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THE ROLE OF THE RUSSIAN STATE IN THE GLOBALISATION OF THE RUSSIAN ECONOMY

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The Role of the Russian State in the Globalisation of the Russian economy

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Introduction

"The renewed onset of globalisation at the end of the twentieth century was linked with both technological and political factors, though the latter were relatively more important".

– Margaret Thatcher [1]

The Russian state, since the fall of communism, has increasingly become part of the global economy and globalising process. Over this period of time, the extent and scope of the government's role in this process has constantly changed. It is now widely accepted that economic freedom is a pre-requisite for survival in the current global economy; however, the challenge for Russia is to balance that requirement with the political direction that the current government is following.

This paper aims to examine the role of the state in the development of the Russian economy since the fall of Communism, and discuss to what extent globalisation is affecting the Russian economy, and to what extent the Russian economy is dictating its own progress through state-managed policies.

As Martin Wolf, the journalist and *Financial Times* columnist stated in his book 'Why Globalisation Works', "Good markets need good governments. This is just as true of global as of purely domestic markets, if not more so".[2] With this in mind, sections 2 and 3 of this paper analyse the role of the Russian state in the reform which has integrated Russia into the global economic system, and how this role evolved in 1991-1999 and in 2000 to the present day. As is well-known, and as this work will discuss, the arrival of President Putin in 2000 heralded a shift in economic policy. The two periods can briefly be summarized as follows: 1991-1999 is characterized by the fragmentation of the central state, whose inability to exercise influence over the regulatory decisions of central and regional public authorities, takes place within an uncertain institutional context. During this time firms, often with the implicit approval of the government, were able to implement strategies of asset and cash stripping. This period is concisely summarized in a number of books, for example of that of the renowned economist and Nobel Prize winner Joseph E. Stiglitz "Globalisation and Its

[1] Margaret Thatcher, "Statecraft: strategies for a changing world" (London : HarperCollins, 2002), p. 460

[2] Why Globalisation Works?', Martin Wolf (Yale University Press New Haven and London, 2004), p. 73.

Discontents"[3] and another book "Reaganomics goes global: What can the EU, Russia and Other Transition Countries learn from the USA?"[4], which presents an interesting analysis of the essence and applicability of Reagan's economic policies in USA and their impact for Europe and transition economies, including Russia. Such a status quo was challenged at the end of the 1990s with the post-crisis recovery and the arrival of Mr Putin into power on New Year's Eve 1999. Putin's reforms, especially following his re-election in 2004, broadly have aimed to reinforce the 'apex of power', whose strategies are prioritized in order above all to strengthen the perceived 'national' interest. During this period, the state has effectively reinforced control over natural resources and other strategic industries. Despite Russia having succeeded in effectively re-gaining control over many parts of the aforementioned strategic industry, it is widely accepted that there is a need to further diversify its economy in order to decrease the current reliance on the natural resources sector.

As Joseph E. Stiglitz pointed out in his book 'Globalisation and Its Discontents', "only now we are wrestling with the question of "Who lost Russia?" – and why. The answers, as we are beginning to see, are not edifying".[5] Although the author is questioning the role of Western countries in the process, we can address the same issue to the Russian state. What re did the Russian state play in the process of reforms? And if the state was involved, who was responsible for loosing Russia?

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[3] Norton & Company Ltd: 2002.

[4] "Reaganomics goes global: What can the EU, Russia and Other Transition Countries learn from the USA?" edited by Wojciech Bienkowski, Josef C. Brada and Mariusz-Jan Radlo (Palgrave Macmillan, c2006).

[5] Joseph E. Stiglitz, Globalisation and Its Discontents (Norton & Company Ltd: 2002), p. 165.

Concepts

'Globalisation is the other side of deregulation, that is, an erosion of political sovereignty vis-à-vis the interested workings of the global economic system'.

– Valeria Gennaro Lerda [6]

Globalisation - some definitions

The word 'globalisation' can be traced back to 1944. The term has been used by economists since 1981; however its concepts did not infuse popular consciousness until the latter half of the 1990s. Globalisation can be found in five different areas: economic, cultural, political, religious, and social systems. It should not be equated solely with economic globalisation, which is but one aspect of it. Nevertheless, it is economic globalisation that this paper, in the context of the Russian state, will focus upon.

In economics, globalisation depends on the role of human migration, international trade, foreign direct investment (FDI) and capital market flows. The International Monetary Fund has noted "the growing economic interdependence of countries worldwide through the increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology." [7]

In his book 'Why Globalisation Works'[8] Martin Wolf claims that 'the market is the most powerful institution for raising living standards ever invented'. As well as Wolf, the economist Jagdish Bhagwati is another who shares this pro-globalisation perspective. In his book, 'Defence of Globalisation' Bhagwati expounds the view of globalisation as the promotion and deeping of market relations across borders, a system which, as he argues, does not diminish government authority or environment, but rather transforms the economic success to help to diminish inequality though trade and competitiveness between nations.

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[6] Valeria Gennaro Lerda, "Which 'Global Village?': Societies, Cultures, and Political-Economic Systems" (Praeger Pub, Westport, 2002), p. 10.

[7] IMF World Economic Outlook 1997.

[8] Yale University Press New Haven and London, 2004.

'Washington consensus': the role of state

So, on a global level, what role does the state play in this whole process of reforms and integration into the world economy? Supporters of the "free market" approach to economic and social policy have an ambiguous relationship with the 'state'. John Williamson, who is said to have coined the phrase 'Washington consensus' described this policy as a set of economic assumptions and policy prescriptions favoured by major Washington-based institutions including the IMF, the World Bank and the United States Treasury, "*that have been imposed on hapless countries... and have led them to crisis and misery. There are people who cannot utter the term without foaming at the mouth*".[9] Such policies, according to Williamson, imply fiscal discipline, redirection of public expenditure priorities toward fields offering high economic returns, tax reform, interest rate, trade and FDI liberalisation.

One of the most vociferous of today's critics of this concept, Joseph Stiglitz, notes: *"Behind the free-market ideology there is a model, often attributed to Adam Smith, which argues that market forces — the profit motive — drive the economy to efficient outcomes as if by an invisible hand. One of the great achievements of modern economics is to show the sense in which, and the conditions under which, Smith's conclusion is correct. It turns out that these conditions are highly restrictive. Indeed, more recent advances in economic theory... have shown that whenever information is imperfect and markets incomplete, which is to say always... then the invisible hand works most imperfectly".* [10]

"If, for instance, markets are opened up for competition too rapidly, before strong financial institutions are established, then jobs will be destroyed faster than new jobs are created. In many countries, mistakes in sequencing and placing led to rising unemployment and increased poverty". [11]

More and more analysts see eye to eye with Stiglitz on the perils of unrestricted international capital markets. Prominent among them, Jagdish Bhagwati has long argued that capital flows raise different issues. Bhagwati begins by separating the issues of free trade and free movement of capital, arguing that foreign direct investment is generally beneficial for developing countries, but that short-term speculative flows can be destabilising and that liberalisation of capital markets should be taken gradually.

"First, I do not believe in 'shock therapy', as I have written frequently including in the Globalisation book (Chapter 18). That is a technocratic solution of the kind that my

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[9] John Williamson, "Did the Washington Consensus Fail?" (Outline of Remarks at CSIS. Washington DC: Institute for International Economics, November 6, 2002).

[10] Joseph E. Stiglitz, Globalisation and Its Dis contents (Norton & Company Ltd: 2002), p. 73.

[11] Joseph E. Stiglitz, Globalisation and Its Discontents (Norton & Company Ltd: 2002), p. 18.

colleague Jeffrey Sachs sold to Russia with manifest ill-effects; this technocratic approach is again something that he offers to Africa today, ignoring important issues like the absorptive capacity of many of these countries. Therefore, the best speed of reform such as trade liberalisation is not likely to be the maximum speed". [12]

This debate still continues, with Dani Rodrik arguing that there now exists an 'Augmented' Washington Consensus, which adds to the original list measures like corporate governance, anti-corruption and other.

It is evident that the question is not whether to support or oppose globalisation. Virtually everyone involved in the debate agrees that globalisation, in the form of expanded global flows of goods, services, capital and labour is both inevitable and desirable. The question is – and for Russia in particular it is a particularly pertinent one - how best to manage globalisation?

"*I am sure that if we focus on globalisation, we focus on the number one problem. We cannot just criticize, cannot just blame; we should try to understand what's happening and particularly try to understand what you need to do*".[13]

[12] Prof. Jagdish Bhagwati lecture: The consensus for free trade among economists — has it frayed (Published 8 October 2007, Financial Times).

[13] Interview with State of the World Forum Co-Chair Mikhail Gorbachev, "Glasnost is working, globalisation isn't", Mark Hertsgaard, (State of the World Forum: September 4-10, 2000).

Russia in transition and the Soviet economic legacy

Before examining globalisation in Russia and the extent of the government's role in it, it is pertinent to examine the legacy of the Soviet economy, and the challenges that 70 years of a planned economy passed down to the post-Communist government.

The Soviet economic and political system was characterized by an extremely high degree of centralization, impacting all aspects of society – political, civil, judicial, and economic. The command economy's legacy was all-pervading, with the major issues it bequeathed being:

- *"State planning for state-owned industries, demand structuring by the state budget, and a state-determined monetary policy with a one-tier banking system.*
- *Production in a state-run system of mostly monopolistic firms, producing a narrow range of goods at state-administered prices and facing monopolistic suppliers.*
- *Risk aversion by managers/administrators who were reluctant to innovate or introduce quality improvements and engaged in hoarding material factor inputs to be sure of fulfilling quarterly specified state plans.*
- *A full employment guarantee and, as a consequence, impossibility of firms going bankrupt — a soft budget constraint policy".*[14]

By the beginning of the eighties the Soviet economy had exhausted its development potential. Thereafter, it was kept afloat by exports of oil and gas and after the mid-eighties by rapid accumulation of foreign debt. The real average wages in the first half of the nineties declined by more than 40 — 60 per cent[15].

