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# The Impact of the Financial Crisis on Russia

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**THE IMPACT OF THE  
FINANCIAL CRISIS  
ON RUSSIA**

by Silvana Malle  
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## INTRODUCTION

The economic crisis has had a devastating effect on the Russian economy in absolute and comparative terms. Not only has it had a significant impact on Russia's economic and industrial strength, it has also underscored the wider difficulties and limitations in managing the Russian economy: private and public investments have been falling dramatically under the impact of the crisis; transport and residential infrastructure remains in a dire state; innovation cannot be driven by fiat from above and there is no sign of systemic institutional change. Moreover, the interrelations between the economic, political and structural aspects of the Russian crisis highlight that there is little room for economic diversification in so far as the leadership continues to pursue two fundamentally contrasting goals – state control over natural resources and their use as strategic weapons versus a level playing field where investors compete for the best allocation of resources. However, state control over the economy has rapidly increased. The share of state in the economy has gone up to 50% (from an estimated 35% before the crisis).

This paper examines the impact of the economic crisis on Russia and the Russian government's response to it in depth in four parts. It looks first at the economics of the crisis in Russia, outlining the scale of the crisis, its cost to the Russian economy and the impact of credit problems such as non-performing loans (NPLs) in exacerbating the cost of the crisis in the near future and sketching the context in which the Russian government is likely to have to seek domestic and foreign loans. Second, the paper assesses the economic structure of the Russian corporate state, looking at the role of the budget funded state corporations, and plans for modernisation and economic diversification. Third, Russian regional projects and attempts to introduce reforms to the international financial system and establish the rouble as a reserve currency are then examined, including the decision to set up a Customs Union with Belarus and Kazakhstan and international elements of the Long Term Socio-Economic Development plan to 2020. Fourth and

finally, the paper assesses the evolving political situation as the crisis has unfolded. The key points to emerge are that central power has continued to strengthen under President Medvedev and that a Russian-style corporate state is taking shape. Essentially, while the power elites take credit for social stability, private businesses are forced to abide by government's instructions against lay-offs and wage arrears.

## THE ECONOMICS OF THE RUSSIAN CRISIS

The impact of the global crisis on the Russian economy came as a surprise to the authorities, and the unravelling of the crisis was shocking. In a few months from mid-September 2008, the fall in the prices of oil and commodities combined with sudden reversals in capital movements, the depreciation of the rouble, and the crash of the Russian stock exchanges. A large share of non-governmental foreign debt accumulated over a decade of growth was coming to maturity,<sup>1</sup> just as industrial output and GDP growth turned negative by December 2008.

The authorities were slow to react. Patchy government support measures were approved under the pressure of events in the first months of 2009. Precious time was lost before a sound appraisal of the current and potential damage to the Russian economy, caused by the burst of the financial bubbles in the USA and the spreading of the crisis all over the world, was carried out. Indeed during this time, government and presidential authorities often produced conflicting assessments, projections and proposals.<sup>2</sup> The revised federal budget lowering the reference oil price from \$95 to \$41 per barrel (pb), was finally approved in May 2009. For the first time since 2000, a new budget was based on a deficit of 7.4% of GDP (largely due to the fall of oil revenues) to be almost entirely funded by the sovereign reserves. The deficit was (optimistically) based on a -2.2% GDP projected growth, much lower than that projected by the major international organisations (IMF, OECD

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<sup>1</sup> The foreign non-government debt accumulated by state and private entities reached about US\$500bn in 2008, of which US\$36bn was coming to maturity in the last quarter of 2008 and 140bn in 2009. While, as a rule, public balances are not concerned with non-government debt, in practice the latter becomes a contingent liability to the government if entities involved, as in the Russian case, are considered strategic or too big to fail. For more, see Malle, S, "Soviet legacies in post-Soviet Russia: insights from crisis management", *Post-Communist Economies*, Vol.21, no.3, September 2009, p. 258.

