>84</sup> This so-called Chintz Revolution marked the first time that Putin’s regime faced anything close to an existential challenge; it received serious attention in Russian and foreign media. Though the incident passed without revolution and political upheaval, in the view of Sam Greene it highlighted the existence of a latent dissatisfaction with the provisions of the social contract, a force that had potential to become overt under certain pressures.<sup>85</sup> The Kremlin delayed responding to the 2005 unrest, perhaps a reflection of incoherence and poor preparation in internal deliberations about how to placate the dissatisfaction. Ultimately, Putin acquiesced, and despite temporarily dented popularity ratings

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<sup>81</sup> Michael McFaul and Kathryn Stoner-Weiss, “The Myth of the Authoritarian Model: How Putin’s Crackdown Holds Russia Back.”

<sup>82</sup> Jeremy Bransten, “Russia: Putin Calls for Growth, Bolder Economic Vision.” *Center for Defense Information Russia Weekly* # 201. April 12, 2001.

<sup>83</sup> Michael McFaul and Kathryn Stoner-Weiss, “The Myth of the Authoritarian Model”

<sup>84</sup> Claire Bigg, “Protests across Russia force Putin to double increase in pension payments.” *The Guardian*. January 19, 2005. <http://www.guardian.co.uk/world/2005/jan/19/russia>

<sup>85</sup> Sam Greene, *Eyes Wide Shut: The Social Consequences of Russia’s Economic Crisis*. The Carnegie Moscow Center Briefing, Vol. 10 Issue 4. December 2008.

he maintained political power and sovereignty in economic decision-making. The pensioners' crisis did little to alter the weight that the welfare of the population at large carried in considerations of economic policymaking. "Labor unrest has not played a large role in Russia since the collapse of the Soviet Union,"<sup>86</sup> write Andrew Kuchins and Thomas Graham. The residual memory of the 1990s has seemed to lead Russians to prefer stability and prosperity over democracy, a potential explanation for the parallel emergence of an enriched middle class and an increasingly authoritarian and centralized state.

With so much of Putin's economic policy predicated on sustained economic growth bolstered by high oil prices, the links between high natural resource rents and mounting autocracy would likely grow stronger. Existing literature describes the link between a ruling elite largely dependent on resource rents and the continuation of policies aimed at maintaining a degree of exclusive access to the benefits of these rents through authoritarian political policies. The suppression of democracy in the presence of this economic dynamic can continue until resources begin declining; in the case of Russia, the time horizon for falling commodities prices and oil and gas resource depletion seemed far off before the crisis, leading to the prediction that efforts at finding new sources of economic growth, improving investment and productivity, and especially policies favoring democracy faced little likelihood of becoming government priorities. The macroeconomic revolution that occurred between 2000 and 2008 fuelled the independence and power felt by those in the state apparatus. In December 2007, the public economic rhetoric became "statist;" Putin espoused "protectionism, state intervention, and subsidies," lessening the probability of a shift to progressive structural reforms.<sup>87</sup> Deviating from the economic trajectory constructed by Putin and continued by Medvedev would be costly from the perspective of the

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<sup>86</sup> Andrew Kuchins, *Alternative Futures for Russia*

<sup>87</sup> Anders Aslund, "Putinomics." Op-ed distributed through Project Syndicate. December 3, 2007.

ruling elite, as it would cause uncertainty over control of economic policy and, subsequently, the balance of power among individuals in leadership positions. Putin worked diligently to consolidate power in the early years of his presidency, and any deviation from this standard, whether necessitated by outside forces or by his own will, would likely occur gradually. Additionally, existing scholarship generally agrees on the lack the impetus for reform from below, that is, from the Russian populace, a phenomenon consistent with Russia's absence of a tradition of popular political activism. It is important to note, however, that the social contract and its associate authoritarianism thrives under the consent of the governed; Russian citizens do not want a return to the chaos and poverty of post-1998, and Putin offered a system addressing these concerns. In the words of Anders Aslund, "the emergent, highly centralized government, combined with a weak and submissive society, is the hallmark of traditional Russian paternalism."<sup>88</sup>

### ***Conceptions of reform***

Given the trajectory set forth by these economic policies and priorities, which contain elements of economic liberalization and political centralization, it is possible to outline the actions and policies that would constitute reform. The understanding of immediate pre-crisis economic policy is limited, however by the multitude of mixed signals sent from the Kremlin regarding factors, such as the approach to state corporations and international integration, which continued when the crisis hit in late July 2008; as Aslund notes, "Russia's course is difficult to discern because overt economic policy changes every few months with the oil price."<sup>89</sup>

Nevertheless, experts and think tank leaders have put forth several papers outlining future

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<sup>88</sup> Andrew Kuchins, *Alternative Futures for Russia*, p 4

<sup>89</sup> Anders Aslund, "Russia's Economic Mess." *The Moscow Times*. July 30, 2009.

scenarios for Russia's political and economic situation, the most cited being *Alternative Futures for Russia to 2017* from the Center for Strategic and International Studies. It is important to distinguish between long-term, structural objectives carrying broader political and social implications and more distinct policies representing deviations from the pre-crisis course.

Based on a variety of interpretations and analyses, reforms include:

- Opening the closed economy and improvement of the business environment: deregulation, privatization, administrative reform freeing small and medium businesses from bureaucratic red tape;
- Strengthening the rule of law and enforcement of property rights,<sup>90</sup>
- Concentrated efforts at international cooperation and institutional integration: aggressive pursuit of WTO accession through negotiations and compliance with entry standards;
- Improvement of productivity and greater openness: transparent procurement procedures for major investments, increase investment to over 23 percent of GDP; policy concentration on infrastructure and human capital; movement away from heavy monopolization in the economy, increasingly protectionist policies, and state support for failing industries
- Greater macroeconomic stability through monetary policy: allow the ruble to float freely, relax preferred rate of 24–25 rubles to the dollar, target inflation as opposed to money supply, raise interest rates to achieve positive real interest rates
- Improvement of the banking system: raise the general capital requirements of banks, reduce the amount of related party lending, privatization, increase foreign ownership
- Fiscal policy (pro-cyclical in the pre-crisis period): pursue budget deficits with temporary fiscal stimuli (a combination of spending increases and targeted tax cuts) to unlock investment and boost flagging aggregate demand,<sup>91</sup> adjust long-term expenditures to ensure fiscal sustainability

Broadly speaking, measures causing the Russian economy to become less centralized, better managed with less state intervention, to exhibit more trust between business and government and less hostility to foreign investors all indicate reform. Furthermore, one can envision a more nuanced notion of “reform:” having considered external factors more so than

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<sup>90</sup> Leon Aron, “Putin’s Risks.” *American Enterprise Institute Outlook Series*.

<sup>91</sup> Carlos Caceres and Eric Chaney, “Risk of Recession Rising.” *Morgan Stanley Global Economic Forum*. July 31, 2008.

before, the Russian government may pursue policies that do not differ significantly from pre-crisis ones, or may in fact tip even further away from the above policies than before towards state involvement in economic affairs (for example, through nationalization). This response would indicate a “tightening” of state control over the economy in attempt to mitigate perceived vulnerability caused by external forces. The existence of this type of shift motivated by external shocks from the financial crisis, while certainly more difficult to detect and prove, would demonstrate that Russian policymakers now interpret external factors differently – as necessitating stronger state guidance than before.

Several actors hold a stake in Russian economic policymaking; this thesis assumes that Vladimir Putin retains a major influence over the direction of the country’s economic development, and thus economic policy remained consistent during the transition of the presidency from Putin to Medvedev in 2008. In October 2008 Medvedev created a “Council for the Development of the Financial Markets of the Russian Federation under the auspices of the President of the Russian Federation” and allocated the portfolio of financial policy to his array of powers, though financial policy and economic policy are typically handled by the Prime Minister.<sup>92</sup> The Council is chaired by First Deputy Prime Minister Igor Shuvalov, who is also the head of the Anti-Crisis Committee of the government, and its members include Arkadij Dvorkovich, Medvedev’s economic affairs aide, Deputy Prime Minister and Finance Minister Alexei Kudrin, Minister for Economic Development and Trade Elvira Nabuillina, and Chairman of the Central Bank Sergei Ignatjev.<sup>93</sup> Prime Minister Putin is not a member of the Council. The Ministry of Finance oversees macroeconomic stability and inflation control; the Central Bank

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<sup>92</sup> Dr. Eberhard Schneider, “Split in the Russian Political Tandem?” *Caucasian Review of International Affairs*. Vol 3 (2) – Spring 2009.

<sup>93</sup> Ibid



“stimulates” economic growth, which it has attempted to facilitate in the past decade by “keeping the exchange rate at a lower level than it would be under a floating exchange rate regime.”<sup>94</sup>

### ***Transmission of global crisis to Russia: process tracing of external events***

The Russian reaction to the global financial crisis evolved from initial confidence in the country’s insulation from adverse effects and blaming of the American-led capitalist system to a realization the crisis threatened the utter collapse of entire segments of the Russian economy and the foundation of state power itself. Since the effects of the global crisis began to emerge in Russia in August 2008, Russian policymakers have implemented an extensive set of policy measures geared towards the provision of liquidity (domestic and external, short-term and long term), direct support to the stock markets and the banking sector, and fiscal support for the maintenance of the level of economic activity and of the exchange rate regime. Many actions of the Russian government occurred one to ten days after a significant event of foreign origin that in some manner transmitted the global crisis to Russia’s capital and current accounts with negative consequences. The transmission mechanisms may be broadly segmented into those originating in the financial sector and those operating through the real sector of the economy.

### ***Stimulus***

In September 2008, the United States stock markets plunged as the global crisis hit its most critical stage. Sharp withdrawals from money markets instigated a global investment panic; as a result, international investors cashed out their Russian holdings – which at that point accounted for about half the Russian stock market – in a bid to generate cash and cover their

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<sup>94</sup> *What Russia has to learn from the crisis: Macroeconomic policy*. Sberbank Center for Macroeconomic Research. November 27, 2009.

obligations elsewhere.<sup>95</sup> By October 2008, foreign investors withdrew \$74 billion out of the market.<sup>96</sup> The dollar-denominated RTS and ruble-denominated MICEX (Russian stock markets) fell by 20 percent on September 16, 2008, eventually plummeting by over 60 percent.<sup>97</sup> In response to these events, which had constricted the external debt-financing channels to Russian borrowers, the Russian government created a \$130 billion rescue package under which the Central Bank and Finance Ministry bought shares in Russian companies and strengthened bank balance sheets. The Central Bank and National Welfare Fund would loan the equivalent of \$36.1 billion to Sberbank, VTB (formerly Vneshtorgbank) and VEB (Development Bank) at 7 percent interest for five years (later raised to ten years).<sup>98</sup> These state-supported banks were instructed by the government to loan to Russian banks and corporations whose liquidity, previously foreign funded, had dried up with the massive capital outflows. European bank failures continued throughout September, causing a fluctuating Russian stock market and increasing liquidity pressures. Medvedev pledged an estimated 400 billion rubles (\$15 billion) of additional liquidity, and the reserve requirements dropped to 0.5 percent.<sup>99</sup> Liquidity injections continued until February 2009 and represented the first time in years that the Central Bank had used a policy other than restriction of foreign exchange reserves to drive monetary growth.

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<sup>95</sup> Peter Rutland, "The Impact of the Global Financial Crisis on Russia." *Russian Analytical Digest*, No. 48. October 17, 2008.