"Command central planning was justified by its alleged ability to achieve sustained rates of growth and to catch up with advanced industrial countries. The slowdown in growth rates from the mid-1970s to economic stagnation in the 1980s, along with environmental abuse, attested to central planners' inability to deal with complex, over industrialized economy's need for constant adjustment". [16]

In August 1991 Gorbachev was ousted from power, the coup attempt against Gorbachev lasted from 19th to 21st; he was severely weakened, and things tumbled towards the eventual

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[14] "Comparative Economics in a Transforming World Economy", 2nd Edition, J. Barkley Rosser, Jr. and Marina V. Rosser (Cambridge, Mass.; London: MIT Press, 2004), p. 285.

[15] Branko Milanovic, "Income, Inequality, and Poverty During the Transition from Planned to Market Economy", (World Bank Publications: 1998), p.29.

[16] "Comparative Economics in a Transforming World Economy", 2nd Edition, J. Barkley Rosser, Jr. and Marina V. Rosser (Cambridge, Mass; London: MIT Press, 2004), p. 285-286.

collapse of the USSR. Although Gorbachev formally remained president of the USSR until December 1991. On 25 December 1991 the signing of the treaty establishing the CIS heralded the end of the Soviet Union. Gorbachev had to step down because he was President of a country which no longer existed. As Leon Aron observed in his book "Russia's Revolution: 1989-2006": *"The political 'centre'... disappeared. This was a revolution, and in revolutions there is no centre."* [17] The Russian State also lost the necessary mechanisms to adjust governmental policies, and as a result the ongoing. Russian transition can alternatively be seen as a full-fledged catastrophe or a cardinal re-shaping. In the immediate aftermath of the USSR's demise, the state was in chaos, degeneration of the inherited economic system, political and economic decentralization, and rapidly rising income inequality. As a result, as Barkley and Marina Rosser commented, *"the economic transition in Russia revealed significant perversities in its implementation and escalated ethnic and regional tensions".* [18]

"For the vast majority of Russia's regions, the end of the USSR did not mean the end of local established elites, which continued to exercise the power of the nomenklatura. The industrial and managerial nomenklatura pursued control over economically strategic resources in their aggressive discrimination against outsiders". [19]

After the break-up of the Soviet Union, ethnic, regional, ideological, religious, economic, and other tensions that had accumulated over decades were relatively peacefully accommodated by the establishment of 89 political and economic entities at the sub-federal level within the Russian Federation. However, within such an environment, an emerging new ruling class of former federal level communist elites was able in many cases to maintain influence in these new power structures, and in many cases even increase their power. Rosser accurately summarizes the dilemmas faced by the new government and the course it chose in response to these challenges;

""The effects of shock reforms from the centre and the increasing authority of the regional elites generated a wide range of behaviours. At one extreme, there were regions that declared themselves special economic zones with economic sovereignty (such as Kaliningrad) and engaged in barter transactions among themselves to avoid federal taxes. At the other extreme, some regions (along the Volga River, in particular) remain unprivatised and essentially untouched by the transition, and are mostly dependent on subsidies from the centre. Yeltsin responded to this growing decentralization with discretionary bilateral manipulation of individual regions and displayed remarkable

[17] Leon Aron, "Russia's Revolution: 1989-2006", (AEI Press: 2007), p. 85.

[18] "Comparative Economics in a Transforming World Economy", 2nd Edition, J. Barkley Rosser, Jr. and Marina V. Rosser (Cambridge, Mass.; London: MIT Press, 2004), p. 295.

[19] "Comparative Economics in a Transforming World Economy", 2nd Edition, J. Barkley Rosser, Jr. and Marina V. Rosser (Cambridge, Mass.; London: MIT Press, 2004), p. 290.

political craftiness, especially during his re-election campaign in 1996. His willingness to compromise and tolerate independence-minded regions, however, was tested by rebellious Chechnya's bid to achieve its full independence". [20]

The newly emerged state of Russia had a very weak system of state regulations and control. Such a chaotic environment provided the regional former communist and now business elites with the perfect moment to seize the initiative and increase their hold on regional power.

"*The liberal ministers who were appointed to head the economic ministries in Russia in November 1991 took over economic policy in a country which had neither a national currency nor effective customs frontiers... In this way they hoped to attain the important policy goals of reducing inflation and restoring macroeconomic stability*". [21]

Yegor Gaidar was acting Prime Minister under President Boris Yeltsin in June-December 1992. It was he who implemented liberal economic reforms according to the principle of shock therapy, abolishing price regulation by the state, which immediately resulted in a major increase of prices and amounted to officially authorizing a market economy in Russia. Gaidar was a firm believer in minimizing the role of a state in the economy. In the book "State and Evolution: Russia's Search for a Free Market" he wrote: *"Social government or market capitalism...is certainly a topic for academic discussion. Neither von Hayek, nor Lord Keynes were able to create a theory that could be applied to the struggle of a bureaucratic Asian-type state attempting to break free of the influence of a criminal-infested government. We will change the system and observe the fundamentals of Western society at first hand – only then will these problems at the root of our society become apparent. At the centre there has always been an all-pervading bureaucratic power, acting as a magnet on society. This powerful force has been present throughout the entirety of Russian history…will we be able to succeed in throwing off its shackles?*"[22]

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[20] "Comparative Economics in a Transforming World Economy", 2nd Edition, J. Barkley Rosser, Jr. and Marina V. Rosser (Cambridge, Mass.; London: MIT Press, 2004), p. 290.

[21] "The Role of the State in Economic Change" (Wider Studies in Developmental Economics) edited by Ha-Joon Chang and Bob Rowthorn, (Clarendon Press: 1995), The State under Sate Socialism and Post-Socialism, Michael Ellman, p. 232.

[22] ???? ??????, "??????????? ? ????????: ??? ???????? ????????????? ?? ?????? ? ???????? ?????????????? ???????", ???.: ?????, 1997.

Introduction to globalisation: 'Shock therapy'

"The collapse of the Soviet empire between 1989-1991 – the most pleasurable surprise of my life – appeared to confirm the global transformation in politics and economic policy. Socialism was dead... If history teaches anything, it is what we have choices. We can choose a better world – or a worse one".

– **Martin Wolf** [23]

"In the bureaucracy, the identity of state interest and particular private aim is established in such a way that the state interest becomes a particular private aim over against other private aims."

– **Karl Marx** [24]

Post Soviet reforms

After seventy years of self-autocratic socialism, the Russian entry to the global economy was doubtlessly difficult. At the beginning of the 1990s, Russia had to deal with a double challenge. Firstly, it was moving from the command system to a capitalist market economy, and secondly, from an all-but closed economy towards integrating into the globalising world economy. This double challenge raised questions relative to the allocation of property rights over assets and of the configuration of relations between the state and the private sector. Wojciech Bienkowski, Josef Brada and Mariusz-Jan Radlo discuss the challenges the old system bequeathed the new Russian state:

"The first after-effect stems from the fact that the formation of Russian capitalism was, from the very beginning, illegal, often criminal, parasitic... The second after-effect is that the creation of such large firms gave rise to Russian monopolies that are incapable of competition and that replace Ricardo's formula of capital accumulation 'Money-Product-Money' with the exclusively Russian one 'Money-Power-Money...' Russia's bureaucratic model of capitalism has created millionaires and billionaires, but has not developed their business abilities. A Russian Ford, Morgan or Gates unfortunately has not emerged." [25]

[23] Martin Wolf, "Why Globalisation Works?" (Yale University Press New Haven and London, 2004), p. 3.

[24] Works of Karl Marx 1843, "Contribution to the Critique of Hegel's Philosophy of Right".

[25] "Reaganomics goes global: What can the EU, Russia and Other Transition Countries learn from the USA?" edited by Wojciech Bienkowski, Josef C. Brada and Mariusz-Jan Radlo (Palgrave Macmillan, c2006), p. 118-119

Gaidar's economic programme of 'shock therapy' was presented as the alternative to the failed attempts of the 'perestroika-era' Soviet leadership and their failed attempts to carry out gradual modernisation of the highly-centralized socialist economy.

The first radical reform in the beginning of January 1992 was the liberalization of prices, which jumped 10-12 fold, which resulted in a sharp fall of living standards for the majority of the population. Moreover, the reform delivered a blow to savings deposits of citizens, destroying the value of these savings, in the absence of any mechanisms for their indexation. These dramatic and far reaching results manifested themselves in a deep distrust of the government and the reforms as a whole across much of the population.

"Members of Yeltsin's government, as true revolutionaries, strove for immediate results. For example, they announced that 'in six months markets will be saturated and key difficulties will be overcome.' When deputies of the parliament laughed at theses ideas, the 'reformers', as they used to call themselves, took offence and accused us of being incompetent in market reforms.

Their first shattering step was President Yeltsin's decree 'On Economic Reform', which abolished most price regulation for goods and services, including the consumer sector. It took place in conditions of monopolistic state property and absence of private property. Do you know anything more stupid? As a result of this step, prices for goods rose a thousand fold, people's savings became worthless and the whole population of the country became poor.'[26]

The second problem, which the government was facing, was the crisis of reciprocal defaults of payment. By June 1, 1992 the sum of debts in the economy had reached nearly two trillion roubles. As a result, not getting money for goods production, enterprises of the country were on the verge of bankruptcy. A way out of that situation was to grant state enterprises lax credit from the Central Bank, which in turn, created conditions for hyperinflation. Wages were chronically delayed. In 1993, thanks to the stronger efforts of the Central Bank, inflation for the first time fell below 10 per cent a month and the depreciation of the rouble slowed down. However, once the reserves of the Central Bank became exhausted, the national currency lost a quarter of its value in only one day. Ultimately, without a firm financial system within the country financial credits from the International Monetary Fund (IMF) and the World Bank led only to growing corruption and strengthened the inflation processes.