<sup>2</sup> *Ibid*, pp. 255-257.



and WB). At that time, the worst projection was the World Bank's  $-7.9\%$  GDP growth released in June 2009.<sup>3</sup>

By the beginning of 2009, international reserves were down by one third, from the peak of almost US\$600bn reached by mid-2008, declining to a low of US\$386,5bn by end-January 2009. This was in part due to the depreciation of the rouble, in part to spending schemes set up by the government to help large banks and enterprises meet their foreign obligations. The Central Bank of Russia (CBR) carried out a policy of managed depreciation of the rouble, before announcing by the end of January 2009 its policy of keeping the value of the rouble within a band of 26 roubles (appreciation limit) to 41 roubles (depreciation limit) to a basket made up of 45% euros and 55% US\$.<sup>4</sup> Though costly for reserves, this policy helped protect household savings, in contrast to the damage inflicted to the public by the August 1998 rouble devaluation. By March 2009, 30% of savings had been converted into foreign currency. Domestic capital flight started mitigating in the second quarter of 2009, following signs of stabilisation of the rouble driven by the gradual increase in oil prices from the low of US\$33.8p/b attained by end-2008 and the concurrent surplus of the current account of the balance of payments (BoP).

Altogether, however, the cost of the crisis for Russia was high, estimated over the three quarters of 2009 to have been 11 trillion roubles (about US\$370bn).<sup>5</sup> Russia fares worse than OECD economies whose output fall is projected to be around  $-3.5\%$  in 2009<sup>6</sup> and much worse than the other three large emerging market economies, China, India and Brazil of the so-called BRICs. OECD projections are that the rate of growth in Brazil will stagnate, whilst China and India are projected to grow by 9% and 6.1% respectively.<sup>7</sup> In comparison, by the first half of 2009 Russian

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<sup>3</sup> See the World Bank's June 2009 Report on Russia from <http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer19-eng.pdf>

<sup>4</sup> See *Financial Times*, 22 January 2009.

<sup>5</sup> Cfr. data reported by Reuters and other agencies in <http://www.rg.ru/printable/2009/09/17/krizis-tsena-site-anons.html>

<sup>6</sup> See *OECD Economic Outlook*, Volume 2009/2, No. 86, November 2009.

<sup>7</sup> See *OECD Economic Outlook*, Volume 2009/1No.85, June, pp. 178-189. On estimates and projections for China based on national data see

GDP had fallen 10.1% driven by a collapse in industrial output of over 14%.<sup>8</sup> Recent estimates published by the Russian Ministry of Economic Development (MED) suggest GDP growth could fall by 8.0-8.5% in 2009 while the OECD estimates an output fall of -8.7%.<sup>9</sup> According to official data published in September 2009, the unemployment rate is up to 8.3%.<sup>10</sup>

The cost of the crisis is likely to increase further. It is difficult to assess what will be the effective cost of Russian banks' recapitalisation by the end of 2009 and in 2010 when a huge portion of NPLs will surface.<sup>11</sup> Nevertheless, the volume of NPLs has increased dramatically: by 43.2% in 12 months from July 2008 and is estimated at 1.2 trillion roubles (c.US\$40bn).<sup>12</sup> But the CBR's estimates on NPLs do not reflect effective costs, since they do not meet more severe international standards that include the principal and not only foregone interest rates.<sup>13</sup> According to Russian experts, losses to creditors are increasing by US\$2bn a month.<sup>14</sup> It is worth noting that Russian banks, not unlike others but probably to a larger extent, prefer to restructure their credits (which helps to clean their credit portfolio) than immediately initiate

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[http://www.bof.fi/bofit\\_en/seuranta/kiinatilastot/index.htm](http://www.bof.fi/bofit_en/seuranta/kiinatilastot/index.htm) and on India, the estimates of Barclays Capital in <http://in.reuters.com/article/economicNews/idINIndia-39016020090413>

<sup>8</sup> January-August 2009 estimates in [http://www.gks.ru/bgd/free/B04\\_03/IssWWW.exe/Stg/d03/177.htm](http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d03/177.htm)

<sup>9</sup> See RBK- RosbiznesKonsalting, September 1, 2009 on S&P estimates and IMF, *Global Stability Report*, September 2009 and OECD Economic Outlook, no. 86, cit.