<sup>96</sup> Ibid

<sup>97</sup> Ibid

<sup>98</sup> Ibid

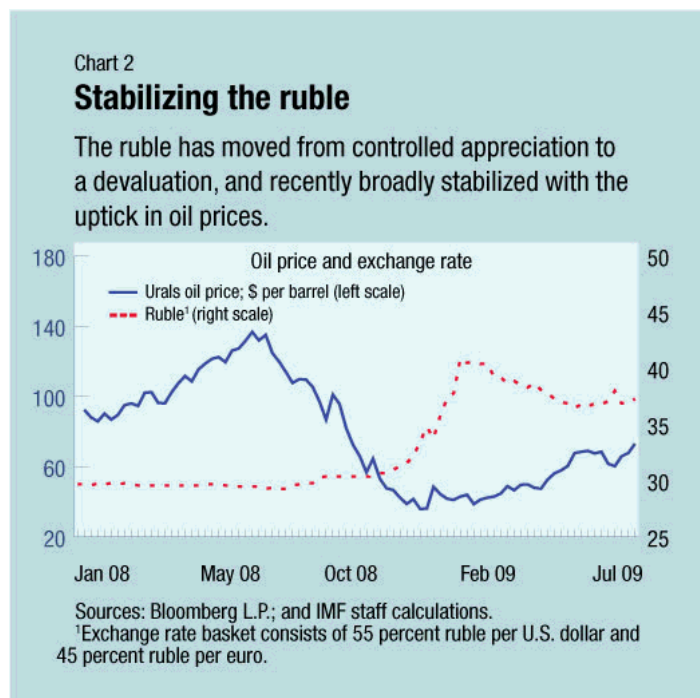
<sup>99</sup> Ibid

## Exchange rate

Capital outflows catalyzed by global crisis impacted the Russian government's exchange rate policy. Between 2002 and 2008 the ruble, bolstered by high oil prices and large balance of payments surpluses, appreciated 36 percent to the dollar, encouraging foreign borrowing and making exports, particularly those in commodities, more globally competitive (see Chart 2).<sup>100</sup>

Prior to November 2008, the Central Bank was able to maintain the ruble within its desired dollar exchange rate despite a 4.5 percent fall in September, spending a total of \$16.7 billion in the week ending October 3.<sup>101</sup>

Total hard currency reserves amounted to \$546 billion, down from a peak of \$596 billion on July 31.<sup>102</sup> In November 2008, however, the country experienced a sharp reduction in its trade surplus (caused by a fall in global oil prices, detailed below), initiating depreciation and large capital outflows that prompted a shift in the Central Bank's exchange



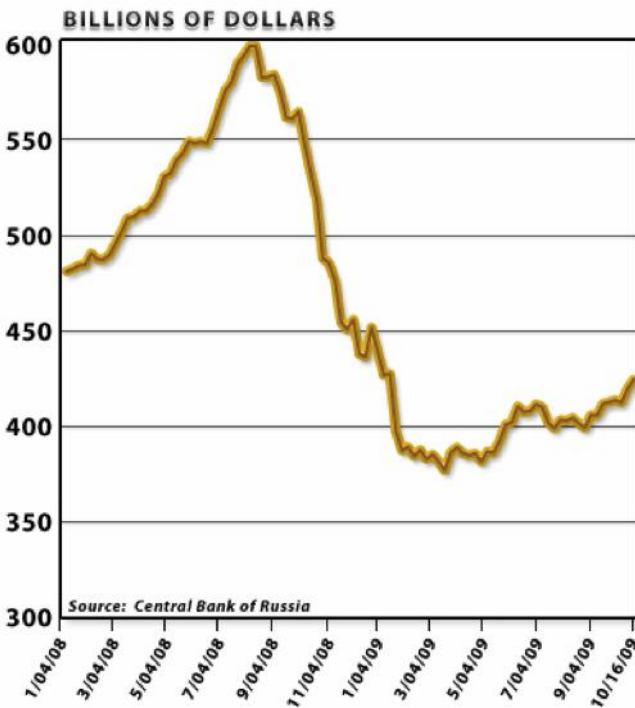
rate policy (see Chart 4). Internally, defense of the ruble likely came to be viewed as too rigid; in its place, the Central Bank began employing incremental devaluations of roughly 1 percent against the previously used basket comprised of 55 percent US dollar and 45 percent Euro. As the year, and the crisis, progressed, the devaluations became more frequent: “from once per week in November 2008, they reached three devaluations per week in December 2008, and four by

<sup>100</sup> “Russia in the financial crisis and beyond.” *Deutsche Bank Research*. December 11, 2009.

<sup>101</sup> Peter Rutland, “The Impact of the Global Financial Crisis on Russia.”

<sup>102</sup> *Ibid*

Chart 4: Russia's Foreign Currency Reserves, 1/08 – 10/09



mid-January 2009.”<sup>103</sup> Gradual devaluation “allowed households to protect savings, banks to arbitrage between unsecured loans and the pace of devaluation pace, and helped stabilize banking sector,”<sup>104</sup> but made foreign exchange speculation very profitable; to address this issue, the Bank of Russia raised interest rates to stabilize devaluation expectations. According to an analysis by Sberbank, one of Russia’s state

banks, the policy of gradual devaluation caused lost GDP growth.<sup>105</sup> On January 22, 2009, the Central Bank stated that it would allow the ruble to fall freely up to 10 percent, then pledged to defend it indefinitely at this level. Anders Aslund recognizes the present level as a “realistic market exchange rate.”<sup>106</sup> Although hemorrhaging foreign exchange reserves seemed to indicate a policy mistake at first blush, the policy of gradual devaluation represented an appropriate response to the externally driven portfolio investment and capital outflows. According to Deutsche Bank Research, the chosen policy allowed the Central Bank to “ensure an orderly deleveraging of private-sector external debtors without major bankruptcies, [and] avoid massive deposit runs that could have brought the banking sector under additional serious stress.”<sup>107</sup>

Alternatively, the government could have allowed the currency to crash – since most Russian

<sup>103</sup> Lúcio Vinhas de Souza, “Effects of financial and economic instability in Russia.” *Pan-European Institute, Baltic Rim Economies Bi-Monthly Review*. February 2009.

<sup>104</sup> *What Russia has to learn from the crisis: Macroeconomic policy*.

<sup>105</sup> *Ibid*

<sup>106</sup> Interview with Anders Aslund, “Russia’s Road Back.”

<sup>107</sup> “Russia in the financial crisis and beyond.”

institutions, large companies, and the Russian government hold their reserves in dollars and euro, this policy would have harmed small and medium Russian enterprises and the average citizen.<sup>108</sup> The combination of tempered devaluation with continued foreign exchange reserve depletion indicates a nuanced adaptation of economic goals (gradual lowering of exchange rate and subsequent rise in domestic prices to accommodate social stability, and safeguarding of financial positions of important banks and corporations) to crisis realities.

### *Budget*

Commodities prices constitute a key driver of Russian GDP growth in addition to external, fiscal and monetary developments. The fall of global commodities prices by nearly 75 percent since July 2008 carried significant ramifications for the Russian economy. Crude oil and gas account for two-thirds of Russian exports, and thus continued increase in export prices over 2003-2008 improved Russia's terms-of-trade by more than 120%.<sup>109</sup> On October 16, 2008, oil prices dropped below \$70 per barrel, coinciding with a drop in Russian oil production.<sup>110</sup> Total oil exports fell 10 percent year-on-year in October.<sup>111</sup> In September 2008, Deputy Prime Minister and Minister of Finance Alexei Kudrin announced that Russia's 2009 budget would enter a deficit if oil prices sank below \$70 per barrel.<sup>112</sup> Two months later, Kudrin pronounced acceptance of a long-term drop in oil prices and that the existing state budget plans will hold unchanged if the oil prices stabilize on 50 dollars per barrel mark.<sup>113</sup> In 2009, the government increased its expenditures by 33 percent in an anti-crisis stimulus package. Indeed, the federal

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<sup>108</sup> Lauren Goodrich and Peter Zeihan, "The Financial Crisis and the Six Pillars of Russian Strength." *STRATFOR Global Intelligence*. March 3, 2009.

<sup>109</sup> Ibid

<sup>110</sup> Greg Walters, "Russian Oil Output Falls for Ninth Straight Month." *Bloomberg*. October 2, 2008.

<sup>111</sup> Ibid

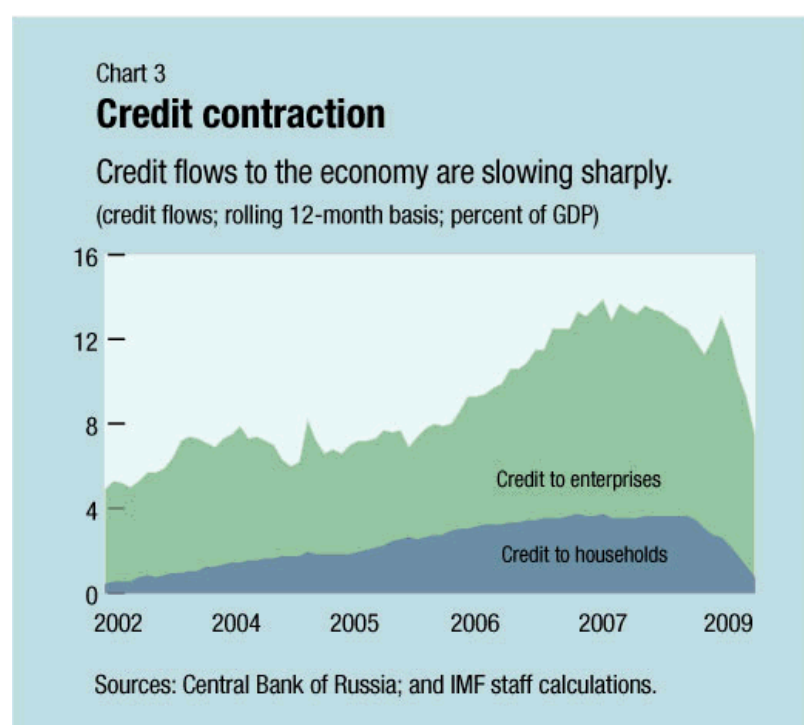
<sup>112</sup> Alex Nicholson and Stephen Bierman, "Kudrin Sees Russian Oil Price Averaging \$50 a Barrel in 2009." *Bloomberg*. November 12, 2008.

<sup>113</sup> Ibid

budget entered a deficit that year, its first in a decade; in February 2009 First Deputy Prime Minister Igor Shuvalov announced plans to limit the deficit by introducing budgetary cuts, a policy which would serve to protect foreign exchange resources. This policy directly demonstrates consideration for external events: by turning away from a sustained policy of increasing public spending, or maintaining the pre-crisis level, the government indicated awareness that continued low oil prices may cause a prolonged recession, seriously degrading the cushion of foreign exchange reserves and limiting the scope of future recession-combating measures. Since this policy is contractionary in nature, it opposes the ambitious growth goals pursued before the crisis. However, in light of the severe constraints imposed by the global slowdown in demand for commodities, this is a fiscally responsible response balancing stimulus and appreciation for the possibility of a sustained global “rainy day” scenario.

### *Interaction with big business*

The stock market crash, plunging commodities prices and global credit crunch each contributed to a deterioration of the ability of many Russian state corporations<sup>114</sup> and banks to generate revenues, finance acquisitions and roll over debts (see Chart 3). Struggling companies such as Lukoil, Rusal and Norilsk Nickel became debtors of the state in 2008 and 2009, surrendering shares in their companies and board seats as collateral for receipt of loans disbursed by Vneshekonombank (VEB).<sup>115</sup> In September 2008 the Ministry of Finance increased the



number of banks with access to budget funding from three to twenty-eight,<sup>116</sup> and in February 2009 the state put rehabilitation of the banking sector, which was then mired in write-offs from bad loans to Russian companies, at the forefront of its agenda in a shift away from attention to industry.<sup>117</sup> First Deputy Prime Minister Shuvalov's comments

on this shift illustrated a seeming realization within the government that it would have to be much more selective in disbursing state aid than ever before, especially to businesses with which it has close ties. Coinciding with changes imposed by the global economic climate, namely the

<sup>114</sup> "The restructuring of Rusal: Saving the oligarchs." *The Economist*. December 3, 2009.

<sup>115</sup> "Russian Oligarchs Face Financial Crisis." *Oxford Analytica*. December 15, 2008.

[http://www.forbes.com/2008/12/12/russia-oligarch-billionaires-cx\\_1215oxford.html](http://www.forbes.com/2008/12/12/russia-oligarch-billionaires-cx_1215oxford.html)

<sup>116</sup> "Summary of measures adopted by the Russian Government to support the Russian banking sector." *Promsvyazbank Investor Relations*. January 20, 2009.

<sup>117</sup> Gregory White, "Russia Shifts Bailout from Industry to Banks." *The Wall Street Journal*. February 5, 2009.

downgrading by Fitch Ratings of Russia's credit rating based on large-scale capital outflows and rapid reserve depletion, Shuvalov "suggested the government might have been wrong" to lend \$4.5 billion, its largest bailout loan, to Rusal, and discontinued a \$50 billion support fund intended to assist "magnates at risk of losing stakes in their companies to margin calls."<sup>118</sup> Until recently, small- and medium-sized enterprises were ignored by policymakers, as criteria for government credit guarantees included annual sales of over 15 billion rubles or half billion dollars and a workforce of no less than 4,000 employees.<sup>119</sup> As the size of state funds themselves varies with the rate of inflation and volatile oil prices, there is broader uncertainty about the economic capacity of the state to maintain control over the business community as before. On one hand, the constraints on federal tax revenues would imply a sobering effect on spending for support to the private sector and a policy of lending to the firms that would use funds most efficiently in order to stimulate the economy. Russia's tycoons, however, control the companies that are most closely tied to the state (for example, RusAl, Gazprom, Aeroflot, Rosneft, among others) and are considered to be the most inefficient and corrupt. Thus, the problem of leading the country out of crisis and the arrangement of existing state-business relationship imposes new challenges for maintaining the existing regime and political system. In the next section, more attention will be devoted to explaining the Economist's recent statement that "The Kremlin is bailing out the business tycoons it was once expected to curb"<sup>120</sup> from the perspective of both societal demands and domestic politics.