The third major task of economic modernization was privatisation of property in the country. Voucher privatisation was the chosen method of the government, which was aimed

[26] "Reaganomics goes global: What can the EU, Russia and Other Transition Countries learn from the USA?" edited by Wojciech Bienkowski, Josef C. Brada and Mariusz-Jan Radlo (Palgrave Macmillan, c2006), p. 177.

at neutralizing the negative effects of radical reforms and encouraging the development of a 'middle class'. The Economist reported that *"by the end of 1993, in many areas of the country, virtually all shops, restaurants, workshops and so on were in private hands"*.[27] The distribution of vouchers began on October 7, 1992. On paper, 8,010 middle-sized and large enterprises were privatised in this way during 1993. [28]

This arguably high-risk strategy failed to bring the desired results, and the government in July 1994 took the decision to change direction. No tangible middle class had emerged, growth of small and medium-sized businesses was negligible, and opposition to the government's privatization policy was significant, despite the initial support which this policy commanded.

Despite the questions which have subsequently been raised as to the validity and general success of this policy, Yegor Gaidar in his book "State and Evolution: Russia's Search for a Free Market" argues that such dramatic measures were indeed the only option open to the government of the time:

"Swapping power for private gain might sound less than noble, but if we are to be realistic, if we are to proceed from the actual alignment of forces in the late 1980s, this exchange was the only peaceful way for the society to reform or the state to evolve. The alternative was civil strife, civil war, and yet another dictatorship — this time a dictatorship of a new nomenklatura". [29]

Nevertheless, in the same book Gaidar recognises that: *"This sort of privatization corrupts and weakens a state, of course, but by no means changes it into a different type of state. Government officials remain government officials. They have no intention of 'seceding' from government and taking 'their' property with them. The entire purpose of Eastern bureaucratic privatization lies in one thing: to satisfy, within the framework of the existing system, the voracious appetities of those in power, to do this by maintaining the indivisibility of property from the always dominant state... Given this sort of 'perestroika', true and legitimate private ownership never evolves into a social institution. Instead, state officials merely redivide the spoils among themselves. The vicious cycle [circle? That's the usual phrase] in which Eastern civilization revolves is never really broken. It merely begins a new turn*". [30]

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[27] *The Economist* (12/3/94).

[28] Ted Grant, Russia: From revolution to counter-revolution, (Wellred Publications: 1997), p.442.

[29] Yegor Gaidar and Jane Ann Miller, "State and Evolution: Russia's Search for a Free Market", (W.University of Washington Press: 2003), p. 83.

[30] Yegor Gaidar and Jane Ann Miller, "State and Evolution: Russia's Search for a Free Market", (W.University of Washington Press: 2003), p. 7.

Anders Aslund in his book "Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed" claims that 'Chubais' privatization was the greatest success of Russia's reform'.[31] While the privatisation of state industries and assets certainly cut down the direct involvement of the state in the production and distribution of many goods and services, the process of achieving this has been accompanied by new state regulations, subsidies and institutions aimed at introducing and entrenching a 'favourable environment' for the newly-privatised industries. Mass privatization and 'shock therapy' resulted in the formation of free market relations in the society on the one hand, and on the other there arose the growth of social tension in society and the breakdown of whole industries. Four per cent of Russians in 1993 had incomes which exceeded by approximately 300 times the incomes of the poorest citizens of the country. [32]

Thus, rapid privatisation, often carried out in an anarchistic way, allowed those closest and with most influence over the assets themselves to obtain them at knock-down prices and to exchange their political power in a hierarchic system for economic power in a market system. This state of affairs undermined entrepreneurial activity; diminished individual freedoms; and led to the inefficient use of resources, and also to the gradual formation of an oligarchic system of capitalism which roughly equated to the above-discussed 'Money-Power-Money' model. The price of reform also often appeared tragic, as the death rate in Russia sharply increased by 20 per cent from 1992 to 1993. At the same time, the birth rate fell by 14 per cent from 1992 to 1993. [33]

Obviously, Gaidar's and Aslund's opinions cannot be considered as totally objective as both of them were significant figures involved in the process of reforms, Gaidar as Prime Minister and Aslund as an economic adviser to the Russian government. Some of these players try to justify their actions by reference to the goal of the rapid integration of Russia into the global economy, and the creation of a market economy and a middle class. Aslund said in Russia, the Washington Consensus has worked. Yegor Gaidar wrote in his aforementioned book, that *"Between January 1994 and August 1994, official statistics for Russia showed a drastic drop in industrial output. At the same time, they showed a gradual increase in retail trade, in real income and personal savings for the population in foreign currency reserves. In normal market economies such a thing would be impossible, and, of*

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[31] Peterson Institute: October 2007.

[32] "Social Situation and the Living Standards of the Population of Russia", 1993. Moscow, Goskomstat of Russia, 1993, p. 41- 42 (in Russian).

[33] "Russia: Demographic Trends Pose Economic Problems", Economic Bulletin, (Springer Berlin / Heidelberg: Volume 37, Number 8 / August, 2000), p. 256.

course, we cannot expect this to last for long. But it is instructive, in any case, to investigate the reasons for such a paradox". [34]

According to official Russian data, which admittedly cannot be taken as 100 per cent reliable, in 1994 the national gross domestic product (GDP) was 604 trillion roubles, or about 4 per cent of the United States GDP for that year.[35] It is likely that this figure underestimated the size of the Russian economy as it does not take account of the huge, tax-evading shadow economy which is not reflected in any government statistics. This shadow economy, according to a study prepared by the Russian Academy of Sciences' Institute of Socioeconomic Problems of the Population, accounted in 1990-1991 for approximately 10-11 per cent of the country's GDP, in 1993 for 27 per cent of GDP and in 1994-1996 for 46 per cent.[36] Taking into account the shadow economy, the actual GDP in 1994 was $4,573 per capita, approximately 19 per cent of that of the United States.

Boris Yeltsin was re-elected in 1996 with financial support from influential business oligarchs who owed their wealth to their connections with Yeltsin's administration.

The twin tasks of instilling macroeconomic stabilization and restructuring the economy envisaged the transition from central planning to a market-based economy. Macroeconomic stabilization entailed implementing fiscal and monetary policies whilst the economic restructuring required establishing the commercial, legal, and institutional entities — banks, private property, and legislation, that permit the economy to operate efficiently.

Gaidar's reversal of the priorities in the process of reforms met with vociferous opposition from radical liberal reformers, the main reason for this being freeing prices without undertaking a prior programme of privatisation and demonopolisation. '*Even a limited price liberalisation due to be effected too quickly late in 1991 was called into question by Mr Gennady Burbulis, the Russian state secretary and one of Mr Yeltsin's closest aides. "Mr Burbulis said: 'We can't free prices until we create at least some kind of dynamism in basic privatisation. In conditions of economic monopoly, freeing prices will yield nothing. We will not release a mechanism of real competition between producers*." [37]

The Russian state played a central role in implementing free market policies and, moreover, has a continued involvement in regulating the minutiae of the market economy — a direct

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[34] Yegor Gaidar and Jane Ann Miller, "State and Evolution: Russia's Search for a Free Market", (W.University of Washington Press: 2003), p. 98.

[35] "Milestones of Transition", the news letter about reforming economies, and "*Beyond Economic Growth* Student Book", Comparing Levels Of Development, World Bank, www.worldbank.org.

[36] "The long shadow of Russia's second economy" by Paul Goble, (*Asia Times*: 30 September 1999).

[37] Yeltsin wins sweeping powers to push reform, John Lloyd, (Financial Times: 2 November 1991), London Page 3.

consequence of the hand-in-glove relationship that free market governments have fostered between 'adjusted' state institutions and market interests. Thus the view that states and markets are somehow intrinsically opposed to each other emerges as something of a myth. The 'free' market needs the protection of states —and their powers of enforcement. The minimalist state is, quite simply, utopian — in the original sense of the word, it exists nowhere. At issue, therefore, is not whether modern economies require any involvement from the state, but there is a question about the scale and scope of state involvement, and the state's own conformity with market principles. Underlying the free market agenda has been an insistence that the state has neither the management capability to run the economy, nor any legitimate authority to do so.

Cost of globalisation: Rouble crisis 1998

The belt-tightening policy of stabilisation implemented after 1995 included two elements: the cessation of loans by the Central Bank to the government, which were substituted by debt, and the stabilisation of the rouble-dollar exchange rate. As a result, the rate of inflation decreased, yet the shadow economy continued to expand, particularly within Russia's industrial base. Overborrowing by the government not only from international sources but equally by means of issuing GKOs, short-term government bonds, (when the largest banks made up the bulk of resident GKO holders), and the Asian crisis of 1997 exacerbated this situation to the extent that the government was reduced to bankruptcy. On 17 August 1998, it was forced to default on Russia's debt payments, and devalue the rouble. New international loans boosted Russia's debt to a dangerous level. Russia by the time of writing (2000) [Er...but you're writing this in late 2007...Surely simply: By 2000, Russia] accumulated some $150 billion international debt apart from internal debt, about $50 billion of this borrowed since the end of the Soviet Union.[38]

Russian government revenue and expenditure 1992-1998 (as % GDP)

	1992	1993	1994	1995	1996	1997	1998 (first half)
Federal government revenue	15.6	13.7	11.8	12.2	13.0	11.9	10.2
Federal government expenditure	26	20.2	23.2	17.6	22.0	18.9	16.1

Source: Complied from IMF, World Economic Outlook, May 1998, p.100, October 1998, p.70.