<sup>10</sup> <http://www.ng.ru/printed/231413> September 25, 2009.

<sup>11</sup> The draft budget for 2010 includes the emission of 150bn roubles of government bonds for banks' recapitalisation against banks' preferential shares to be transferred to the government see <http://www.rbc.ru/rbcfreenews/20090922112517.shtml>

<sup>12</sup> <http://www.vedomosti.ru/newspaper/article/2009/09/22/214433>

<sup>13</sup> The Deputy Governor of the CBR, A. Ulyukaev hoped for NPLs in the range of 10 to 12% of total credit by the end of 2010, see interview published on 15 June 2009 in <http://www.kommersant.ru/doc.aspx?DocsID=1181297&print=true>. The CBR's Governor stressed later that NPLs were increasing slowly (by only 5% in August 2009) and capital adequacy at 19% (much higher than the 10% threshold fixed by the CB) was comfortable. See [http://www.rian.ru/crisis\\_news/20090909/184314954.html](http://www.rian.ru/crisis_news/20090909/184314954.html). But other bankers point to an increase of NPLs in August by 8.5% and anticipate a peak by mid-2010, see M. Zadornov, Head of the Vneshekonombank, in <http://www.vedomosti.ru/finance/news/2009/09/23/844263>

<sup>14</sup> Bloomberg, 24 September 2009.

bankruptcy procedures that in Russia are comparatively more problematic – not least due to institutional obstacle to the seizure of the collateral.<sup>15</sup> A credible warning, based on the amount of restructured debt (about 25% of the total) plus a multiple by 2.5 of the official 6-7% NPLs' estimates (to raise them to international accounting standards), is that NPLs could have reached already 40% of total credit.<sup>16</sup> Indeed, many of the NPLs that underwent short-term restructuring should emerge already by the end of 2009, when loans issued before the crisis and/or restructured in the course of the crisis by foreign and domestic banks will come to maturity. The CBR has been considering the possibility of setting up *ad hoc* institutes for the management of loss loans, but, given the fragility of the Russian financial system, and opaque information on governance, it will not be easy to implement schemes aimed at a partial recovery of credits by placing in the market *ad hoc* financial instruments. Debt-equity swaps are also unlikely to take place to the benefit of foreign investors in strategic sectors.

So the most negative effects of the financial crisis will become tangible from 2010. The 2010-2012 budget estimates, approved on 23 September 2009, are based on the assumption that the reserves accumulated in the years of bonanza will be exhausted and the government will have to tap both the domestic and the foreign financial markets for resources. According to recent estimates by the Russian Ministry of Finance (MoF), the Sovereign Reserve Fund is likely to be exhausted by 2010.<sup>17</sup>

The outcome could be less damaging depending primarily on effective oil prices, GDP growth and actual budget expenditure. But the underlying developments are problematic. There is a deficit of 1 trillion

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<sup>15</sup> For an expert opinion see *The Moscow Times*, 24 July 2009. For a critical view on legal actions undertaken by Alpha Bank to seize the collateral of a large company (RUSAL) see <http://top.rbc.ru/economics/24/09/2009/331863.shtml> . On this bank's initiative being qualified as raiding (*rederstvo*) see <http://top.rbc.ru/economics/24/09/2009/331932.shtml?print>

<sup>16</sup> See S. Aleksashenko's estimates published at [http://www.expert.ru/interview/2009/10/22/aleksachenko\\_serg?esr=17](http://www.expert.ru/interview/2009/10/22/aleksachenko_serg?esr=17)