### *International cooperation*

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<sup>118</sup> Ibid

<sup>119</sup> Andrei Yakovlev, Yuri Simachev, and Yuri Danilov, "The Russian Corporation: Patterns of Behavior During the Crisis." *Centre for Comparative Economics*. UCL School of Slavonic and East European Studies. October 2009.

<sup>120</sup> "The restructuring of Rusal: Saving the oligarchs." *The Economist*. December 5, 2009.



As the crisis unfolded, the attitude of the Russian state to international cooperation evolved from disinterest to desire for leadership and discussion. In October 2008, when Russian leaders still widely denied the presence of crisis in their country, Kremlin spokesmen communicated a cool reception of an invitation by the US to hold a summit to discuss the international crisis. Dmitry Peskov, spokesman for Prime Minister Vladimir Putin, said it was too early to determine who from Russia would attend, if at all.<sup>121</sup> Three months later, in January 2009, Putin urged the development of multiple, regional reserve currencies in addition to the dollar, noting "excessive dependence on a single reserve currency is dangerous for the global economy."<sup>122</sup> This constituted an altered approach to the nature of the crisis: the blame, according to Putin, now fell on the system created and mismanaged by the United States, and Russia offered a solution to the problem. The assertive independence characteristic of the Kremlin's rhetoric during the boom years was replaced by a more conciliatory tone towards the US, despite potential hostility in late 2008 stemming from failure to agree on Russian accession to the WTO and US criticism on the invasion of Georgia; Putin wished the Obama team luck and said he looked forward to cooperating in the future.<sup>123</sup>

In April 2009 Russian and Chinese leaders signed twelve bilateral agreements on cooperation in energy and finance, supporting agreement by companies from both nations for building 205 joint projects in the Russian Far East, Siberia, and northeast China.<sup>124</sup> Earlier in the year, Chinese Premier Wen Jiabao had, like Putin, called for tighter regulation of the international financial system and reserve currencies and blamed the inappropriate macroeconomic policies of some nations for the crisis. Given China's increased importance in

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<sup>121</sup> Anna Smolchenko, "Russia in no rush for crisis summit." *The Moscow Times*. October 20, 2008.

<sup>122</sup> Marc Champion, "Russia, China Blame Woes on Capitalism." *The New York Times*. January 29, 2009.

<sup>123</sup> Ibid

<sup>124</sup> Li Xiaokun, "China, Russia sign energy accords." *China Daily*. April 22, 2009.

the international economy, Putin may have attempted to align his country more closely with China as a bet on the future benefits of such an alliance. The central role of the state in managing both country's economies rendered China a more suitable ally at a time when Russia opposed America's economic program and brand of capitalism. Through June 2009, President Medvedev continued to cautiously promote this position, stating at the St. Petersburg Economic Forum, "The artificial and monopolistic support of a monopoly on key segments of the world economy became the fundamental cause of the crisis."<sup>125</sup> On the eve of the Group of 20 Summit in September 2009, however, calls for new global reserve currencies waned. Presidential aide Arkady Dvorkovich did not discredit the idea entirely, but offered a timeline of uncertain length for when such a scenario might arise. Further tempering the Russian government's tone, he reiterated President Medvedev's acknowledgement that Russian shortcomings, not simply the irresponsible actions of the US, had contributed to transmitting crisis to his country.<sup>126</sup> By this point, the negative effects of the crisis had hampered significant parts of the Russian economy and consumed the state resources; realizing the magnitude of the downturn and the futility of denying its existence and Russia's role in its occurrence, Putin, Medvedev and others took a pragmatic and active, not victimized or defeatist, approach to the international anti-crisis dialogue.

### *Analysis*

After process tracing from externally driven disturbances to government responses, substantial evidence exists that the Russian state responded directly to these instances through distinct policy measures following an initial period of skepticism regarding the magnitude of

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<sup>125</sup> Andrew Kramer, "Medvedev Calls Dollar Unsuitable as a Reserve Currency." *The New York Times*. June 5, 2009.

<sup>126</sup> Steve Gutterman, "Russia to push for reform at the G20 summit." *The Toronto Star*. September 17, 2009.

influence these forces could exert on the country's economy. Massive liquidity injections, gradual devaluation of the ruble, a revision of the federal budget based on projections of lower global oil prices, and bailouts to state-supported banks and corporations each demonstrate shifts in state policies occurring directly as a result of the determination that previous policies were untenable in the conditions created by the crisis circumstances. Based on the assessment of pre-crisis policy and the low likelihood that policies outlined above and others in a similar vein of reform would be undertaken in the absence of such a cataclysmic event, it is reasonable to conclude that the state adopted these measures out of a sense of necessity given the economic environment sprouted in Russia by the crisis. Additionally, the instances of willingness to cooperate, or at least continue to interact with other nations demonstrates Russian leaders' desire to increase Russia's presence in global economic affairs as an extension of its desire not to end up on the periphery of world politics. China's rise on the global stage and its more successful navigation of the crisis has made it both a threat and an opportune partner for Russia. Adjustments in Russian foreign policy may be necessary if the country is to avoid marginalization in the international economy: increasing influence in global processes will likely require a more conciliatory and less ideological approach to interactions with the United States, France, and other major powers.

Having traced the impact of external events on Russia's macroeconomic indicators, federal government, big business, and foreign economic relations, the analysis now turns to consider the consequences of crisis for the majority of Russians. Their experiences differed widely from that of individuals in large state corporations, but the collective negative impact on popular sentiment yielded a detectable discontent whose effects on state economic policy must be examined.

## SOCIAL PRESSURES

Threat of social pressure, defined as popular discontent from average citizens, heightened between September 2008 and April 2009. While large-scale street protests were unthinkable in the last five years, several instances of explicit opposition to government policies occurred during this time, though overall social unrest has been “isolated and parochial.”<sup>127</sup> The adverse impact of the crisis in the real economy affected aggregate demand, labor demand and asset prices: prices rose for staples such groceries, the number of poor increased by roughly 2.7 million people in 2009,<sup>128</sup> and unemployment hovered around 13 percent in 2009.<sup>129</sup> As is generally characteristic of the government response to the crisis and ambiguity about future economic development, Cliff Levy pointed out in February 2009 that “the authorities remain unsure whether to address the country's financial troubles with a thaw or a crackdown.”<sup>130</sup> In December 2008, the Russian government raised tariffs on imported automobiles in an effort to protect domestic manufacturers. Many citizens of Vladivostok earn their livelihood by importing used Japanese cars and thus took to the streets in response, asserting that the tariff had devastated sales of such vehicles and left many families impoverished. Special riot police sent by the Kremlin from Moscow initiated a bold crackdown more aggressive than any similar response in recent years.<sup>131</sup> As capital continued to flow out of the country and the general economic outlook deteriorated, state actions in Vladivostok exhibited the heightened sensitivity of the Kremlin to popular uprisings, most of which occurred in “monocities” – areas whose existence depends largely on a single firm or industry such as construction, manufacturing or retail trade. According

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<sup>127</sup> Andrew Wilson, “Russia’s economic crisis: no cue for Perestroika 2.0.”

<sup>128</sup> Zeljko Bogetic, “Global Crisis and Its Impacts on Russia: Refocusing Policy on Households.” *International Economic Bulletin*. Carnegie Endowment for International Peace. April 2009.

<sup>129</sup> Ellen Barry, “World Bank Grim on Russian Economy.” *The New York Times*. March 30, 2009.

<sup>130</sup> Michael Schwirtz and Clifford Levy, “As Economy Sinks, Russians Protest.” *The New York Times*. January 31, 2009.

<sup>131</sup> Vladimir Nikitin, “Russia’s Crisis Unmasks Putin’s Flimsy Foundations.” *Foreign Policy Blogs Network*. The Foreign Policy Association. January 31, 2009.

to the Institute of Regional Policy (IRP), over 20 percent of the Russian population lives in roughly 460 such single-industry cities, whose production facilities account for more than 40% of Russian GDP.<sup>132</sup> By sharply reducing the revenue of the companies driving the economies of monocities and making the attainment of loans nearly impossible, the crisis forced cuts to social welfare expenditures. Rollbacks such as continuing non-payments of wages, firings, and decline in the living standards are more salient to ordinary Russians, many of whom are unfamiliar with government actions regarding the exchange rate, support to the financial sector, and the federal budget, but agitate for welfare spending and pensions. On this dimension, the situation exhibited similarities to the 2005 pensioners' strike: on "bread and butter" issues, broad affected segments of the population are capable of demonstrating signs of discontent.

A series of economic protests in Pikalevo in June 2009 received national attention as a result of Vladimir Putin's personal visit. In a public address characteristic of the paternalistic, assertive crisis-management techniques of past Russian leaders, Putin ordered the owners of the town's cement factory to re-open its doors. Keeping the industries of the monocities open, however, is inefficient. Relics of the Soviet era maintained through federal support, their products are inferior to imported substitutes, and their operations inefficient and outdated.<sup>133</sup> Before the crisis, monocities received relatively little investment and development attention from the government; by negatively impacting the direct livelihood of their populations, the crisis has made them epitomes of Russia's gravest infrastructure and inefficiency woes and sharply elevated their importance for Putin and Medvedev. Minister of Economic Development Elvira Nabiullina stated that the unrest in Pikalevo prompted the decision to appropriate \$315 million to assist two hundred of the most threatened monocities and to more closely monitor their

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<sup>132</sup> Andrei Starodubtsev, "Crisis and Discontent in Russia's Regions." *openDemocracy Russia*. February 11, 2009.

<sup>133</sup> Charles Clover, "Russian one-company towns face decline." *The Financial Times*. October 27, 2009.

problems.<sup>134</sup> Putin's personal involvement has indeed come on the heels of social unrest, evidence of vigilance to popular concerns, a populist manner of maintaining political power. The experiences of 1998 and 2005 demonstrated to Putin that there is a certain value in nipping nascent social flare ups in the bud early, as they have the potential to evolve into more destabilizing problems for the state if allowed to fester.

The government response to the social pressures unleashed by the crisis has a dual nature. On one hand, there have been many highly publicized instances geared towards showcasing the continued strength of the state, its concern for the welfare of its people, and its ability to mitigate the negative social effects of the crisis. These include Putin's promise of more state aid for the machine tools and car industries in August 2009 following continued protests of wage cuts at AvtoVAZ. Two days after an opinion poll revealed that high food prices were the chief concern of 75 percent of Russians, Putin stormed into a Moscow supermarket and decried the high price of sausages.<sup>135</sup> In its negative pressure on employment, poverty reduction, wages and prices for staple food and living items, the crisis directly threatened the principal pillar of Putin's legitimacy, the provision of improving living standards and economic stability, in a manner not seen over the course of Putin's eight-year presidency. Between 2008 and 2009 the fact that not only the politically marginalized expressed vocal protest proved to unsettle federal officials: in November 2008 Medvedev "instructed law enforcement agencies to stamp out any unrest and take action against those seeking to 'exploit the consequences' of the financial crunch."<sup>136</sup> Yet the fiscal response to the crisis up to April 2009 primarily targeted banks and firms rather than households through a lower tax burden and direct support, with a smaller share of total stimulus

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<sup>134</sup> Ibid

<sup>135</sup> Adrian Blomfield, "Vladimir Putin humiliates Russian supermarket chiefs over expensive sausages." *The Telegraph*. June 25, 2009.