'The rouble came under pressure as a result of fall-out from the East Asian financial crisis... The international market pressure continued and the IMF together with the World Bank and Japan provided $17.1 billion of new loans. But the market would not be bucked.

[38] Margaret Thatcher, "Statecraft: strategies for a changing world" (London: HarperCollins, 2002), p. 84.

In August, after $4.8 billion of the loan had disappeared across the exchanges, the rouble was devaluated and then floated... The Russian stock market fell by 80 per cent. Some experts estimated the rate of capital flight as at least $17 billion per year (Washington Post, 30 September 1998). Money poured out of Russia, doubtless much of it ours. Russians lost, perhaps permanently, faith in their own currency...' [39]

Prices for almost all Russian food items went up by almost 100 per cent, while imports have quadrupled in price. Many citizens, unsure what the future held, stocked up for bad times. Throughout the country shop shelves were being emptied. By 1998, Russia's GDP had fallen by nearly 40 per cent from the 1991 level.[40]

"Why did the IMF seem to offer poor advice? The Fund was caught between powerful members on one side and scarce resources on the other. The United States pushed the IMF to lend at particular junctures such as in 1993 and 1996 to support Yeltsin – regardless of his economic policies – and to avoid turmoil in the markets when the financial crisis occurred in 1998. In these cases decisions to lend to Russia were being taken outside of the IMF and this left the institution with little negotiating or enforcement power in respect of conditionality. However, in other cases the IMF had more influence". [41]

There is plenty of blame to go around for Russia's troubles, and most of it, of course, lies with Russia. As *The New York Times* columnist A. M. Rosenthal wrote: "*Western guilt — I think not. Russia did this to Russia.*"[42] Indeed, Yeltsin's reforms had seemed to have gone drastically wrong, and it is ironic that the infusion of foreign aid from the IMF, the World Bank, and other Western sources became the fuel that kept Russia's hybrid economic system running. But it is equally true that democracy, the free market, and 'reform' have been given a bad name in Russia by leaders and politicians who were incompetent and unprincipled. A legacy of both Soviet and post-Soviet times was that most Russians consider their rulers corrupt and criminal. The Yeltsin era seemed, for ordinary Russians, to add weight to this argument: just because he and his government were elected through a democratic process, this did not automatically grant them any additional legitimacy in the eyes of most Russians.

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[39] Margaret Thatcher, "Statecraft: strategies for a changing world" (London: HarperCollins, 2002), p. 83.

[40] "The Russian Economy In 2006" by Igor Nikolayev, (RIA Novosti: Jan 04, 2007).

[41] Ngaire Woods, "The globalisers: The IMF, the World Bank, and Their Borrowers" (Cornell University Press, 2006), p.137.

[42] "On My Mind; Russia: Who's to Blame?", A. M. Rosenthal, (The New York Times: December 17, 1993).

'Some Russians believe that the transition to the market was all part of a devilish plot to weaken Russia, hatched in the West and undertaken on the West's behalf by the IMF and the World Bank'. [43]

An understanding of this context is extremely important to understanding the degree to which a genuine aversion to a global economy pervades Russian society. The sense that the outside world poses a threat is reflected today in the self-protective, occasionally aggressive attitude adopted by Russia in its foreign relations in both the political and economic spheres.

'Today Russia feels itself surrounded as the United States and China gain influence in what was formerly Soviet territory... The West's attitude to, and criticism of, Russia also contributes to its feeling of being surrounded... But according to opinion surveys, the leadership is not interested in democracy. There appears, on the contrary, to be almost a contradiction in terms between stability and democracy. To a certain extent, this view is also held by the public at large. One explanation for this lies in the fact that many associate democracy with the chaos and the power of the oligarchs during the Yeltsin era... Moreover, as Russia sees it, "foreign powers" are attempting to take over its important raw material resources. These raw materials therefore have to be protected, especially the energy resources, since it is these that provide the most important guarantees of independence in the face of the outside world'. [44]

So what did the 1998 financial crisis change in Russia's economic and political development? It showed that Russia was more of a free market then a stable economy, that globalisation without internal economic development can be pernicious, and the role of the state in this process is crucial.

"Most significant, the crisis revealed (even to those who had preferred not to notice it before) Russia's basic domestic institutional and structural weaknesses: a government that was unable to devise, let alone implement a coherent economic policy; a public administration that was unable to administer; a regulatory framework which either did not exist or was not enforced; and the almost complete absence of some of the legal and institutional foundations (such as well-defined property rights, a clear system of taxation, and a bankruptcy law) without which no market economy can function". [45]

In short, together with the unpopularity of 'democracy' and partly 'free market economy' quickly gained a bad reputation among most of the Russian population. The subsequent

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[43] Ngaire Woods, "The globalisers: The IMF, the World Bank, and Their Borrowers" (Cornell University Press, 2006), p.105.

[44] 'Russia suffering from globalisation fears' by Robert L. Larsson *(Published* 5-2005, *Framsyn Magazine)*

[45] "Financial markets and development: the crisis in emerging markets" edited by Alison Harwood, Robert E. Litan, and Michael Pomerleano (Washington, D.C. : Brookings Institution Press, 1999), p. 39.

hardening of government economic policies today, particularly since 2000, has broadly won public approval with the centralised policy, increasingly aimed at protecting Russia's natural resources and national interests. Russia's initial integration into the world economy saw it as a state that produced fuels and raw materials. Its reliance on these commodities is a mixed blessing which continues to pose questions as to its future development to this day.

"*Globalisation itself is neither good nor bad. It has the power to do enormous good, and for the countries of East Asia, who have embraced globalisation under their own terms, at their own pace, it has been an enormous benefit, in spite of the setback of the 1997 crisis. But in much of the world it has not brought comparable benefits. For many, it seems closer to an unmitigated disaster*". [46]

[46] Joseph E. Stiglitz, Globalisation and Its Discontents (Norton & Company Ltd: 2002), p. 19.

Globalisation and protectionism: The role of the State, 2000-2007

"I only want to draw your attention straightaway to the fact that you have yourselves formed this very state, to a large extent through political and quasi-political structures under your control, so perhaps what one should do least of all is blame the mirror."

– **Vladimir Putin** [47]

It is now almost two decades since Russia started the lengthy and challenging transformation from central planning to a normally functioning market economy. After sharp economic decline and the events of the early 1990s – such as the privatisation of public enterprises, and the collapse of the bubble economy in 1998, Russia experienced sound economic growth. This reciprocal process continues to reshape Russian politics and economics in fundamental ways, which still leaves the on-going conflict between the natural-resources sector and on questions of exports, profits, and foreign investors.

This chapter examines the question of whether more centralised policy which the state follows now, protecting monopolies in the sphere of natural resources, is objectively effective in a long-run prospective; and if and how mechanisms, such as WTO as an example of globalisation and integration in the competitive global economy, can compensate for the weaknesses of the current policy.

Russia's economic recovery: longer-term concerns

In absolute terms, Russian economic performance across the board is strong and enviable. The World Bank claimed in a report published in November 2007 that Russia's economy is growing at maximum capacity, boosted by high global energy prices and a strong inflow of foreign capital.[48] Between 1998 and 2006, Russian GDP expanded by an estimated 57.6 per cent. Having said that, we should not forget that besides the fact that 2006 and 2007 were remarkable years, total GDP in 2006 has barely regained its 1990 level. Having grown by 7.9 per cent (year on year) in the first half of the year, Russia is likely to post full-year GDP growth of over 7 per cent in 2007. Poverty rates were cut in half and regional disparities declined somewhat. The average salary has increased to $540 per month in August 2007,

[47] Vladimir Putin's to Russia's business leaders in their meeting in late July 2000 (*Washington Post:* July 29, 2000), p. A1.

[48] World Bank, Russian economic report ? 15, November 2007, p.1.

from $65 per month in August 1999, and the population's real disposable income doubled between 1999 and 2006.[49] The income gap between the richest and poorest in Moscow, for example, has narrowed by 10 per cent, with the wealthiest seeing income 34 times that of those at the bottom of the scale.[50] But the true significance of headline figures lies in their broader context. There are several reasons why the current very favourable picture nonetheless gives cause for concern.

It is not clear how sustainable Russian performance is in the longer term. While the current consumer boom is strong, the Russian economy is vulnerable to the international prices' fluctuations — especially if this were to occur in several commodities markets simultaneously. Russian economy is heavily dependent on imports, and the domestic market in almost all industries is restricted by one or a few monopolistic producers. The Federal Customs Service's latest data says that Russia increased goods import from non-CIS countries by 49.7 per cent, up to $101.055 billion, in January-August 2007. [51] *"The availability of cheaper imports, which improves the terms of trade, is seen as a reduction in competitiveness... True danger is that a new competitor emerges in a country's export markets (or pushes up the prices of its imports). That does make a country worse off, or less competitive... "*[52]

As a recent example with consumer prices in Russia illustrates, which are currently rising at an alarming rate, and which is arousing the ire of the general public, the government has no control over the situation, taking forceful measures to alleviate this problem in pre-election times. As *The Daily Telegraph* reported, the price of milk alone rose by 9.2 per cent in September 2007 alone, to which the government's response has been to summon the respective food producers to Moscow in order to force them to fix prices.[53] Basically, that means that economy is not competitive and very dependent on high oil prices donations, and such measures can have very negative impact on the overall economic output in the long-run prospective. *"There has been a clear increase in direct state intervention in the economy since 2003. What exactly lies behind it, and what its implications are for the future, are controversial matters*." [54]

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[49] "Comment: 8 years in power - Putin's economic legacy" by Katya Malofeeva and Tim Brenton of Renaissance Capital, (*Business News Europe*: August 14, 2007).