<sup>17</sup> The Reserve Fund that was at its peak of US\$142.6bn in September 2008 was down to US\$76.8bn on 1 October 2009 see Malle, S. cit., p.260 & <http://www1.minfin.ru/ru/reservefund/statistics/volume/index.php?id4=5796>

roubles (c.US\$33bn) in the pension fund. This means that in 2010 the government will have to finance the increase in pensions, approved by Putin, by drawing from the resources of the Sovereign Fund for National Prosperity that will concomitantly shrink.<sup>18</sup>

Due to the rapid fall in GDP, budget spending increased during 2009 compared to projections, lifting the deficit up to 8.3% of GDP, equal to 3,2 trillion roubles (more than US\$100bn).<sup>19</sup> The preliminary draft budget for 2010 includes a cautious US\$58/pb reference oil price and a deficit reduction of 1.5 percent down to -6.8% of GDP, assuming that growth would gradually stabilise and become positive at around 1.6% during 2010-2011. The MED forecast a GDP growth of 3.0% in 2011 and 4.3% in 2012.<sup>20</sup> The draft budget, however, is under pressure from strategic sector lobbies and the Duma that has already pushed through an additional spending figure of 0.4% of GDP.

In this context, the government will have to resort to domestic and foreign borrowing. Until the end of 2008 the Russian government debt was insignificant (below 4% of GDP),<sup>21</sup> granting the country a high credit rating and easy access to foreign loans by public and private companies. The preliminary budget draft for 2010-2012 indicates that foreign debt is to increase steadily over the period as the government is planning to place abroad certificates for: US\$12.7bn (2010), US\$14.8bn (2011) and US\$15,8bn (2012).<sup>22</sup> While such volumes are not high *per se*, returns on treasury bonds may become an increasing burden for the budget over time. Indeed, with economic recovery quantitative easing in

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<sup>18</sup> See <http://newizv.ru/print/108500> and <http://www.vedomosti.ru/pda/newspaper/articles/2009/04/28/193309.shtml>

<sup>19</sup> See <http://top.rbc.ru/economics/23/09/2009/331603.shtml>

<sup>20</sup> See MED's forecast in <http://www.economy.gov.ru/wps/wcm/muconnect/economylib/mert/welcome/economy/macroconomy/administmanagementdirect/doc1254407742765> The OECD Economic Outlook (Volume 2009/2, no. 86, November 2009) projects more favourable estimates for 2010 and 2011: respectively 4,9% and 4,2%.

<sup>21</sup> It should be noted that the Russian government has met the payment schedules for 2009 towards the Paris Club and the international organisations. <http://www.vedomosti.ru/newspaper/article/2009/09/22/214432>

<sup>22</sup> See <http://top.rbc.ru/economics/23/09/2009/331603.shtml>. The figures are author's estimates using the MED exchange rate estimates for each year respectively 33,9, 34,8 e 36,4 roubles per USD.

OECD economies will cease and interest rates will have to increase to fend off inflationary pressures stemming from excessive liquidity in the market.<sup>23</sup> It is worth noting that Russia, as a member of the IMF, could resort to IMF lending at lower interest rates (at around 1%), but this option has been ruled out by Putin, as it would entail attached conditionality feared by the government.

Other caveats should be considered with regard to increasing foreign indebtedness. First, despite the comparatively still favourable reserve and debt maturity positions, the fact that the Russian foreign currency reserves (US\$ 378.2bn versus total reserves of US\$ 434.4 that include other assets such as gold) have fallen by early November 2009 below the total foreign (government and non government) debt (US\$487,4bn)<sup>24</sup> could be considered by foreign investors as a sign that the exit from the crisis will not be easy for Russia.<sup>25</sup> Second, the restructuring of non-government debt coming to maturity may become increasingly onerous for banks and companies but also for the budget, if the government, as it appears, continues to be hostile to debt-equity swaps in strategic sectors to which most of the problematic companies and strategic, budget-funded state corporations, the *goskorporatsii* belong. The non-government debt will turn into a contingent liability for the budget and will be perceived as such by experts.