<sup>136</sup> Claire Bigg, "Financial Crisis in Russia Holds Threat of Social Unrest."

devoted to on-the-job training, temporary work programs, and higher unemployment benefits.<sup>137</sup> Furthermore, in November 2009 Putin revealed that the amount devoted to the labor market in 2010 will be less than the 2009 stimulus for similar measures. The announcement, at the end of an address to the 11<sup>th</sup> party congress of United Russia, Putin's political party, did not figure into the top policy priorities of modernizing sectors of strategic national importance, improving Russia's high tech industry, stimulating housing and boosting domestic demand.<sup>138</sup>

On the other hand, limited financial resources implied the government could no longer shore up AvtoVAZ and others without introducing new considerations of "how to restructure local enterprises, bring in new sources of employment or, as a last resort, shut them down."<sup>139</sup> In this vein, President Medvedev ordered a probe into the operation of state corporations in August 2009 following a reduction of the working week at AvtoVAZ, which received billions of rubles in state aid.<sup>140</sup> Such moves, however, have yet to result in a notable reformulation of the state's relationship with these major corporations to the benefit of more transparent operations. Furthermore, measures targeting the elite at times almost directly superseded populist messages: less than a week after Putin's derision of Oleg Deripaska's management of the Pikalevo cement factory, state-controlled Vneshtorgbank extended another credit line to Deripaska.<sup>141</sup>

Overall, government policy since the start of the crisis through 2009 has shown a continuation of Putin's pre-crisis balancing of oligarchs and other elite interests; the economic crisis imposed new limitations on the tools which could be used towards this end. Thus far, the state has managed to preserve its symbiotic relationship with the oligarchs, utilizing some as scapegoats for the layoffs and wage arrears inflicted on average Russians. As Gregory White and

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<sup>137</sup> Sam Greene, *Eyes Wide Shut: The Social Consequences of Russia's Economic Crisis*.

<sup>138</sup> Irina Filatova, "Putin Thanks Party, Sets Priorities for 2010." *The Moscow Times*. November 23, 2009.

<sup>139</sup> Charles Clover, "Russian one-company towns face decline."

<sup>140</sup> Catherine Belton, "Medvedev orders probe into state companies." *The Financial Times*. August 7, 2009.

<sup>141</sup> Andrew Wilson, "Russia's economic crisis: no cue for Perestroika 2.0."

Alexander Kolyandr note, "Most likely, the decision on [automobile] import duties was made in order to help Kremlin favorites like Sergei Chemezov and Oleg Deripaska whose holding companies own the AvtoVAZ and GAZ carmakers;"<sup>142</sup> the state's support of these tycoons and others shows that the need to demonstrate some degree of control over big business existed during the acute period of crisis as it did before the crisis, especially since promises of support to various sectors initially "appeared to me made as and when those sectors came to the government looking for help rather than as part of a carefully considered stimulus package."<sup>143</sup> As the crisis wore on, the fiscal constraints facing the state came into sharper view, and "the idea of a 'rescue list' for oligarchs mooted in the autumn of 2008 was quietly abandoned."<sup>144</sup> In this manner, Putin has been able to keep his preferred method of state control over big business while providing isolated and targeted support to those deemed most worthy – whether based on political or economic considerations. White and Kolyandr question whether doling out large stimulus sums to favored enterprises will save the domestic car industry, a concern echoed by those who believe the crisis response foreshadows a continuation of heavy state interference in the economy, favoritism towards big business, and a lack of attention towards investment and development of a competitive and business environment.<sup>145</sup>

Rising inflation, unemployment and wage arrears, three major factors of importance to the Russian population, threatened to ignite future opposition to the government economic program. A study conducted by the All-Russian Public Opinion Research center (VTsIOM) revealed inflation and growing prices as the main problems seen by Russians as the top threats facing the

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<sup>142</sup> Yulia Latynina qtd in "Is Russia's Social Contract Breaking Down?" *Radio Free Europe Radio Liberty*. December 26, 2008.

<sup>143</sup> Sam Greene, "Eyes Wide Shut: the Social Consequences of Russia's Economic Crisis."

<sup>144</sup> Andrew Wilson, "Russia's economic crisis: no cue for Perestroika 2.0."

<sup>145</sup> *Ibid*



country (61 percent of respondents ranked these problems at their major concerns).<sup>146</sup> Inflation targeting received little attention during the acute phase of crisis, when measures for financial sector revitalization and gradual devaluation took precedence. According to Deutsche Bank, official plans to switch to an inflation-targeting framework do exist.<sup>147</sup> It seems likely, however, that “the Central Bank will continue to pursue exchange rate targets and, simultaneously, aim to lower inflation,”<sup>148</sup> which will be challenging given the volatility of capital flows exacerbated by the economic crisis. Rising inflation, however, is largely contingent on rising oil prices; even without a significant state focus on limiting inflation in 2009, its level declined to 8.8 percent in December 2009 from 14 percent in March 2009 and may fall lower in 2010,<sup>149</sup> a well-established correlation supported by economic scholarship. Between August 2008 and December 2009, the critical level of inflation at which social and political unrest sets in, judged to be 15 percent by many economists,<sup>150</sup> did not occur. Overall, though the crisis has prompted a reevaluation of monetary policy as evidenced by official statements regarding the high inflation rate and interest rate decisions, this reassessment did not come about rapidly as a result of social disruptions related to high food prices. These social disruptions, in turn, were minimal as a result of rebounding oil prices. In the long term, inflation targeting can be achieved through a commitment to fostering investment and domestic savings – a reform scenario as dictated earlier in this thesis. It is clear that though crisis has contributed to planting the seeds of a new willingness to consider these policy options, any structural reforms or coherent, resolute pursuit of these goals will likely not occur in 2010 if the social impact of the crisis lessens with moderate global recovery.

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<sup>146</sup> “Russians fear economic crisis more than democratic freedom restrictions –poll.” *Interfax*. January 23, 2009.

<sup>147</sup> “Russia in the financial crisis and beyond.” *Deutsche Bank Research*.

<sup>148</sup> *Ibid*

<sup>149</sup> “Fitch Upgrades Russia Outlook to Stable.” *BusinessWeek*. January 22, 2010.

<sup>150</sup> Ira Iosebashvili, “High Inflation Raises Specter of Unrest.” *The Moscow Times*. March 18, 2009.

Criticism of the government's crisis response and broader economic policy has also come from a faction of respected Russian economists, former politicians, business leaders and scholars which has begun to question the fundamental principles of the authoritarian regime, evidence of the critical nature of the current period for the country's future development. In November 2008, Dr. Evgeny Gontmakher, head of a social policy research centre in the Russian Academy of Sciences, authored an article explaining how protests could ripple through monocities to ignite a violent social uprising similar to a notorious Soviet-era eruption.<sup>151</sup> Though a senior government official chastised Gontmakher for his "extremism," his predictions were also deemed by officials to be incorporated into crisis management strategy.<sup>152</sup> The presence of special forces to quell unrest in Vladivostok followed this development. In February 2009 the Institute of Contemporary Development, a Moscow think tank run by Igor Yurgens, a liberal economist and one of Russian President Dmitry Medvedev's closest economic-policy advisers, sharply criticized the government for its actions in response to the crisis and outlined measures for shedding the country's dependence on commodities exports and a bureaucratic dead weight. In an interview, Yurgens noted the lack of dialogue and accountability between the state and common Russians in regard to economic measures. On January 16, 2009, an open letter signed by former Prime Minister Mikhail Gorbachev, Vladimir Ryzhkov, a liberal former member of parliament, and Russian billionaire and former government official Alexander Lebedev condemned the government's tight control of politics and crisis management and accused leaders of unfairly bailing out favored wealthy businessmen at the expense of taxpayers. In March 2009, Boris Nemtsov, a former vice-premier, and Vladimir Milov, a former energy minister, issued a report

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<sup>151</sup> Robert Horvath, "The end of the Putin Era?" *Inside Story*. April 15, 2009.

<sup>152</sup> *Ibid*

outlining the failed crisis response policies of the Putin-Medvedev tandem.<sup>153</sup> Amidst the crystallization of perspectives on the major sources of Russia's failure and the regime's role in the future of the country, control over television, which is "completely whitewashed by the Kremlin's censors"<sup>154</sup> has contributed to maintenance of popular support for the regime and a lack of coherent reply to the diatribes of liberal critics.

Certain individuals within the government have expressed discontent with the charges levied by critics; interpretation of these expressions will be carried out as part of the analysis of domestic politics and actors in the following chapter. It will be necessary to attempt to discern whether ideological or personal interests of policymakers have dictated actions in recent years, and thus whether the crisis is an input into the considerations of these individuals, or its own independent variable exerting significant influence on policy.

## DOMESTIC POLITICS

The 2008 economic crisis initiated a new chapter in the struggle for power within the Russian political establishment. As the single greatest short-term challenge facing the regime between August 2008 and the end of 2009, the turmoil disrupted the mechanism created by Putin to maintain a balance of power between two main competing factions in the ruling elite, the *civiliki* and the *siloviki*. In proposing solutions to the economic downturn and addressing the reform agenda, government officials have demonstrated varying ideologies and approaches to governance, suggesting the existence of competition for political power among various groups and individuals. The personal preferences of top economic decision makers, that is, their ideological leanings, may be viewed as alternative explanatory factors driving the crisis response

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<sup>153</sup> Robert Horvath, "The end of the Putin era?"

<sup>154</sup> Leon Aron, "Samizdat in the 21<sup>st</sup> Century." *Foreign Policy Online*. July/August 2009.

and movements toward economic reform. In this view, officials with liberal mentalities pursue certain policies despite economic circumstances or considerations regarding personal power. More broadly, Russia's unique domestic political landscape may exert a more critical influence on economic policy than either the externally imposed constraints on the economy or the detrimental effects to society. I posit that the government response to the crisis through December 2009 reflects, at least to some degree, attempts by Putin and his trusted inner circle of government officials to protect their legitimacy and personal interests while responding appropriately to the adverse externally imposed and social effects of the crisis. The economic turmoil ignited various points of disruption that both threatened the existing policies and the individuals promoting them, and seemingly opened the door for contrarian viewpoints on economic management to be voiced within the government.

To be certain, as the crisis developed, the problem of how to address it received attention from the Putin-Medvedev tandem. The actions and messages of the two leaders have at times opposed one another; in other instances, the attitudes have been consistent. Later, Medvedev focused on championing the need for eradication of corruption and liberalization of the Russian political system, whereas Putin continued to assert the value of the state's role in supporting economic affairs. The nature of the ruling duopoly has been a central topic of debate among top scholars and Russia experts; this thesis assumes that at the start of 2010, Prime Minister Putin retains a monopoly on the country's political resources. Prior to the beginning of the economic crisis, President Medvedev lacked Putin's strong personal charisma and confidence in his popularity with Russians, as well as an influential inner circle capable of ousting Putin's incumbent allies. Heralded by some as a leader more open to Western-style democracy and one with a less aggressive style, Medvedev appeared to be a subordinate of Putin, his long-time

mentor, despite making public declarations of intentions to reform several dimensions of Russian society. Speculations about the precise terms of the power sharing agreement and the degree to which Medvedev can influence his own destiny in the regime flourished; yet the Russian political system remains an enigma. This thesis assumes, however, that Medvedev and several others do harbor personal desires to liberalize and modernize the Russian economy and have pursued these goals not opportunistically, but steadily. By challenging the successfulness of the basic economic policy associated with Putin, the crisis may have bolstered the legitimacy of the program advocated by members of the liberal-leaning faction. Two questions arise: to what extent can Putin control the emergence of this group and its principles, that is, has the crisis limited his ability to ensure his own political survival through suppression of competing interests, and to what extent does he actually wish to do so, that is, does Putin in fact desire to maintain the status quo, or does he recognize the need for the power structure to evolve? While critical junctures such as economic crises may render a country susceptible to political or economic upheaval, policies are ultimately the choices of individuals. A multitude of questions surrounds the political dimension of economic policymaking and reform in Russia, most of which are vastly outside the research parameters of this thesis and which other scholars acknowledge as generating speculative answers. Instead, I will focus on describing the ideological inclinations and policy preferences of key leadership factions and economic policymakers and the instances of various policies that may indicate the influence of certain groups. Linkages may then be made between proponents of successful policies and shifting balances of power within the government.

### *Putin's agenda*

During his first term, Putin consolidated power by appealing to a wide variety of interest groups; this period coincided with the introduction of the structural reforms described earlier. However, in 2003 and 2004, the year of Putin's reelection, deinstitutionalization, centralization and state capitalism came into focus as the chief pursuits of the Putin administration.<sup>155</sup> By choosing Mikhail Fradkov as his Prime Minister and reducing German Gref's power, Putin "transformed his reform government into a non-reform government"<sup>156</sup> to allow his closest allies, the *siloviki*, to amass power at the expense of reformers. As the executive branch amassed power, factionalism, personality clashes and bureaucratic maneuvering carried more weight in policy determination.<sup>157</sup> Putin's dual goals of macroeconomic stability and high economic growth did not require reform due to high oil prices and capital inflow from foreign investors attracted to state-controlled companies' high asset values. The stifling of reform also coincided with the public discontent with Putin in relation to the 2005 attempt at pension reform. Throughout his second term, Putin words stood at odds with his actions: while espousing the merits of privatization, he carried out large-scale renationalization of efficient enterprises. Anders Aslund contends that this effort was driven by "state officials' interest to extend their power and wealth" because it was not part of a broader socialist or nationalist ideology, and converted well-functioning, "superior" private enterprises into less efficient tools of the state.<sup>158</sup>

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<sup>155</sup> Anders Aslund, *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*. Peterson Institute of International Economics. October 2007. P 234.