[50] "Average wages in Moscow fall, gap between rich and poor closes" (*Investor weekly*: August 20, 2007).

[51] "Oil for Food" by Sergei Minaev, (*Kommersant*: September 24, 2007).

[52] Martin Wolf, "Why Globalisation Works?" (Yale University Press New Haven and London, 2004), p. 266.

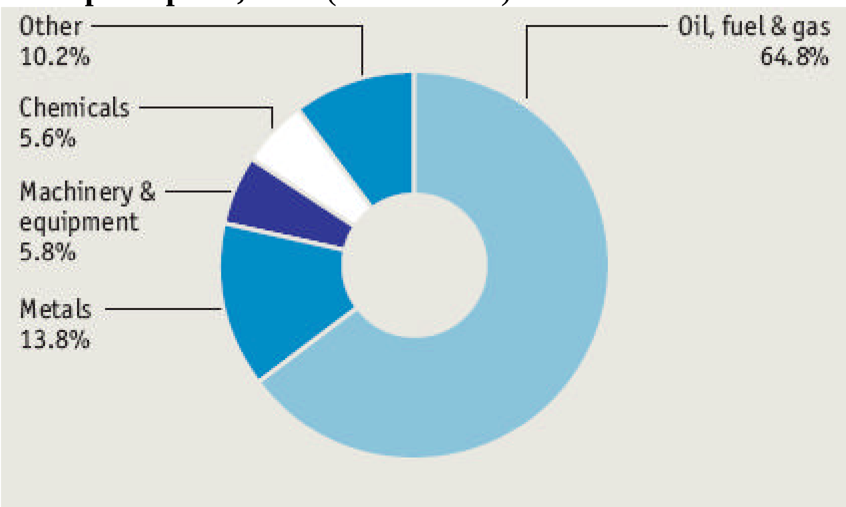
[53] "Soviet-style food prices return to Russia" by Adrian Blomfield in Moscow (*The Daily Telegraph*: 25.10.2007).

[54] Philip Hanson, 'The turn to statism in Russian economic policy', (*International Spectator* 42: 1, March 2007), pp. 29–42.

"The bureaucratic component of Russian capitalism is not the whole story. Russia's economic model is slowing evolving into that of a petro-state... The petro-state has an interest not in modernisation but in preserving the natural-resource economy". [55]

The official statistics reports that the share of the oil and gas sector in GDP has remained within 9 per cent in the past few years, which is much less than in many other countries that rely on oil exports. Some experts with the Development Centre believe that official statistics diminish the role of the oil and gas sector, which, including pipeline transport, account for 20 per cent of GDP, while the country's industrial sector apart from oil and gas for 15 per cent.56 In the absence of a possibility of more vigorous performance from oil and gas, Russia needs to promote the growth of the production sector in Russia, and to achieve this further reforms are necessary.

Principal exports, 2006 (share of total)



Source: Economist Intelligence Unit

"Curiously, the Russian government's Energy Strategy envisages very slow growth in total Russian oil output up to 2020. If that proves indeed to be the case, further growth in Russian oil earnings will depend far more on price rises than was the case up to 2004... That circumstance may not be too damaging for Russian economic growth, because a large proportion of incremental oil revenue is 'sterilized'—taken out of circulation by withdrawing it from the circular flow of funds—by being placed in the Stabilization Fund... It is necessary, however, to note both the nuances and the limited coverage of Russia's current state intervention, and put its damaging attributes into perspective". [57]

[55] 'Post-communist Russia: a historic opportunity missed' by Lilia Shevtsova (*International Affairs* 83: 5 (2007), p. 895-896.

[56] The Russian economy: not by oil alone, opinion & analysis (*RIA Novosti*: 01. 09.2006).

[57] Philip Hanson, 'The turn to statism in Russian economic policy', (*International Spectator* 42: 1, March 2007), pp. 883–884.

In addition, the exchange rate of the rouble has strengthened 20 per cent against the dollar, which is extremely dangerous for Russian producers, as well as for the overall revenue, which will be affected by decline in non-fuel trade.[58] This in turn would reduce domestic liquidity, potentially creating problems for a still-underdeveloped financial system. A declining trade balance could be accelerated by further rouble strengthening, and by consumers switching to perceived higher-quality foreign imports as incomes rise, which causes the serious damage to the local producers. "*A range of problems in the business environment and competitiveness-eroding real rouble appreciation are further obstacles in the path of Russia's economy*", wrote the *Economist*.[59]

The next major issue is that Russia also will experience tougher competition for the share of foreign direct investment (FDI) against other emerging economies (so-called 'BRIC' countries such as Brazil, India and China). All the weaknesses that the economic system has at the moment will not help to gain more investment inflows in the future. The Swiss business school IMD has released the results of its annual survey of the world's competitive economies and Russia is ranked 43rd out of 55 countries.[60] Analysts believe that foreign capital investment in Russia will grow gradually in the near future, provided that Russia sustains a favourable investment climate. Experts name the following components of investment attractiveness: competitive economy, the rule of law, political stability, and high level of integration into the global economy. Furthermore, analysts point out Russia's high dependency on oil prices. However, it is likely that foreign investment in new facilities and modernisation of existing ones will become Russia's primary source of capital inflow. Some experts believe that securing foreign investment by enhancing reforms is a positive process, as it helps to boost capitalisation of the country's banking system. Furthermore, Russia needs to secure investments in non-energy sectors.

World Bank in its Russian Economic report in November concluded: "*While much has been achieved during transition, more needs to be done to further improve the investment climate so that Russia can fully benefit from global economic opportunities". Increasing the stock of infrastructure in Russia to the level of the median industrial country would raise productivity growth in Russia by 1.4 per cent, improving the quality of infrastructure — 1.4 per cent, increasing financial development — 0.9 per cent, improving institutional — 0.5 per cent, education — 0.3 per cent, lowering inflation — 0.2 per cent*. [61]

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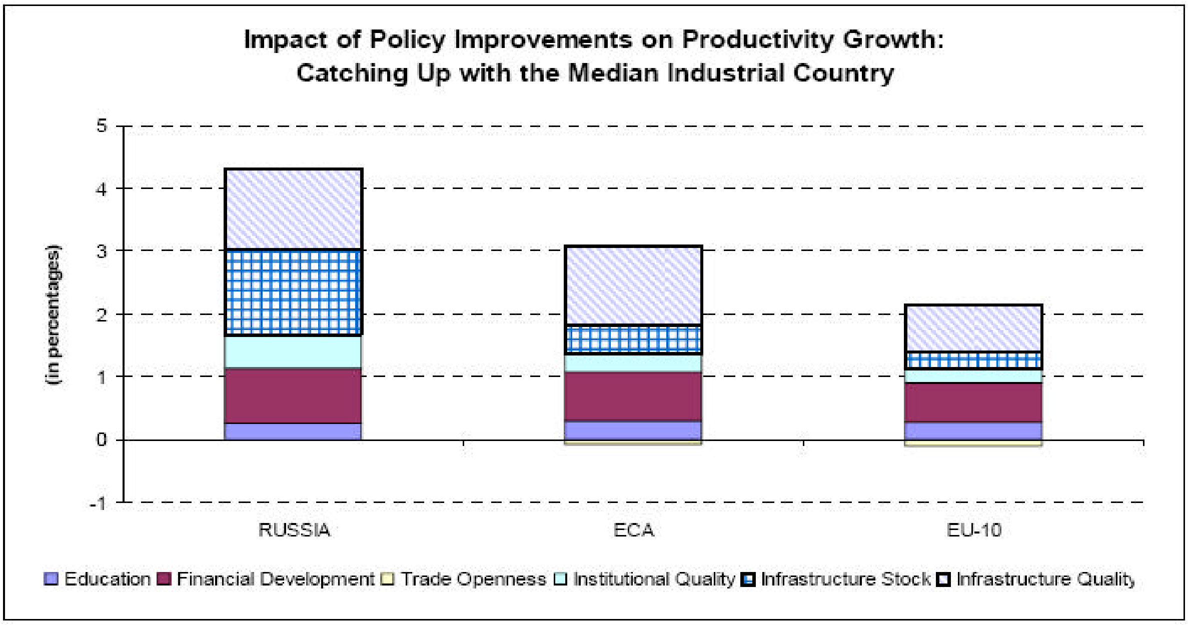
[58] "Russia to stop strengthening the rouble: central bank", Mikhail Khmelev (*The Financial Express*: August 28, 2007), originally the information was published by RIA Novosti.

[59] "Russia's booming economy" from the Economist Intelligence Unit ViewsWire, June 18 2007.

[60] Russia economy seen as one of the world's least competitive, (*Novye Izvestia*, May 14, 2007).

[61] Russian Economic Report ? 15, (World Bank Russian Country Office, Economic Management and Policy Unit: November 2007).