Plans to tap the domestic market for funding can turn to be even more problematic in the light of memories of Russia's default on domestic debt in 1998. The draft budget indicates a cautious starting of treasury bonds emission, followed by a peak in 2011 and downsizing in 2012: US\$7.7bn (2010), US\$19bn (2011) and US\$6.1bn (2012).<sup>26</sup> The peak in 2011 is probably related to the disappearance of the Reserve Fund by end-2010 and an estimated budget deficit of -4.0% of GDP in 2011.

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<sup>23</sup> Australia was the first to increase its benchmark rate to 3.23%, see *Daily Telegraph*, 6 October 2009.

<sup>24</sup> See [http://www.cbr.ru/statistics/print.aspx?file=credit\\_statistics/debt\\_est.htm](http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/debt_est.htm) & [http://www.cbr.ru/statistics/print.aspx?file=credit\\_statistics/inter\\_res\\_09.htm&pid=svs&sid=mra#week](http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/inter_res_09.htm&pid=svs&sid=mra#week)

<sup>25</sup> See Connolly, R. "Financial Vulnerabilities in Russia", *Russian Analytical Digest*, No.65, October 2009, pp.2-6.

<sup>26</sup> <http://top.rbc.ru/economics/23/09/2009/331603.shtml> (based on an Exchange rate of 30 roubles/USD).

How high the returns will have to be to allow for the placement of such a volume of public debt is a matter of concern to the MoF.

In this context the authorities are struggling to foresee other sources of revenues: one could be the privatisation of some assets. Some 7bn roubles revenues from the selling of 5,500 companies are estimated in the 2010 budget.<sup>27</sup> This suggests an estimated average value of circa 1.3m roubles (US\$43,000) per company, hinting in turn that the companies included in the package are in a dire state. In a separate move, Putin announced later a privatisation package for an estimated value of 70bn roubles (c.US\$2.3bn), a tenfold increase compared to original plans.<sup>28</sup> Companies included in this plan may be more interesting for investors. But this remains to be seen as the Minister of Economic Development, Elvira Nabiullina, has made it clear that national security will be the primary concern when selling stakes in strategic companies, effectively ruling out the acquisition of controlling stakes in them. Until the market improves, the privatisation of attractive companies such as Sberbank, Aeroflot, Rosneft', VTB (Foreign Trade Bank), RZhD (railways) and Gazpromneft' is ruled out.<sup>29</sup> The primary concern to the government continues to be keeping control of strategic assets while at the same time trying to lure in private investment.

The crisis has not contributed to any change of state priorities. On the contrary, it may have reinforced *dirigisme* in the economy and a selective approach in industrial policy that is pursued by the Government, apparently in contrast to the agenda of the institutional changes promised by President Medvedev. Corruption that is endemic to the country is worsening as the state's share in the economy rapidly increases. Government interference in individual companies and banks is also on the rise.

From the start of the crisis, and before drafting the new budget for 2009, the government has engaged in selected bail-outs of banks and

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<sup>27</sup> <http://www.vedomosti.ru/newspaper/article/2009/09/23/214563>

<sup>28</sup> The package includes 250 unitary enterprises and bulk of state shares (20-25%) in 462 state controlled joint stock companies to be offered for sale in 2010. See <http://top.rbc.ru/economics/06/10/2009/335096.shtml?print>