<sup>156</sup> Ibid

<sup>157</sup> Ian Bremmer and Samuel Charap, "The Siloviki: Who Are They and What Do They Want?" *The Washington Quarterly*, 30:1. Winter 2006-2007.

<sup>158</sup> Ibid

## *Siloviki*

Putin's closest colleagues from his tenure in the Russian security services and the St. Petersburg government have occupied key positions in the state administration and state-run companies since 2000; they and others who share common political views and pursue similar economic interests form the *siloviki* faction. According to Ian Bremmer and Samuel Charap, the term is derived from the word *silovyestruktury*, Russian for "force structures," a reference to the "armed services, law enforcement bodies, and intelligence agencies that wield the coercive power of the state."<sup>159</sup> Though not all members of the *siloviki* clan are current and former officials from these government agencies, the term is used by Western analysts for familiarity.<sup>160</sup> Leading this group is Deputy Prime Minister Igor Sechin, who is responsible for Russia's energy sector and also serves as Chairman of Rosneft. Sechin and other government officials and businessmen, including Russian Railways head Vladimir Yakunin, First Deputy Prime Minister Sergei Ivanov, Rostekhnologii head Sergei Chemezov, champion the notion of a sovereign and independent Russia, led by a strong state able to exert influence over a significant portion of the economy, whose natural resources belong to the Russian people – Ian Bremmer refers to these preferences as "statism" and "economic nationalism."<sup>161</sup> The *siloviki* have shown their intention to control the country's major economic resources, for instance, through Rosneft's acquisition of smaller oil and gas firms, likely motivated by a desire for personal enrichment as well as continued political influence.<sup>162</sup>

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<sup>159</sup> Ibid

<sup>160</sup> Ibid

<sup>161</sup> Ibid

<sup>162</sup> Ibid

## *Civiliki*

Experts have claimed the existence of a faction of so-called liberal reformers in the Russian governmentsince the early 1990s. This group is linked to President Medvedev’s political ascendancy, with many of its members originating in the civil law network in St. Petersburg. Western media refers to the *civiliki* as intellectuals interested in pursuing democratic reforms and modernizing the country. The term refers to the origins of most members of the clan in the St. Petersburg civil law agencies.<sup>163</sup> Proponents of market economies with transparent and competitive practices, they seek to shift the focus of economic development to increasing investment in the country instead of continuing the harvesting of commodities exports revenues into government funds. First Deputy Prime Minister Igor Shuvalov, First Deputy Chief of Staff Vladislav Surkov, Finance Minister Alexei Kudrin, former Minister for Economic Development German Gref, Chief Economic Advisor to President Medvedev Arkadiy Dvorkovich, and Economic Development and Trade Minister Elvira Nabuillina have each been associated with the government’s liberal faction, albeit with varying degrees. Dvorkovich has stated that, “The government cannot replace the private sector, the market, and business, nor is it going to do so;”<sup>164</sup> in February 2010 he authored an article appearing in *The Huffington Post* encouraging the Russian state to act “pragmatically by formulating both a plan of priorities and the basics of long-term policy”<sup>165</sup> for “the innovative renewal of the Russian economy.” In pursuit of privatization and structural reforms, the *civiliki* support the release of state corporations from the control of *siloviki* associates, whose management they view as inefficient and corrupt. The

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<sup>163</sup> Graham Stack, “The Kremlin, Decorporated.” *Russia Profile*. August 26, 2009.

<sup>164</sup> Stephen Sestanovich, “Russia and the Global Economic Crisis.” *Council on Foreign Relations*. November 25, 2008.

<sup>165</sup> Arkady Dvorkovich, “Modernizing Russia Through Innovation.” *The Huffington Post*. February 8, 2010.



reinvigoration of a strong business relationship with the West also constitutes a goal of this group.

### ***Domestic politics during the crisis***

A variety of individuals have played key roles in constructing the government anti-crisis plan since August 2008. In the most acute phase of the crisis, lasting through October 2008, Putin and Medvedev both met with business leaders to discuss state bailouts for corporations facing serious liquidity challenges. In November 2008 Putin spoke to a meeting of his political party, United Russia, introducing stimulus measures and optimistically setting forth the goal of using the crisis to strengthen the economy.<sup>166</sup> In this speech, he underscored his intention to render the state the dominant provider of credit to institutions in need and thus strengthen its control via bailouts and liquidity injections. As problems spread to the real economy, however, Putin made a greater effort to appear in as protector of the Russian people against injustice – an image he has promoted throughout his political life – appearing, as noted earlier, in supermarkets and publicly scolding an oligarch. Given the weight macroeconomic stability and the lack of societal chaos carry in the Putin formula for power, these overtures come as no surprise. Aside from wide-sweeping remarks about the need for restoration of the pre-crisis economy, Putin refrained from becoming intimately involved with the formulation of specific anti-crisis measures. In April 2009 he introduced a 2010 budget that carried a large fiscal deficit, a small investment budget, and populist measures such as an increase in pensions through direct payments that deviated from Medvedev’s ideas regarding innovations.<sup>167</sup> Liberal critics lamented

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<sup>166</sup> Vladimir Putin. Speech at United Russia’s 10<sup>th</sup> Party Congress. *The School of Russian and Asian Studies*. November 20, 2008.

<sup>167</sup> Pavel Baev, “Putin Opts for a Large Deficit and Small Investment 2010 Budget.” *Eurasia Daily Monitor*, Volume: 6 Issue: 148. Jamestown Foundation. August 3, 2009.

the lack of attention to the anti-crisis goals of clearing bad loans from the banking system and addressing inefficiencies in state-supported enterprises.

In December 2008 Putin formed a new Anti-Crisis Commission (formally, the Governmental Commission on Sustainable Development of the Russian Economy) to handle both the economic and social dimensions of the crisis. Igor Shuvalov leads on economic and business issues, while Deputy Prime Minister Alexander Zhukov is in charge of mitigating the societal impact of the crisis. Acting on Putin's orders, the two divisions worked jointly to monitor the Russian labor market and recommend a list of 1,500 businesses eligible for state aid and criteria for this aid to the Finance and Economic Development Ministries.<sup>168</sup> Both Shuvalov and Zhukov are considered key Putin allies: the more liberal Shuvalov was Putin's key economic aide in the Kremlin and Russia's Group of Eight Sherpa and is tasked with "promot[ing] economic freedoms and oversee[ing] foreign trade, WTO talks, small business, state property and anti-monopoly policy,"<sup>169</sup> whereas First Deputy Prime Minister Zhukov retained his current position from the Medvedev government. Exemplifying one aspect of the state's altered approach to economic policy, in October 2008 Shuvalov, speaking to journalists in what he promised would be the first in a series of regular state briefings about the financial crisis, dismissed rumors that the state was embarking on nationalization projects and promised more transparency from the government in the future.<sup>170</sup> He described the state's intent in March 2009 to focus on stimulating growth through industries other than commodities instead of waiting for global oil prices to stabilize, optimistically stating that growth was possible "even without high

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<sup>168</sup> Transcript of Vladimir Putin's meeting with Igor Shuvalov and Alexander Zhukov to discuss the work of the Governmental Commission on Sustainable Development of the Russian Economy. December 20, 2008. <http://www.premier.gov.ru/eng/events/news/2807/>

<sup>169</sup> Anna Smolchenko, "Old Faces Follow Putin to New Jobs." *The Moscow Times*. May 13, 2008.

<sup>170</sup> Anna Smolchenko, "Shuvalov Says No Need to Fear State." *The Moscow Times*. October 28, 2008.

prices for oil, metals and gas.”<sup>171</sup> In June 2009 he stated that the government “should behave very conservatively” regarding the federal budget, and should not revise its figures simply because oil prices had grown to \$70 per barrel since reaching record lows in 2008.<sup>172</sup> Shuvalov had relatively little visibility in the Putin presidential administration, not appearing as a top contender to succeed Putin. One example of his liberal leaning came in 2006, when Shuvalov declared that state-controlled Rosneft would be “fully privatized” within the three to ten years, contradicting statements by other officials.<sup>173</sup> In 2008, Shuvalov appeared in a prominent position at the St Petersburg International Economic Forum, assuring foreign investors of his government’s intention to secure their property rights and scale back the state’s involvement in the economy. In 2009, he chaired a low-level panel at the Forum, while Igor Sechin, associated with the *siloviki* faction, assumed center stage.<sup>174</sup> Thus, Shuvalov’s limited presence at the center of the crisis management scheme seems to indicate a continuation of the balance Putin seeks to strike between liberals and hardliners. When the circumstance requires the espousal of support for liberal or free market principles, such as the foreign investor panic in the autumn of 2008, officials with corresponding track records surface in support of these goals.

Finance Minister Kudrin is widely considered one of the main architects of the Russian state’s crisis response. Since the start of the crisis, both Russian and Western media have commented on his centrality to the crisis as controller of the Stabilization Fund, a position which has embroiled him in politicking between state factions. Kudrin has publicly disagreed with

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<sup>171</sup> Andrew Kramer, “Russia Recalibrates after Commodities Downturn.” *The New York Times*. March 23, 2009.

<sup>172</sup> “2009 budget should not be reviewed despite oil price growth – Shuvalov.” *RIA Novosti*. June 6, 2009.

<sup>173</sup> Valeria Korchagina, “Shuvalov Says State Will Sell Off Rosneft.” *The Moscow Times*. September 18, 2006.

<sup>174</sup> “Putin and his men steal show at Russia business forum.” *Reuters*. June 6, 2009.

Putin in pre-crisis times: in 2007 he, along with similarly liberal-minded Economic Development German Gref, opposed Putin's proposal to invest energy revenues in the domestic stock market to prop up stagnating stock prices on the grounds that such a move would fuel inflation and speculation.<sup>175</sup> The *Financial Times* emphasized Kudrin's discontent with state intervention during the crisis: on the subject of price freezes on basic foods, he stated, "it sends a wrong signal to the market."<sup>176</sup> The preservation of a substantial cushion of foreign exchange reserves at the conclusion of 2009, however, is evidence of a triumph for Kudrin: he resisted pressure from stakeholders in major state-supported enterprises (mostly *siloviki*) to spend reserves on financing the debts of these corporations. Kudrin also faced demands from Vladimir Yakunin, head of state-operated Russian Railways and a close colleague of Putin, to institute capital exchange controls to stem capital flight.<sup>177</sup> The Kudrin-led policy of gradual devaluation, described in the previous chapter, demonstrates that the government did not simply acquiesce to pressures from well-connected business elites and government conservatives, instead tempering policy choices with options put forth by liberals like Kudrin who were not previously at the heart of domestic politicking. In February 2009, Kudrin spearheaded a reversal in anti-crisis policy in conjunction with a revision of the 2009 budget to account for falling oil prices: he ended a foreign debt refinancing program of Vneshekonombank (VEB), arguing that the commercial banks, fuelled with foreign currency from the government's devaluation measures should perform this function.<sup>178</sup> Throughout the crisis, Kudrin has taken cautious positions, being the first government official to admit mishandling the economy in the pre-crisis period and insisting that oil price rebounds should not fuel "excess appetites." A supporter of stronger links with the

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<sup>175</sup> Polya Lesova, "Putin proposes state investment in domestic stocks." *MarketWatch*. May 22, 2007.

<sup>176</sup> Neil Buckley, "Alexei Kudrin: A guarantor of fiscal discipline." *The Financial Times*. April 17, 2008.

<sup>177</sup> Stefan Wagystl, "Currency Dispute Exposes Moscow Rift." *The Financial Times*. February 17, 2009.

<sup>178</sup> Gleb Bryanski, "Kudrin says budget revision difficult." *Reuters*. February 16, 2009.