Russia has most to gain from policy catch-up



Source: Bank staff calculations. See Calderon, C (2007)

"The most obvious answer to critics of recent Russian state intervention is to point to the country's continued high growth and surging inward foreign investment. Russian economic liberals like Evgeniy Yasin or Andrei Illarionov counter this by arguing that the economy would be doing even better if the state intervened less (or intervened in a more predictable, rule-of-law-governed way)... If the Russian state is undermining business confidence by making property rights more uncertain than they were before, how does it come about that western banks are lending more than ever to Russian companies, western and Russian investors are shovelling funds into a spate of Russian company initial public offerings, mainly on the London Stock Exchange, inward foreign direct investment exceeded outward in 2006 and the first quarter of 2007, and capital flight is down?" [62]

The last and the most serious concern is that Russia's domestic economy urgently needs modernisation of its infrastructure and industrial facilities, including its vital energy sector. Given that Russia is not only the world's largest country but also its coldest, roads, transport, communications, housing and utilities and financial services are not only in a poor state in a large part of the country but in many places are absent altogether. According to the Transport Ministry, 60 per cent of federal roads do not measure up to standard and 27 per cent are overloaded. Meanwhile, road construction is progressing at a rate of less than 1 per cent per year. This means that the situation is near critical point and that if something is not done soon Russia will face the very real possibility of an infrastructure collapse. But this kind of large-scale infrastructure construction and modernisation requires absolutely

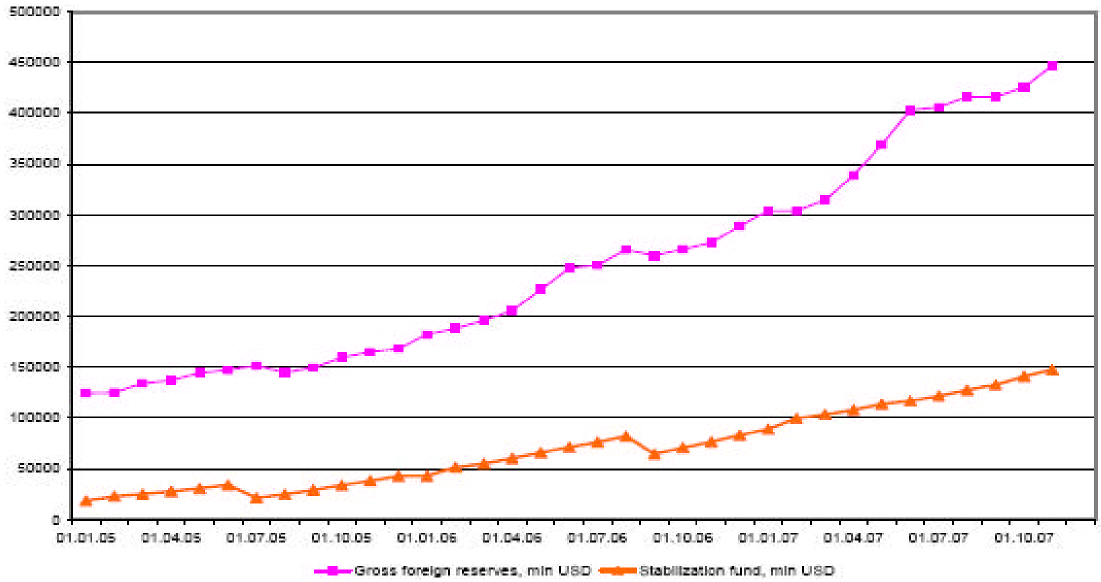
[62] Data from the Central Bank of Russia, see http://www.cbr.ru/statistics; "The Russian economic puzzle: going forwards, backwards or sideways?" by Philip Hanson, (*International Affairs* 83: 5 (2007), p. 884

immense sums of money. These are big projects that need investment over a period of 15-20 years, and it means serious portfolio investment.

"To many (or at least to the media), it seems obvious that we need to develop our infrastructure, using money from the Stabilization Fund. We know this from the experience of the rest of the world; a simple analysis of successful economic leaps forward in other countries proves that it is so. Intellectual exercises are one thing, however, and political decisions and practice are another. The mighty Soviet infrastructure, especially in the energy field, has proved to be extremely viable. It has made it possible for the country to survive over the past fifteen years, without practically any renovation or modernisation. For Russian capitalism in its initial stage of development, it was entirely sufficient... There's absolutely no doubt that in the coming years we will see answers to the infrastructure problems. It seems that we are already on the verge of a boom in this field... But what about the "wrong" government, the one that does not want to see any serious changes in its policy? Well, there will simply be another government". [63]

The debate about how to use the money from Russia's $148 billion oil windfall fund, one of the world's largest sovereign wealth funds, is still on. There are few options articulated by the official politics: to invest in Western stock market indexes or turn it into the Reserve Fund to be used to finance voluntary pension savings and to cover deficits in the state Pension Fund.

Accumulation of Foreign Reserves and the Stabilization Fund



Source: CBR

[63] "The Year We Became Aware of Ourselves as a Nation" by Valery Fadeev, (*Expert magazine*: ? 1-2(543): 15 January 2007).

If the opinion of using the Stabilization Fund money inside the country gains the upper hand, this could lead to higher inflation rates, and hence, growing social discontent and a further slowdown in economic growth. Moody's predicted the growth of inflation in case of this scenario at 9,1 per cent.[64] All this may lead to a crisis. In an interview Boris Titov, chairman of the national organisation Business Russia, said, "*We need to decide urgently what makes more sense for us: to not give anyone money for development and place our funds abroad at 2 per cent annual interest, which amounts to financing other country's economies, or to take the risk and invest in our own economy. If we put money into infrastructure projects we get the chance to create thousands of new jobs and fill the order books of construction firms, carmakers and service companies. This will give an impulse to business development right along the line, from the small firms to the big companies. America pulled its economy out of the great depression through infrastructure projects, mortgages and defence procurement*".[65]

Moreover, the 2008 reorganization of the Stabilization Fund into a Prosperity Fund (for long-term benefits) and a Reserve Fund (to protect budget spending against a large and sustained fall in oil prices) could weaken money 'sterilization'. Under the new rules, amounts coming to the Reserve Fund when it is already at or above 10 per cent of GDP can go either to the Prosperity Fund or to subsidize the budget. Because of the dominance of the state decision in the economy and lack of market mechanisms Russia is unable to use the currently favourable international economic conditions to push through the reforms of domestic structures that would lay the foundation for high-quality, sustainable growth.

The Stabilisation Fund is a by-product of state regulating economic policy as well as high oil rents. The lack of pressure on the state to transfer resources in other projects with participation of private investors due to current lack of marketing mechanisms and policy regulations, combined with prudent management of the state budget, has resulted in a situation, where the state has built up a large Stabilization Fund, indented to act as a cushion for the state budget when the price of oil falls. The existence of such a fund in itself undermines business confidence, which will affect investment and perpetuate the problem of capital deficiency.

Though some improvements can be seen mostly due to Sochi hosting the 2014 Winter Olympic Games. Speaking at the Sochi investment forum, Putin said his administration was working to encourage private investment, the sums of which can double and triple the state investments. The government though ordered the Economic Development and Trade

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64 "?????? ?? ???????? ????? ?????????? ???? ?????????? ????????? ? 2007 ????", www.k2kapital.com 13.12.2007

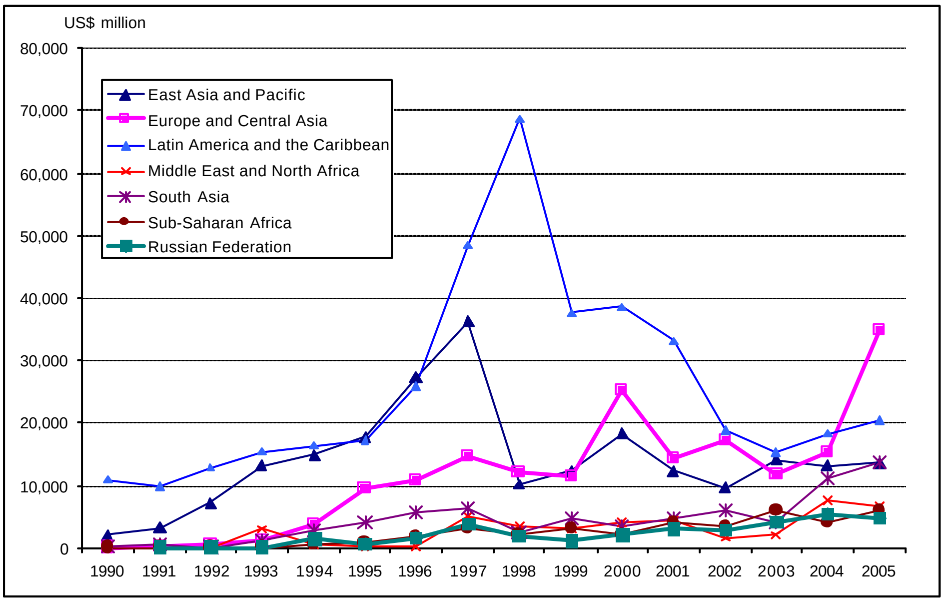
65 "A promising partnership", Maria Semenova, article published in Russian in, (*The RBCC Bulletin:* June 2006).

Ministry to transfer 90 billion roubles from the Stabilization Fund to the Investment Fund, which is used for infrastructure projects, according to *Prime Tass*.[66]

Russia, currently in the middle of an election cycle, plans to spend $1 trillion over next ten years to improve its ageing infrastructure in the next ten years: over $195 billion on the road system modernisation, $204 billion on Russia's railways, $380 billion on health system, $118 billion on energy systems, etc. It has created several development institutions to channel public funds into the economy, *Reuter's* reports.[67]

This is a positive sign though the process is again driven by the state controlled procedures rather then by market competition, and at the moment Russia is the country with the lowest level of participation of private investment in major infrastructure projects. It is hard to believe that within the existing reality it will not be the same over bureaucratised and corrupt system, attracting the certain circles of business elite for the lucrative projects, undermining any market competitiveness and openness, and delivering questionable results.

Private participation in infrastructure projects



Source: World Bank

"In an economy where most of the power is vested in the government, it is the State which will be investing money into economic growth... This climate is seen to be destructive for the 'competing' private business who must struggle against legal instability and monopolised markets. Under such an economic regime the only activity likely to thrive is bureaucracy. Money filters through an ever expanding network of bureaucratic channels and will tend to be concentrated towards those manufacturing giants connected with the State's Military-

[66] Government rules to invest 640 billion roubles in four state funds, corporations, this content was part of the mail product Investor weekly on 3 December 2007.