<sup>29</sup> <http://www.rg.ru/printable/2009/10/07/aktivy.html>

companies and in singling out immediate priorities. Within the latter, 295 strategic companies have been selected for state support.<sup>30</sup> The defence industry, which incorporates more than one thousand enterprises, has been included in the list as one single company. Other enterprises were subsequently added to the list by regional governments. Worth noting is that direct and indirect government support has been subordinated to meeting a number of criteria/indicators that have made access to government funds difficult, if not impossible, to a number of enterprises, and the actual assignment of funds opaque and open to corruption. The main beneficiaries of selective buy-outs seem to have been managers closer to the power elite, whether in charge of private or public companies. This reflects the ambiguous linkage between economic and political interests in the Russian economy while also pointing to a rising stake/influence of the government and its close entities (*goskorporatsii*) in large private companies.<sup>31</sup>

Corruption that is endemic to the Country is worsening as the state's share in the economy rapidly increases. The last report of Transparency International ranks Russia 147th on 180 countries (on an increasing scale of corruption from 1 to 180) down from 71<sup>st</sup> on 102 countries in 2002.<sup>32</sup> With state procurement becoming a main source of funding for enterprises, bribes, on average, are up to 30% of the value of the deal.<sup>33</sup> Other sources indicate that private enterprises that cannot afford paying bribes are retreating from Sochi, where infrastructure for the Olympics is being built under control of the *goskorporatsiia*

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<sup>30</sup> See on this subject Malle, S. "Soviet legacies", cit. pp.257-262.

<sup>31</sup> Among several such examples, worth noting are the cases of Alfa Bank (run by Mikhail Fridman) that received US\$2bn to prevent its stake in VimpelCom falling under foreign control and RusAl (run by Oleg Deripaska) that received US\$4.5bn to acquire a stake in Norilsk Nickel for similar reasons. Among companies under state control, AvtoVAZ got 25bn roubles just to pay wage arrears. The same day a friend of Chemezov, the powerful head of Rostekhnologii, was appointed manager of AvtoVAZ 19% of the latter's shares were transferred to Rostekhnologii, see <http://www.rostechnologii.ru/archive/0/detail.php?ID=4755> & <http://www.rostechnologii.ru/archive/0/detail.php?ID=4820>

<sup>32</sup> *Transparency international* (Corruption Perception Index) in [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2009/cpi\\_2009\\_table](http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table)

<sup>33</sup> Estimates provided by A. Shokhin, the head of the Russian Industrial Business Association, in <http://www.banki.ru/news/bankpress/?id=1488756>

Olimpstroi.<sup>34</sup> Despite Medvedev's announcement in March 2008 that fighting corruption would be his priority, the evidence so far is that economic *dirigisme* and the larger stake of government and public entities in the economy have become tremendous obstacles to the improvement of the business environment and growth of small and medium enterprises (SMEs).

The share of the state in the economy has increased from about 35% before the crisis to 50% to date.<sup>35</sup> With banks' recapitalisation the stakes of the state in the credit institutions will increase considerably, as already apparent in the most exposed banks.<sup>36</sup> There is also considerable evidence of the government interference in the decision-making of ordinary businesses, from the now established practice of separate meetings with private and public industrial and banking magnates publicised on the government website,<sup>37</sup> to instructions to banks (on credit) and companies (on prices).<sup>38</sup>

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<sup>34</sup> S. Aleksashenko, "Rezhut vse, krome voennykh zakazov", *Kommersant*, *Zhurnal "Ogonek"* no.14 (95092) 17 August 2009, accessed on 24 August 2009. Most of the contracts for an amount of 500bn roubles have been allocated to state companies, see <http://top.rbc.ru/economics/21/09/2009/330889.shtml?print>

<sup>35</sup> See <http://www.vedomosti.ru/finance/news/2009/10/06/853393>

<sup>36</sup> The state share in the large VTB (Foreign Trade Bank) has already increased from 77.5% before the crisis to 85.5% during the crisis, see <http://www.vedomosti.ru/finance/news/2009/09/25/846315>. On the *de facto* nationalisation of banks see <http://www.banki.ru/news/bankpress/?id=1453452>