West, in the midst of crisis Kudrin stated, “for the moment, in this global economy our capital market is still a weak link...volatility will be felt on our equity markets, in our currency exchange rate and in our trade balance,” augmenting these remarks in a subsequent presentation in the United States by saying the Russian state is conducting economic planning “based on the assumption that we must be on guard, facing a long-term siege of negative factors... and expect a slow upturn coming out of crisis.”<sup>179</sup> Kudrin, who is not affiliated with any political party, also criticized Putin’s United Russia for its ineffective approach to economic policy and actions against competitive elections in Russia, adding he was disinterested in joining the party.<sup>180</sup> Notably, Kudrin himself hinted at the dependence of economic and political life on Putin, remarking, “only efforts by the government and Putin personally have managed to keep things in balance.”<sup>181</sup>

Yet discord exists even between Kudrin and Medvedev, two politicians frequently thought to be in the same camp. The issue of altering the dollar’s role as the dominant reserve currency of the world indicated one point of disagreement. At a meeting of finance ministers from the Group of Eight countries in June 2009, Kudrin noted that the architecture and mechanics of global financial system were unlikely to undergo change in the near future, adding that Russia would not alter the structure of its reserve funds, given that the dollar was in “good shape.”<sup>182</sup> Days later, Medvedev, speaking at Shanghai Cooperation Organization (SCO) summit, took an opposing position, stating that “the incumbent set of reserve currencies and the U.S. dollar as the main reserve currency has failed to accomplish their function...we will not be

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<sup>179</sup> Speech by Alexei Kudrin. “Russian Economic Policy and the Global Financial Crisis.” *Peterson Institute of International Economics*. April 24, 2009.

<sup>180</sup> Anders Aslund, “The End Seems Near for the Putin Model.” *The Washington Post*. February 26, 2010.

<sup>181</sup> Lyudmila Alexandrova, “Inter-party quarrel ends in non-aggression pact.” *ITAR-TASS*. February 29, 2010.

<sup>182</sup> *Kommersant*. June 15, 2009.

able to do without new reserve currencies."<sup>183</sup> According to [www.polit.ru](http://www.polit.ru), a website lauded by independent international policy discussion website openDemocracy as hosting high quality and unbiased Russian political commentary and daily news, reported Medvedev's criticism of a May 2009 statement made by Kudrin predicting that Russia may not enjoy 2000 – 2004 growth rates for up to fifty years.<sup>184</sup> The clearly opposing views demonstrate divergent interests and roles. Kudrin, described by several political analysts as a technocrat known for avoiding politicking and focusing on pragmatically addressing economic issues, is not bound by the political liaisons and obligations to a broader constituency; it has not been his practice to champion Russia's infallibility or special identity on the world stage. Medvedev carries a different responsibility as president: he must balance special interests and therefore is more likely to make broad-sweeping or nationalistic statements.

Deputy Prime Minister Vladimir Sechin oversees the country's energy sector and serves as Chairman of Rosneft. He is identified in both Western and Russian media as a close associate of Putin and the leader of the government hard-line faction comprised of former security services officials supporting state intervention and nationalism. In June 2009 Sechin upheld state involvement in the country's energy sector, asserting that in the future Russian oil and gas firms can develop fields independently, without production-sharing agreements with foreign firms.<sup>185</sup> There is an abundance of speculation that Kudrin, as the creator of the Stabilization Fund that channeled oil export profits away from *siloviki* associates in big business, is his chief

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<sup>183</sup> *Komsomolskaya Pravda*, June 16, 2009.

<sup>184</sup> Qtd in "Medvedev Clings to Advancing the Ruble as Reserve Currency." Eurasia Daily Monitor Volume 6, Issue 123. Jamestown Foundation. June 26, 2009.

<sup>185</sup> Alexander Osipovich, "Top official says Russian energy firms can go it alone." *The Sydney Morning Herald*. June 20, 2009.

political enemy.<sup>186</sup> Substantial conservative criticism surrounding Kudrin's handling of the crisis and devaluation program occurred since August 2008; in February 2009 head of Russian Railways Vladimir Yakunin blamed Kudrin for not acting sooner to stem the outflow of foreign currency echoed Moscow mayor Yuri Luzhkov's sentiments that Kudrin's policy of mentarism should be abandoned.<sup>187</sup> Such outcries may provide a window of opportunity for Sechin to launch an attempt to seize power from Kudrin: in February 2009 Aleksander Bastrykin, head of the investigative committee of the Prosecutor-General's office, accused two top Finance Ministry officials of embezzling \$18 million, a move interpreted by several Russia experts to be a Sechin-backed initiative.<sup>188</sup> The fact that Kudrin remained in office at the end of 2009 proves a good barometer of the limits to Sechin's machinations.

### *Analysis*

As Russia's economy contracted between August 2008 and December 2009, the complex network of patronage and power politics supporting the Putin system of leadership faced new iterations of the struggle for political resources. As Ian Bremmer wrote in 2008, "the *siloviki* are here to stay,"<sup>189</sup> deeply ingrained at all levels of the complex bureaucratic fabric including the segments responsible for economic policymaking and reform. In 2002, Lilia Shvetsova, a Senior Associate at the Carnegie Endowment for International Peace, identified three criteria that allowed Putin to pass structural reforms between 2001 and 2003 and are useful in analyzing the current prospects for reform motivated by individual interests. Shvetsova writes that Putin "had

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<sup>186</sup> Brian Whitmore, "As Crisis Deepens, Russian Finance Ministry Battles 'Siloviki'." *Rado Free Europe Radio Liberty*. February 23, 2009.

<sup>187</sup> Oleg Shchedrov, "Russian infighting could hurt ruling tandem." *Reuters*. February 20, 2009.

<sup>188</sup> "Russia and the Financial Crisis: Competing economic policies strain political unity." *Strategic Comments*. Volume 15, Issue 3 May 2009. P 1-2

<sup>189</sup> Ian Bremmer and Samuel Charap, "The Siloviki in Putin's Russia: Who They Are and What They Want."

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reason to believe that liberalizing the economy would be preferable to the previous status quo both for the country and for his personal interest in holding on to power,” since the removal of structural barriers to economic progress could be used to capture the endorsement of the population; he likely calculated that “he would not lose his power as a result of liberalization;” finally, “Putin had at his disposal enough resources to carry out at least part of his economic objectives.”<sup>190</sup> Robinson agrees that the weak position of the Russian state immediately after the 1998 crisis complicated prospects for reform.<sup>191</sup> Additionally, this series of reforms came in the midst of economic decline, when the Russian populace was weary from a period of instability.

If one considers the situation today, these same conditions for reform do not exist so clearly. In the early period of his presidency, Putin appeased many societal groups, contributing to the accumulation of consensus for reform to take hold; I have argued that by 2008 he clearly aligned himself with a policy of authoritarianism despite allowing the existence of a liberal faction in the political ring. Thus, liberalization did not appear to be on the horizon for the country, at least in the short term. Some scholars argue that the particular ruling tandem with Medvedev was created specifically for the purpose of creating a mechanism by which Putin could reconfigure power arrangements to guarantee his own interests in an evolving world.<sup>192</sup> Additionally, the period of instability and social discontent remained mild between August 2008 and December 2009, owing to a combination of oil price rebounds, political maneuvers and government policies limiting the negative impact of the crisis. Making the case for a package of substantial changes to the economy was not a primary focus of the state during this period, and would be difficult to accomplish given the lack of extensive dissatisfaction with the government management of the economy and a clear scapegoat or program to rally both elite and popular

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<sup>190</sup> Lilia Shvetsova, *Putin's Russia*. (Washington D.C.: The Brookings Institution Press, 2003).

<sup>191</sup> Neil Robinson, “The global economy, reform and crisis in Russia.”

<sup>192</sup> Joera Mulders, “Pavlovsky Talks about Putin-Medvedev Relationship.” *Russia: Other Points of View Blog*.



support against. More generally, anti-crisis measures seemed geared towards preserving the status quo rather than exploiting change.

Several points and conclusions may be derived from the analysis of the impact of the domestic federal political system on the determination of the crisis response program and the prospects for reform. First, the system comprises a multitude of actors, each with preferences that are difficult to definitively categorize into pro- or counter- pre-crisis economic policy. Most of these actors operate within complex relationship networks that support Putin's continued power. It is impossible to definitively trace and understand who influences which economic policy, as most decisions are made behind closed doors without media access. Thus, scholars and analysts of Russia's politics largely speculate on the impact of personal interests and ideologies on the very processes this thesis seeks to analyze. Nevertheless, based on the assumptions made above, it has been difficult for liberal-minded individuals to break through the stronghold of Putin-supported individuals favoring state intervention and nationalism, especially as the most acute adverse effects of the crisis have shown signs of subsiding and pre-crisis policies appear workable to a ruling elite seeking to maintain its power. If the crisis persisted, previous policies, for example, tolerance of opaque operations of state-supported corporations and prior levels of spending on inefficient social programs, would appear increasingly discredited in the eyes of the ruling elite. I argue that in this case, and over the course of such a condensed time horizon, only acquiescence by Putin and his closest allies would truly permit a vast liberalization of policies in line with the ideas of Kudrin, Gref and, to some extent, Medvedev. This is consistent with the previously described view that change in Russia ultimately occurs from above, not from popular pressures. Igor Yurgens, head of the liberal Institute of Contemporary Development, succinctly reduces the future of domestic politics to a single variable: "The role of Vladimir Putin will be

what he sees for himself.”<sup>193</sup> Of course, there is likely a tipping point, characterized by political failure and a favorable concatenation of events, which could motivate change; however, it did not occur in the period under assessment. That having been said, Putin and other individuals operate within an evolving system, what some have deemed an “overmanaged democracy,” which depends entirely on “leadership popularity and the actual capacity, the talent, of the leadership in actually exercising this manual control of the system in a competent way.”<sup>194</sup> Though this system seems to have held up between August 2008 and December 2009, future crises may affect it in unpredictable ways.

Nevertheless, it is useful to investigate Russia’s prior crisis experience to determine how certain features, including the domestic political landscape, interact to shape the evolution of economic policy. Based on the relative influence of internal versus external catalysts, state capacity, and other societal features conclusions regarding the feasibility of certain state policies in 2010 and beyond may be drawn. A treatment of the lasting impact of the 1998 crisis on the Russian population, leadership and economy cannot be excluded from this analysis, for it is the low point many Russians employ as a benchmark of utter economic collapse and political, as well as social, calamity. Given that Russia spent nearly a decade attempting to shield itself from another disaster based on its experience in 1998, the fact that the 2008 crisis occurred at what had been perceived as a high point in economic success and future development demonstrates the drawbacks of the Putin approach and invites the question of how the years following this crisis may be used in for the aims of economic development.

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<sup>193</sup> Stuart Williams, “Kremlin body proposes radical makeover for Russia.” *Associated Foreign Press*. February 3, 2010.

<sup>194</sup> Nikolai Petrov and Henry Hale, “Overmanaged Democracy in Russia: The Ruling Tandem and the Economic Crisis.” *Carnegie Endowment for International Peace*. September 30, 2009.

## COMPARISON WITH THE 1998 FINANCIAL CRISIS

Russia's development in the past three decades has occurred within a cycle of crisis and stability. The most recent destabilization occurred in 1998 following policy failures and fruitless reform efforts during the Yeltsin years (1990s); its unfolding reflected mismanagement of the opening of the country's financial markets to foreign lenders and investors. The country became vulnerable to the risk of domestic financial difficulties evolving into currency crisis. Indeed, when major capital outflows began in the summer of 1998, the government devalued the ruble, leading to unhedged currency exposures, soaring interest rates, and mass bankruptcies. This interaction of internal and external circumstances in the case of Russia shared features with economic crises in other emerging markets during the late 1990s.

The financial crisis beginning in August 1998 is widely seen as having reshaped the country's political economy, as well as its relationship with the global economy.<sup>195</sup> In its wake, the state introduced some medium-term structural reforms, including the introduction of a flat tax rate and alterations to tax collection, as well as market-oriented policies. Nearly ten years later, a crisis particularly reminiscent of the meltdown in 1998 hit Russia, inviting a comparison of the origins, nature, and consequences of the two events to shed light on the implications of the 2008 economic crisis on the economic policy agenda of the Russian state today.