[67] Russia's EconMin ups '07 GDP growth forecast, (*Reuters*: December 14).

Industrial ambitions... The monies required to fund this State machine are obtained primarily through taxation, this includes high taxation of interest paid on the nation's savings and of small and medium-sized businesses. In essence the middle class of society is bled dry to fund the continuing super-enrichment of the ruling elite."[68]

Little reform and statism

The state itself in Russia remains little reformed and the transition remains incomplete because market institutions function in an excessively opaque and insecure environment. The underlying precondition for this – easy to state, but hard to achieve – is the establishment of bureaucratic and judicial systems that impartially administer clear and consistent rules. This is because, while the state lost the functions of a planned economy, it continues to exert considerable powers which are often administered in discretionary ways.

There is evidence that the state is growing larger. State employment grew by 10.9 per cent in terms of the number of persons in public administration in 2005 alone, a rise driven by a staggering 28 per cent year-on-year increase in the number of people employed in the federal executive branch, accelerating the trend towards a larger bureaucracy that has gathered pace since 2001. Altogether, the number of officials employed in public administration grew by around 33 per cent during 1994-2005.[69] Troika Dialog, a Russian brokerage, has shown that there has been a close correlation between the oil price and the number of state employees in recent years. Some would also argue that the challenge of reforming Soviet state institutions is made harder still by the so-called "resource curse". According to this view, natural-resource abundance risks of stunting legal and institutional development, as conflict over control and distribution of rents tends to dominate at the expense of rule-based governance.[70]

There is little evidence that the state plans to reform itself. This, though, would be the most effective long-term use of any spending increases. A programme of real administrative reform to modernise the state would both raise the efficiency of all future government expenditure and raise market efficiency by reducing the distortions in the bureaucratic environment facing business. Moreover, not only has administrative reform largely stalled, but there are signs of a limited reversal of the partial rationalisation of the federal bureaucracy that took place in 2004.

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[68] ???? ??????, "??????????? ? ????????: ??? ???????? ????????????? ?? ?????? ? ???????? ????????????? ???????", ???.: ?????, 1997.

[69] OECD Economic Surveys: Russian Federation, Vol. 2006/17--November 2006, p. 119.

[70] Troika Dialog, Russia Economic Monthly, Oct. 2006 and 'Duma Approves Bigger Budget, Prompting Fear' by Anna Smolchenko and Oksana Yablokova, (*St Petersburg Times*: September 26, 2006).

Against this background, this growing, unreformed state is playing an increasingly active role in the economy. It seems clear that a policy of gaining dominance over "strategic" sectors, notably energy, continues to be implemented. Less clear, though, is how much further the designation "strategic" will be applied. There are signs that it includes major manufacturing sectors, such as aircraft (United Aviation Company), automotive (AvtoVAZ), metallurgy (VSMPO-AVISMA Corporation) and shipbuilding (Novoship). As well as in other sectors such as mining (RusSpezStahl), technology (RusTechnologia, Russian Nanotechnology Corporation), banking (Sberbank, VTB), oil (Rosneft) and now nuclear energy (Atomenergoprom). *"With annual sales of about $8 billion (£3.9 billion), Atomenergoprom is designed to be a nuclear equivalent to Gazprom, the state-controlled Russian gas monopoly, and forms part of a strategy to bolster the country's position in key international industries in which it has resources and expertise".*[71]

That process may be right for the natural resource industries, most countries have natural reserves industries under state control, and the United Kingdom is rather exceptional from this perspective. At the same time the 'Strategic sectors bill', which was postponed until 2008, names some 39 sectors in all considered "strategic". The state ownership of each sector has grown most notably for the last four years in two areas, namely oil and gas, and manufacturing. Across the rest of the economy, the state tries to liberalise those companies by selling out the shares to public investors. The Kremlin's top economic adviser, Arkady Dvorkovich warned against the creation of more state corporations as a way to boost economic growth: "*I view the fashion of creating state corporations as being extremely dangerous, particularly for the industries being proposed*," he said at a business forum, *Interfax* reported.[72] All in all it creates a vicious circle undermining the free market principles.

"*Two other processes complete the outward and visible signs of this turn to statism. One is the formation of state holding companies in several sectors designated strategic. So far, these comprise the Rosoboroneksport grouping—arms related but also incorporating the largest Russian carmaker, VAZ; the United Aviation Company (making aircraft, not running airlines); the United Shipbuilding Corporation; Atomenergoprom (for the civil nuclear industry; due to come into operation in 2008); and a grouping being formed for research and development in nanotechnology.*

The other process is the drawing up of legislation to define what natural resource deposits will be deemed strategic and what will be classified as a strategic enterprise. Only in

[71] "Russia forms state nuclear giant to compete with overseas rivals" by Robin Pagnamenta (*The Times*: December 11, 2007).

[72] "Kremlin Aide Warns of State Control" by Anatoly Medetsky and Miriam Elder, (*The Moscow Times*: Thursday, October 4, 2007. Issue 3757. Page 1.).

exceptional circumstances, and subject to approval by the government, would a foreign-controlled entity be allowed to control either a strategic deposit or a strategic enterprise. The question of strategic deposits is to be covered by a revised law on the subsoil, the subject of enterprises by a law on strategic enterprises".[73]

The influence of bureaucratic state powers goes beyond formal ownership. Formal studies and anecdotal evidence alike suggest that corruption is becoming a more severe problem. Since corruption usually involves the use of "public office for private gain", analysts link this trend to the discretionary use of regulatory, oversight and other powers. The uncertainty this produces is one important reason for the relatively low level of domestic investment. Business continues to express concern about tax administration, but little has come of discussions about regulating the powers of the Federal Tax Service.

Small enterprises –a motor of growth in the most successful transition economies– remain hindered by over-regulation. As World Bank reports in Russia, only about 5 per cent of firms were created or destroyed during the last decade, and less than 10 per cent of entrant firms survive after 7 years. While the healthy market economies exhibit about 5 to 20 per cent of firms enter and exit the market every year. The lack of correlation between entry of new firms and productivity growth of existing firms in Russia signals weak market competition. Failure rates among young businesses are high in all market economies, but in industrial countries about 50-60 per cent of new firms are still in business after seven years.[74]

"*The key problem with the Russian economy is the role of the state. The state is the economic regulator, but does not respect the supremacy of law and operates on the basis of slippery, unofficial rules that it does not even observe consistently itself. The expansion of a state that rejects the rule of law makes corruption inevitable and drives business into 'grey areas'. Moreover, the bureaucratic corporation has privatized the state, leaving no room for the observance of property rights or economic laws. No amount of economic reform can stimulate business activity while the state is the servant of the bureaucratic corporation and refuses to operate in a competitive environment*".[75]

The state structures remain little reformed. State influence, including direct ownership, in the economy is growing. Over-regulation, uncertainty and corruption remain serious problems. In addition to all that Russian firms have largely exhausted the post-crisis

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[73] Philip Hanson, 'The turn to statism in Russian economic policy', *International Spectator* 42: 1, March 2007, pp. 887.

[74] Russian Economic Report ? 15, (World Bank Russian Country Office, Economic Management and Policy Unit: November 2007).

[75] 'Post-communist Russia: a historic opportunity missed' by Lilia Shevtsova (*International Aff airs* 83: 5 (2007), p. 895.

productivity gains derived from utilization of idle capacity and labour shedding. For several years, firms were able to raise productivity quickly on the basis of little investment, by drawing on the existing underemployed stock of capital and labour. However, capacity utilization rates rose from 42 per cent in 1999 to almost 70 per cent in 2005. Productivity gains far outstripped wage growth in the first years of economic recovery, but wages have been rising rapidly in recent years, and this gap is now closing. The real effective exchange rate has gradually returned to its pre-crisis level, and Russian firms operating in non-energy sectors have to cope with growing pressures from foreign competition.[76]

"*Without a proper rule of law, honest administration, sound banks and secure private property, it is not possible to create a free-market economy".*[77]

Russia is a very big country, rich in natural resources, so it often faces the choice regarding whether to integrate into the global economy with all the material benefits following with it or to stay independent using its internal resources. The latter option is very tempting for Russia. '*It remains the case that countries with big markets are more able to secure market access and deter actions against their exporters than countries with small markets*'.[78] It is a very true statement especially for such country as Russia, and such ability holds a true danger. Following the collapse of the Soviet Union most of the state enterprises that had flourished quickly ceased to exist. The similarity of soviet type of companies and the newly created monopolies is that they are afloat just because they are protected from competition and that the state's and corporations' interests are profoundly inter-related with one another. The market reforms of the 1990s created pseudo-market institutions, which in practice just conceal often authoritarian, oligarchic and bureaucratic system. Without an adequate legal system powerful state becomes an obstacle to further economic development and creating a competitive market economy.

"Yet both theory and experience show that the more interventionist the state and the more closed the economy, the more likely the government is to be captured by powerful interests".[79]

[76] Russian Economic Report ? 15, (World Bank Russian Country Office, Economic Management and Policy Unit: November 2007).

[77] Margaret Thatcher "Statecraft: strategies for a changing world." , 2002, pp. 84.

[78] Martin Wolf, "Why Globalisation Works?" (Yale Univercity Press New Haven and London, 2004), p. 208

[79] 'Why Globalisation Works?', Martin Wolf (Yale Univercity Press New Haven and London, 2004), p. 75.

WTO and protectionism

Though liberalisation of foreign trade is an integral part of the transition reforms in Russia, the Russian government faces an old dilemma. Opening the economy to global, competitive forces may promise new wealth while ending state subsidies and protective measures as required by the World Trade Organization could enhance the competition on the market to the level which majority of existing companies will be unable to sustain.

"The importance of this discussion is illustrated by the government's handling of issue such as the WTO accession bid, EU enlargement, and even foreign investment. In theory, it recognizes that the presence of such challenges could act as a useful spur to Russia's economic development. For example, the requirements of WTO accession and the opening up of the economy to increased foreign competition will force whole sectors — particularly in secondary industry and services — to reform or die... But in practice the Putin administration has tended to see the requirements for such transforming change more as a threat that an opportunity". [80]

The liberalisation process at the moment is rather chaotic and doesn't reveal any coherent strategy. In fact, it is sequence of internal lobbying activity by powerful monopolies and external pressures, such as demands of international organizations, restrictions applied on Russian exports by foreign countries etc. As a result, government became a kind of arbiter between sectoral protection demands, budget revenue considerations and demands from international organizations.

According to a survey of chief executives of Russian major companies by PricewaterhouseCoopers conducted in March 2007, compared with only 27 per cent of respondents around the world, 57 per cent of Russia's business community agree with the position that national governments should protect strategic industries from foreign control, only 45 per cent of Russian top managers agree with this statement that globalisation is equally beneficial for both developed and emerging markets, , while this indicator equals 73 per cent worldwide and 89 per cent in the USA. Russia is negotiating an extension of the 'transition period' for 'strategic' industries, but the question of joining the global community is far deeper. "*The issue of WTO accession is not merely about reconciling liberalising and protectionist tendencies, but is a microcosm of a debate that has been going on for some 10-15 years since Gorbachev introduced perestroika in the mid-1980s, namely, concerning the appropriate pace and nature of economic change*".[81]

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[80] Bobo Lo, "Vladimir Putin Putin and the Evolution of Russian Foreign Policy", (Oxford : Blackwell, 2002), p. 55-56.

[81] Bobo Lo, "Vladimir Putin Putin and the Evolution of Russian Foreign Policy", (Oxford : Blackwell, 2002), p. 59.

Despite the resistance of a powerful lobby to Russia's joining the WTO, as well as the switch in priorities in the international policy which took place from between 2000 and 2003, Vladimir Putin over this period of time has made Russia's WTO accession one of his key priorities. However, when he failed to reach his self-imposed deadline of 2003, it is evident that his interest in further pushing this forward seems to have wavered. Despite all that Russia's WTO accession is just a question of time. About 90 per cent of the work of accession has been done in the course of negotiations. Nevertheless, despite the fact that efforts towards WTO accession seem to have decreased, the fact remains that the majority of the preparation work has already been undertaken, and Russia is now on the back straight of negotiations, requiring (an admittedly concerted) final push to finalize accession agreements. Accession would integrate Russia fully into a rules-based global trading regime and grant it recourse to an international dispute resolution system.

"Russia will probably be a WTO member from July 1, 2008, said Andrei Kushnirenko, deputy head of the trade negotiations' department at the RF Economic Development and Trade Ministry... "There are grounds to suppose that the technical and organizational procedures would be competed in the first quarter of 2008, and legal implementation would take another month. So, Russia could be the WTO member from July 1, 2008," Kushnirenko explained".[82]

Russia remains the largest non-member of the WTO. *"Nowhere is this better illustrated that in the debate and negotiations over Russia's accession to the WTO, a painstaking process that highlights a number of political, psychological and economic issues. The first, and oldest, is the notion of a 'divine right of membership'....* The second, related, issue is the question of primary motivation — why does Moscow want to join? ... As an editorial in The Economist remarked, *'Joining a health club can reflect a genuine interest in fitness — or just a desire to keep up with the neighbours".* [83]

Whenever the reason for joining, the WTO as a dispute-settlement system will force the government to take necessary changes in accordance with the organizational requirements. Russia wants to gain the benefits imbedded within the WTO accession but at the same time without inclination to change the existing system, accepting international norms. *"International economic integration increases competition among governments... This competition constrains the ability of governments to act in a predatory manner... A benevolent government needs to find ways to bind itself, in order to increase the credibility of its commitments to the private sector, both domestic and foreign. One of the best ways of doing so is to make commitments to other governments, as in the WTO, or to powerful*

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[82] "Russia to Join WTO by July 2008", (Kommersant: Nov. 13, 2007).

[83] Bobo Lo, "Vladimir Putin Putin and the Evolution of Russian Foreign Policy", (Oxford : Blackwell, 2002), p. 55-56/ The Economist, 22 November 2001.

outside private parties."[84] Russia's membership in this respect in the WTO is one of the most effective instruments that will oblige the state despite its internal interests to make changes so as to guarantee the development of a transparent and predictable legal environment that meets the international standards. WTO accession must be used as the anchor of a large reform process.

"*Hence the redoubled emphasis on WTO accession, at once the most practical and emblematic representation of economic cooperation and 'integration' with the West*". [85]

Several studies have examined the effects of WTO entry on the Russian economy. It will definitely increase the level of competition and this means that the consumer should get better choices, better quality services and cheaper prices for these services. The real winner should be the person on the street. An assessment by the World Bank concludes that welfare gains from Russia's accession will be equivalent to 3.3 per cent of Russian GDP in the medium term, growing to 11 per cent and up to 72 per cent in the long-run, benefiting from improved investment climate. [86]

All that will provide a strong basis for discovering the consumer society and sustaining the growth of the middle class with the necessary purchasing power, and the beginnings of the medium and small business, the critical elements of any developing economy.

"Free trade" is pulling millions of Indians and Chinese from out of poverty into middle class; America must be willing to compete in order to not lose the velocity of its own middle class… There is nothing better for the promotion of the middle class in the history of the world than is the function of "free trade". America has been the economic superpower for the past sixty plus years as a result. If America abandons, or even minimizes the importance of "free trade", it will be at the expense of its middle, not upper class". [87]

In Russia, there is increasing momentum behind the economic and political trend that is helping the middle class and private business to become a counterbalance to bureaucratic domination. It will increasingly demand democratic political institutions, or perhaps initially simply more efficient and transparent institutions including and maybe first of all a far less corrupted and more independent legal system. That will be a power which will need to be respected and which doesn't exist now.

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[84] 'Why Globalisation Works?', Martin Wolf (Yale Univercity Press New Haven and London, 2004), p. 276.

[85] Bobo Lo, "Vladimir Putin Putin and the Evolution of Russian Foreign Policy", (Oxford : Blackwell, 2002), p. 122.

[86] Jesper Jensen, Thomas Rutherford, and David Tarr, 2004, Economy-Wide and Sector Effects of Russia's Accession to the WTO, Washington: World Bank.

[87] "The benefits of free trade" by Jack Buffington, corp.helium.com

Conclusions

The issue of successful economic development and the government influence to this process is clearly complex. As the two opposed examples in the history of contemporaty Russia illustrate: the stronger state can demostrate better economic results and more productive growth. This fact is widely recognised by institutions incarnating the Washington consensus policy. The IMF admits that the shock therapy condemned entire generation to abject poverty, and the trade protectionism is necessary for transition economies.

To start with it is not possible to ignore the paradoxical fact that in practise is very logical, that the preponderant role of the Russian state has made the country particularly vulnerable after the crush of Soviet Union system. At the beginning of this analysis we questioned the issue of the role of the state in the development of the Russian economy, and what is the good government? The state or the government can not be bad or good, it exists and operates within certain environment. A strong state can deliver positive economic results in certain political situations; while the policy of state expansion has certain limitations. *"Even good and relatively uncorrupt governments are highly imperfect, by their nature. But they are also absolutely essential. So a central question is how to obtain the best governments one can. The answer to this question can be divided into two parts: internal reform and regulatory competition*".[88]

Russia's development is a complex mix of trends that defies easy generalisation. Markets are developing rapidly, offering excellent opportunities for foreign investors. But a bureaucratic state is also growing, fuelled by a large budget surplus. Within the current formation of 'state capitalism' or 'bureaucratic capitalism', which is often called 'crony capitalism', the intertwining interests of the state authorities and certain business entities are deeply interrelated, the busness goals are limited by enrichment through property redistribution. Expanding its influence state applying the standard mechanisms of state entrepreneurship, creating state monopolies, to the extend when the line between business and government gone. This hinders the full potential of market development through inefficiency, over-regulation and corruption. At best, this prevents market growth from achieving its full potential. At worst, it could foster a political economy of high bureaucratic and political risk in which relationships matter more than rules, whose vulnerabilities could be exposed if international economic conditions change.

"*We know one thing that state cannot do — plan an entire economy. We know there are some things states must do — protect property rights. This is a 'must have' if there is to be a*

[88] 'Why Globalisation Works?', Martin Wolf (Yale Univercity Press New Haven and London, 2004), p. 73.

sophisticated market economy".[89] Within the current framework the property rights, juridical reform and effective law enforcement will continue to be pressing issues.

Though the state seems to have a dominant position and the unshable support among the population, it is a deluded stability supported by the high level of annual economic growth, which was mostly provided by high oil and gas price. Whenever the economic growth and population prosperity will be questioned it will put the stability at risk, to keep that in place the state should emforce the further reformes to give way to development of busness and continue its engagement with the global economy. The recent record of emerging markets confirms that globalisation offers major benefits to countries that embrace its potential. It seems that some among those in power in Russia are still deciding how fully to do so. It may be that Russia is considering trade-offs between the clear welfare benefits of international integration, and maintaining a degree of control that attempts to limit them – possibly, in part, to use the strands of foreign economic relations as sources of broader international influence. How fully and effectively Russia meets the challenges of globalisation will have a major impact on its long-term prosperity.

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[89] Martin Wolf, "Why Globalisation Works?" (Yale Univercity Press New Haven and London: 2004), p. 67.