### *Similarities*

Western analysts referred to the economic, social and political developments in Russia between 1995 and 1998 as an example of a successful transition from authoritarianism and a closed economy to a market-oriented democracy. The country experienced profound changes and

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<sup>195</sup> Neil Robinson, "After 1998: State and Economy in Russia at a Time of Resource Abundance." Paper presented at the annual meeting of the International Studies Association, Town & Country Resort and Convention Center. March 22, 2006.

appeared to be on an upward trajectory before the summer of 1998. Similarly, the eight years between 2000 and 2008 comprised the most astonishing, fast and geographically-widespread economic growth in Russia's history, characterized by a thriving stock market and a burgeoning middle class. Commodities exports played a crucial role in the economy prior to the crisis in 1998: oil and gas accounted for almost half of Russia's export revenues and directly for one-fifth of federal government revenues.<sup>196</sup> The share of oil and gas in export receipts had reached 68 percent in the beginning of 2008, and natural resources directly accounted for half of federal government revenues.<sup>197</sup> After the development of rapid growth and asset booms, both cases experienced "default, devaluation and despair."<sup>198</sup>

### *Differences*

At the beginning of the twenty-first century Russia expressed a confident geopolitical stature, motivated in large part by an economy exceedingly more robust than that of the mid-1990s. Then, it had already experienced severe economic difficulty following the failed market reform experiments made by Yeltsin and Gaidar in the 1990s, which impoverished the population. Though disagreement exists over the culpability of the Russian state itself in promoting recession,<sup>199</sup> the crisis of 1998 marked the first true instance when Russia was subjected to negative impacts caused by its interaction in international economic processes. The resulting meltdown reverberated to the political and social spheres, knocking down the

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<sup>196</sup> Erik Berglöf, Alexander Plekhanov, and Alan Rousso, "A Tale of Two Crises." *Finance & Development*. The International Monetary Fund. June 2009.

<sup>197</sup> Ibid

<sup>198</sup> Ibid

<sup>199</sup> Dmitri Travin, "Russia: Lurching Between Two Crises." *openDemocracy*. January 23, 2009.

“imitation of capitalism”<sup>200</sup> that had given rise to an unsustainable division of economic rents among the state, the private sector, average citizens and a virtual economy. The subsequent void of a well-defined relationship between the state, the economy and society permitted Putin to develop his social contract based on a combination of sovereignty and prosperity. Russian and Western media agree that the economic crisis of 2008 had truly global origins of an unprecedented magnitude and thus differed significantly from its predecessor.

The 1998 and 2008 crises differ in several respects, including their origins, the sectoral linkages in existence during their progression, and the sequencing of their spread to various sectors of the economy. Owing to the growing dominance of natural resources in the economy since 1998, vulnerability to global commodity prices played a more prominent role in the origins of the 2008 crisis. According to some estimates, the overall direct share of natural resources and related sectors in the economy's total value added increased from about 15 percent in 1997 to about 20 percent in 2007.<sup>201</sup> In 1998, the Russian banking system remained immature and mainly limited in interaction with large institutional actors; credit to the private sector totaled only 9 percent of GDP.<sup>202</sup> Bankruptcies in the financial sector, therefore, had limited repercussions in the real sector (encompassing economic activities related to aggregate demand and aggregate supply), which is predominantly influenced by the activities of consumers and industry. The nascent middle class shouldered the majority of the negative impact of the crisis, a dynamic to which the government's decision to devalue the ruble contributed since the price of food and consumer goods rose sharply and this income segment had constituted the majority of consumers of these goods. The expanded lower class vocalized its discontent with the state and held onto its

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<sup>200</sup> Ivan Krastev, “The Rules of Survival.” *Reading Russia*, Volume 20, no. 2. April 2009.

<sup>201</sup> *Ibid*

<sup>202</sup> *Ibid*

savings, opting not to put them back into formal banking institutions.<sup>203</sup> In 2008, all three sectors of the economy (real, government and financial) were hit simultaneously, whereas previously the financial and banking crises were layered on top of existing problems in the real sector.<sup>204</sup> Additionally, Russia's financial sector had evolved: in 2007, domestic credit to the private sector had reached 42 percent of GDP, about one-quarter of which was granted to consumers. External borrowing became a widespread practice, financing loan-to-deposit ratios of 150 percent.<sup>205</sup>

### *Size and power of government*

The potency and magnitude of the 2008 crisis revealed coordination problems within the regime, as the official state position on the economy was reformulated from denial to acceptance; yet, despite the results of a January 2009 poll conducted by the Levada Center, an independent think tank, revealing that a majority of Russians doubted their government could effectively handle the crisis, Putin's and Medvedev's approval ratings remain well above 65 percent (78 percent in August 2009).<sup>206</sup> As indicated in previous chapters of this thesis, the strength of the post-Communist Russian state rose to its highest level prior to the downturn of 2008, differentiating the pre-crisis position from that which existed in 1998. The power of the state appears in two dimensions, ideological and financial. As Andrew Wilson notes, "the Putin regime has successfully mythologised 1998 as a crisis of statehood and therefore argues that preserving hard-won stability is the only way to prevent a reversal through 1998 back to the

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<sup>203</sup> Ibid

<sup>204</sup> Erik Berglöf, Alexander Plekhanov, and Alan Rousso, "A Tale of Two Crises."

<sup>205</sup> Ibid

<sup>206</sup> *Journal of Democracy*

social chaos of the 1990s.”<sup>207</sup> This notion of the necessity of absolute sovereignty rationalizes a multitude of actions taken by Putin and other officials, for example, the practice of accumulating foreign exchange surpluses and maintaining prudent federal budgetary surpluses. Practically, this means the state has more room for fiscal stimulus than it did in 1998, when general government revenues accounted for only about 27 percent of GDP , with federal revenues accounting for less than half of this sum (in 2007 the federal budget surplus was 5.5% of GDP).<sup>208</sup> Both these factors, stimulated by lessons learned from the 1998 meltdown regarding the destabilizing effects of a hungry and impoverished populace, contributed to an emphasis by Putin and Medvedev on limiting adverse effects of the crisis on the wallets and psyches of Russians.

### ***Reform***

In the case of Russia, the effect of crisis on the reform agenda is mixed and therefore difficult to extrapolate to the 2008-2009 situation. Some scholars argue that post-crisis stabilization and growth at the end of the 1990s and through the early 2000s were not created “by some corrective effect of crisis” which taught policymakers explicit lessons on how to manage economic affairs and stimulated coordinated reform efforts,<sup>209</sup> but rather through a piecemeal approach and factors not tied to policy. Kathryn Stoner-Weiss credits post-1998 recovery to three factors: an increase in domestic consumer demand due to the low value of the ruble and high cost of imports, the rise in world oil prices which grew consumer income and made exports eventually more affordable, and Prime Minister Primakov’s disciplined fiscal policy.<sup>210</sup> Scholars who apportion a small part of the credit for recovery to the government also cite the development

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<sup>207</sup> Andrew Wilson, “No cue for Perestroika 2.0.” *openDemocracy*. September 4, 2009.

<sup>208</sup> Erik Berglöf, Alexander Plekhanov, and Alan Rousso, “A Tale of Two Crises.”

<sup>209</sup> Neil Robinson, “After 1998: State and Economy in Russia at a Time of Resource Abundance.”

<sup>210</sup> Kathryn Stoner-Weiss, “Russia and the Global Financial Crisis: the End of “Putinism?” *Brown Journal of World Affairs*, Vol. 15 Issue 2. Spring 2009. P 103-115.

of a virtual economy saturated with corruption and a broad reconfiguration of the state's relationship to the economy that Putin exploited and shaped, but never developed into a coherent economic plan.<sup>211</sup> Some reforms in the financial sector and in terms of free markets, trade integration, and enterprise privatization and restructuring were reversed in the post-crisis period.<sup>212</sup> Other, medium-term initiatives were promoted, including restructuring of the electricity sector, tax reform, introduction of deposit insurance, and pension reform.<sup>213</sup> Based on the cumulative government response and recovery prospects at the end of 2009, green shoots of reform have been overshadowed in large part by a temptation for administrative (non-market) measures, such as state support for the auto industry.

### *Analysis*

Each crisis has shown that Russia is becoming increasingly embedded in the international economy; the economic situation today has highlighted a new set of challenges for the country. To what extent are the country's difficulties imposed upon it by the dictates of the global system, and what share of the accountability lies with the policies of the state? The lessons of 1998, as well as the Putin regime's own conceptions of sovereignty and prosperity shape the state's interpretations of this dynamic and its translation into policy. If the fundamental interests of the regime have been threatened, then Putin will seek to preserve his power and eradicate the sources of problem. For at least a period of one year the government demonstrated increased attentiveness to global processes and the country endured a period of instability at the hand of volatile oil prices, fluctuations in foreign stock markets, and other events. Assuming that the Russian state always wishes to maintain its power and achieve maximum political and social

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<sup>211</sup> Ibid

<sup>212</sup> Ibid

<sup>213</sup> Erik Berglöf, Alexander Plekhanov, and Alan Rousso, "A Tale of Two Crises."

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stability, including in the post-1998 period, Putin and Medvedev will each also do so today, bolstered by the reality that they have the sufficient political capital, popular approval and financial resources to do so. Of course, the analysis is complicated by the reality that Putin and Medvedev may in fact be pursuing either complementary or disharmonious goals – the opaqueness of much of the Russian political mechanism leaves this an open question regularly debated by top scholars and experts. Additionally, the domestic political landscape in 2008 is generally characterized by two factions, one largely promoting maintenance of the status quo and the other supporting reform, whereas post-1998 the power vacuum was not characterized by a similarly well-defined and supported tension. However, combining the objective of power maintenance with the presumption that Putin maintains a monopoly over Russia's political resources once again supports the interpretation that the focus has been on responding to the crisis in a manner that most closely preserves the pre-existing order, instead of one which genuinely seeks to address systemic challenges exposed by the crisis and which may prove to be politically destabilizing if addressed.

## **CONCLUSION**

The 2008 economic crisis, together with the ongoing recovery period, represents a critical juncture in Russia's economic, political and social development. The economic turmoil brought new challenges to the political establishment and initiated a vigorous period of debate and dialogue surrounding issues including diversification away from dependence on commodities exports, modernization, the state as an actor in economic affairs, and globalization. The crisis experience may precede far-reaching alterations in the relationship of the state to the economy or to its people, or, conversely, might be viewed in hindsight as a missed window of opportunity

ushering in stagnation or a reversal in fortune. This thesis determined that the 2008 economic crisis acted as an independent variable through several channels to considerably influence the economic policy of the Russian state. By damaging stock markets, federal budgets, and foreign exchange reserves, the crisis rendered the previous approach to economic management untenable given Russia's existing institutions and resources. As a result of its impact on wages and unemployment, exacerbated by limited government financial resources, the crisis ignited demands for greater welfare support to Russian citizens, in turn inciting a variety of populist measures aimed at assuaging these tensions. Confronting a multitude of negative implications of crisis, the Russian state faced policy constraints on many dimensions between August 2008 and December 2009. In the period examined, the dedicated responses to conditions created by crisis were not treated in a coherent fashion by the state; statements on the importance of further reform and on cooperation with other countries clashed with attempts to preserve existing power structures and control over big business.

The crisis laid bare significant weaknesses in the country's approach to economic development and its role in politics and society. A heavy reliance on commodities exports for sustaining rapid GDP and income growth paired with vastly insufficient investment into alleviation of the country's biggest hurdles to economic growth (investment climate, education, health, rule of law) represent the two major pillars of the Putin-led system in place prior to the crisis; in 2010, they remain largely intact. The provision of strong macroeconomic growth during an era of high oil prices and a favorable global economic environment served as an essential element in Putin's social contract with the Russian population and, by extension, in his formula for retaining political power. The 2008 crisis, global in nature and external in origin, introduced disruptions to the equation that must be addressed by Russia's chief decision maker in order to

support his personal interests. Though this thesis has not ventured into the realm of predicting which scenario will occur, broadly speaking two options appear possible: either Putin will retain the main features of existing state controls in the economy and authoritarianism (referred to by others as “illiberal internationalism” and an “overmanaged democracy”), attempting to tweak it on the margins to endure the strains placed upon it by the crisis, or he will permit a dismantling of the system in favor of one more transparent and open to the global economy. The latter option would require reform across a number of dimensions, including technological know-how, enforcement of property rights, and privatization.

In the first section of analysis, this thesis demonstrated that the Russian state directly responded to external events occurring as part of the global crisis; most, if not all, of these policies would not have been pursued in the absence of catalysts like those imposed by the crisis, since they did not promote Putin’s objectives of maintaining political power and stability. Massive liquidity injections, gradual devaluation of the ruble, a revision of the federal budget based on projections of lower global oil prices, and bailouts to state-supported banks and corporations are all examples of measures taken directly in response to these aspects of the crisis. The analysis found that as time progressed and the length of the downturn and global oil prices became more uncertain, state actions incorporated the global recovery to a greater degree; for instance, substantial changes to the federal budget and anti-crisis policy appeared only after months of very low economic indicators. On the whole, however, the state lacked a coherent, well-defined anti-crisis and future development plan.

This thesis concludes that the absence of such a plan and the ad hoc nature of the government response reflect wider problems endemic to Russia: while global recovery may alleviate the sharpest economic pains currently facing the country, it will not itself solve the

fundamental challenges impeding Russia's development. Weak institutions for investment, the lack of programs aimed at igniting engines of economic growth outside the commodities sector, and an oversized and inefficient state sector constitute three paramount challenges confronting the Russian leadership. This thesis found no support for the notion that Russian economic crises necessarily spur reform; indeed the analysis strengthens the notion that the government may be seeking to construct piecemeal anti-crisis measures while resisting the need for broader structural reform. Modernization has become the dominant buzzword in the Russian public discourse: Medvedev has championed the need to diversify the economy, boost technological innovation and develop the private sector, yet the process of doing so remains a subject of debate. The issues Russia is facing lie at the heart of development studies: what is the proper sequencing of such reforms, and to what degree should the state guide them? Tight state control, used in the Chinese model, can arguably lead to a modern free market economy as well as a democratic, private sector-led approach.

Questions remain regarding the need for Russia to attain democratization in advance of modernization, and the willingness of the state to permit this development. This thesis touched on these issues, revealing that the threat of growing popular discontent motivated a state policy of a dual nature: highly publicized instances showcasing a populist-friendly side of the state and its ability to protect Russian from the crisis progressed in tandem with the continuation of Putin's pre-crisis balancing of oligarchs and other elite interests through financial support. The economic crisis, then, may be understood as imposing constraints on the ease with which Putin and others could do so, particularly since demands for state support increased as corporations and banks faced trouble rolling over debts denominated in foreign currency. The uprising of Pikalevo serves as the most illustrative example of the state's increasing alertness to sources of potential

social disruption, a consciousness likely stemming from a lack of experience with similar incidences in the past eight years. Nevertheless, between August 2008 and December 2009 Putin retained his preferred method of state control over big business while providing isolated and targeted support to those deemed most worthy. Given the necessity of institutional and economic reforms, Putin's case-by-case approach to local problems and bailouts (at least in the earlier stages of crisis) indicates a postponement of a decision on how to approach the long-term obstacles. This makes sense, since increasing transparency and the potency of democratic processes underpins or supports a majority of the reform agenda and thereby inherently loosens Putin's grasp on power. Delays in addressing the root causes of the crisis' severe impact on Russia may lead to the growth of social problems, reversing the political apathy of Russians and increasing the sense of threat felt by the regime. Future developments will contribute to research seeking to describe the thresholds beyond which popular discontent forms into coherent political opposition, a dynamic that has not yet crystallized to incite upheaval of the Russian leadership. At the present moment, Russians appear to back the state and attribute the detrimental impacts of the crisis on exogenous forces. Later on, however, if the public determines policy errors or lack of reform to have caused crisis, there is a chance that the state will pursue vastly different, and likely more liberal, growth policies as a result.

The analysis confirmed the continued importance of individuals and political networks in the formulation of economic policy. The economic crisis threatened the legitimacy of Putin and his inner circle as the mechanism supported by this group permitted the transmission of the crisis to Russia. Conversely, a more realistic opportunity emerged for liberals to advance their agenda. Yet by the end of 2009 these interests had failed to materialize into notable policy changes as the ruling elite has been successful in staving off severe recession, due to a combination of prudent

fiscal management and accumulation of foreign exchange reserves, appropriate short-term responses to the crisis, and the barely perceptible prospects of growth on the horizon at the end of 2009. This confluence of events made pre-crisis policies, as well as the measures taken during the crisis, most of which did not differ substantially from the pre-crisis state, appear workable to a ruling elite seeking to maintain its power. Masha Lipman, a political analyst at the Carnegie Moscow Center, notes that any necessary economic reforms imply “relinquishing power and reducing the role of the state” which would “undermine the position of the current decision makers. So the preservation of the status quo is higher on their list of priorities than making Russia a more prosperous economy.”<sup>214</sup> This suggests that to the Russian state, the current period represents simply a new iteration of the previous economic environment – one in which the tantamount goal of preserving the power of the ruling elite is achieved with new mechanisms. Without true political competition, the goal of modernization may not be achieved without wasted resources.

Memories of the 1998 financial crisis in Russia reentered the public and state consciousness and influenced economic policy decisions during the 2008 crisis. Beginning in 2000, at the start of Putin’s presidency, lessons from the chaotic and impoverished 1990s and a desire to avoid recession like the one in 1999 motivated Putin to prioritize the avoidance of federal budget deficits and the pursuit of some structural reforms in the first half of his tenure as president. Yet despite his emphasis on financial sovereignty and a strong state, Putin’s mechanism for ruling the economy and the country proved ineffective in preventing a devastating crisis in 2008. This thesis compared the origins, nature and impact of the two crises to find that in many respects, Russia’s condition between August 2008 and December 2009 was

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<sup>214</sup> Roland Oliphant, “Somewhere Over the Rainbow.” *Russia Profile*. February 4, 2010.  
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not all that different from the post-1998 scenario. Putin's brand of authoritarianism neglected the same maladies that held back the country earlier; today, however, the global nature of crisis has led some to predict a far more challenging recovery. In contrast to the frequent turnover of Prime Ministers and glimmers of democracy under Boris Yeltsin, Putin enjoys high approval ratings and an unprecedented degree of centralized control over the political resources of the country. The modest rollbacks of democracy correlated with the achievement of financial and political sovereignty and high growth rates accumulated to yield a high degree of authoritarianism that has allowed Putin the latitude to contemplate an approach to future economic development without putting forth a concrete plan. Yet with time the connections between the severity of the crisis in Russia to the corruption, absence of property rights and rule of law, and infrastructure deterioration may become more evident to a larger number of Russians, prompting them to voice their discontent on a large scale and making avoidance of these issues impossible for the state.

Authoritarianism and the high degree of state involvement in economic affairs were merely correlated with the high growth rates of the past decade; indeed, there is no conclusive evidence that authoritarian states automatically deliver this success or can sustain it in the long run. Yet the critical juncture at which this claim is tested may be just beginning for Russia: today's public discourse and small sparks of social discontent may precede a more substantial reevaluation of the social contract and development track. In early 2010 the Institute of Contemporary Development (INSOR), a think tank created by Medvedev for consultation on economic policy and modernization, released a report entitled "21st Century Russia: the Image

of the Tomorrow We Want" which advances the view that Russia is at a crossroads in its history confronting a choice between modernization or a demotion of its status on the world stage.<sup>215</sup>

To what extent are the process and components of modernization dictated by the realities of contemporary global economic integration? At a basic level, this thesis has shown how external factors fuelling the 2008 economic crisis constrained the policy choices of the Russian state, forcing alterations of financial and social measures to accommodate the alterations resulting in the domestic economy. The state was unable to maintain previous levels of financial resources and security, leading to revisions in how funds were allocated among societal groups. The tradeoff of remaining linked to international financial markets and the wider global economy were thus increasing humility and conservatism in economic policy (the revision of the federal budget, heightened dialogue on cleaning up and strengthening the financial sector) and an increase in measures aimed at addressing the cost of global economic integration to social welfare.

As economists have noted for over a decade, extensive willingness by states to participate in a system characterized by highly volatile international capital flows defines the present-day international economy. Despite the severe costs capital flight has imposed in all major financial crises since the 1970s, states have not yet abandoned the current architecture, though the 2008 crisis may prompt a reinvention in future years. Thus, if the Kremlin wishes to continue to reap the benefits foreign investment can bring, it must formulate a sustainable arrangement addressing both the social welfare needs of its population and the requirements for successful existence in the global economy. As this thesis demonstrated, many of these requirements relate to Russia's institutional framework, whose deficiencies permitted domestic transmission of the crisis. If

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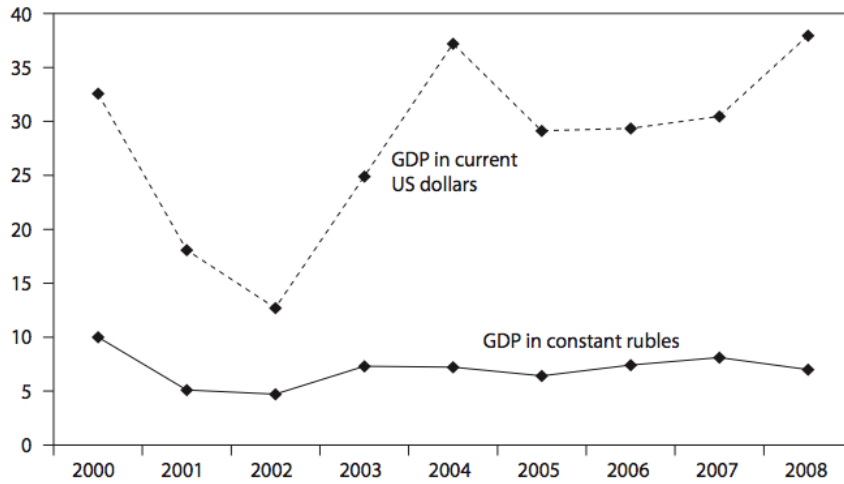
<sup>215</sup> *Russia in the 21<sup>st</sup> Century: Vision for the Future*. INSOR Russia: Institute of Contemporary Development. February 18, 2010.



nothing else, the crisis has posed a stark challenge to Putin's system of delivering prosperity and ensuring sovereignty, prompting a reexamination of some of its basic tenets. Predicting what this reexamination, which is occurring internal to the Russian state, will yield was not a subject of this thesis. There are several potential models for economic development, each carrying its own merits and drawbacks. On the dimension of interaction with other states, there are two options. The first is a movement towards international cooperation to revise the global financial and economic framework, which may be termed mutual insurance against the inherent instability of the global system. Self-insurance, that is, attempting to build resilience to volatility through accumulation of foreign currency reserves, regulation, protectionism, or other measures, is the second option. Putin attempted to develop the Russian economy by the latter approach until 2008. The evolution of the Russian state's attitude towards multilateral discussions on global recovery between August 2008 and the end of 2009 indicates an awareness of the need to alter the aggressive geopolitical stance of the recent past. Putin and Medvedev certainly continue to seek a way of elevating Russia's stature and power on the world stage, but the ruinous effects of the crisis have significantly discredited their brand of economic management. Attempts to lead discussions on the international monetary regime have been balanced by a stated desire to cooperate with other nations. Thus, regardless of whether the country will pursue an evolution of the status quo or attempt to deeply root modernization, sole reliance on global commodities prices as before is no longer viable option for the long term.

## APPENDIX A: Russian economic boom, 1999 – 2008

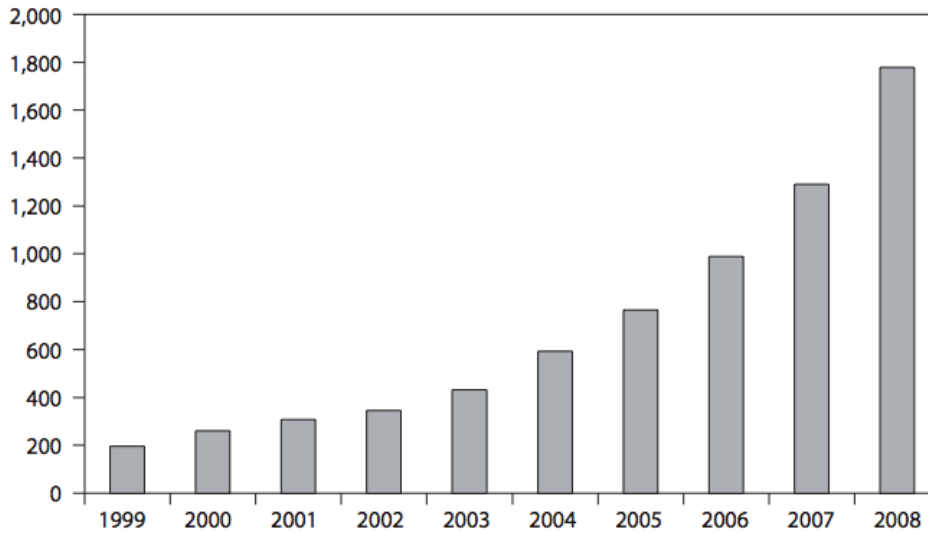
*GDP growth (percent year on year), 2000 – 2008*



Source: International Monetary Fund, *World Economic Outlook* database, October 2008 (accessed on November 22, 2008).

*GDP growth in current US dollars, 1999 – 2008*

billions of US dollars



Source: International Monetary Fund, *World Economic Outlook* database, October 2008 (accessed on December 23, 2008).



Source: <http://russiablog.com>

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