<sup>37</sup> Go to <http://www.government.ru/content/>

<sup>38</sup> See on credit instructions <http://www.rbcdaily.ru/print.shtml?2009/07/23/finance/424058>. On prices of inputs for agriculture, see Bloomberg, 5 August 2009 & <http://www.rbc.ru/rbcfreeneews/20090703155215.shtml>. On gas preferential price for selected companies see <http://www.vedomosti.ru/newspaper/article/2009/11/19/219248>



## THE ECONOMIC STRUCTURE OF RUSSIA'S CORPORATE STATE

Command of resources by the government and its budget-funded structures, *goskorporatsii*, has strengthened in the course of the crisis. The economic structure has become increasingly dependent on, and subservient to, political power. Development plans have been approved with the aim of modernising the economic structure and making Russian industry more competitive by granting state structures large autonomy in decision-making. A law approved on 5 May 2008 introduced barriers to foreign investments in 42 strategic sectors, including defence, aviation, space industry, digital technology, extraction and commerce of natural resources, media and publications. A 50% participation of foreign – and in some cases even minority shares up to 10-25% of capital, must be authorised by the government and foreign partners are barred from taking strategic decisions.<sup>39</sup>

Under the impact of the crisis, in September 2009 amendments to the law on FDI have been approved making it possible for foreign investors in strategic companies to augment capital through emission of shares with no preliminary approval by the Russian authorities.<sup>40</sup> But since such a decision must be taken by the majority of shareholders – and foreign investors are highly unlikely to be in control of strategic companies – these amendments do not necessarily entail lesser leverage on FDI on the part of the Russian stakeholders. It could make a difference in practice, however, whether the latter are let free to agree/disagree on the basis of considerations merely related to economic performance or remain subject to the political fiat of central authorities.

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<sup>39</sup> Cfr. Malle, S. “The Unravelling of the Market Economy in Russia and the Challenges Ahead”, *Il Politico*, Anno LXXIII, no.2, p.69. Ironically, in the light of the Yukos developments, Putin affirmed before foreign businessmen in Sochi that this law had been approved to meet their demand for transparency in FDI, see <http://www.government.ru/content/governmentactivity/mainnews/archive/2009/09/18/3515131.htm>

<sup>40</sup> See <http://www.rg.ru/2009/10/01/putin.html>

The state's share in the economy is presently estimated by official sources to be about 50% of the total, half of which under the federal government control.<sup>41</sup> State influence is visible in the banking and hydrocarbon sectors particularly. About 45% of banks' assets are controlled by the state, a share that is bound to increase due to banks' recapitalisation. Though the latter will be implemented by exchanging treasury bonds for banks' preferential (no voting) shares, banks will hardly preserve their autonomy. State companies control 83% of natural gas production and 45% of oil output. While *de facto* the energy strategy is under the government's control, *de jure* these companies abide by the commercial code's provisions that include, among else, rules on corporate governance and financial accounts. In theory, at least, this framework should provide some transparency on decision-making and economic results.

It is more problematic to assess the effective role and management strategies of the *goskorporatsii* that are subject to a special regime. The *goskorporatsii* represent the government in the economy though the legal nature of the *goskorporatsii* is unclear.<sup>42</sup> Each holding was created by *ad hoc* law and federal budget funding. Common to all is accountability to the government, rather than parliament.<sup>43</sup> They are not supposed to be managed according profit criteria,<sup>44</sup> although they benefit from fiscal and tariff preferences. They may not incur bankruptcy procedures. Their managers are appointed by the government and are not responsible for economic outcomes. There are neither procedures nor criteria for the evaluation of their activity. Being neither private, nor properly state-owned companies, they are not subject to financial control that applies to the public sector. By allowing *goskorporatsii* to be accountable only to government, the latter also bears no accountability to the public.

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<sup>41</sup> From the deputy head of MED Andrei Klepach cited in *RIA Novosti*, 2 July 2009.

<sup>42</sup> The first *goskorporatsii*, the State Financial Company and the State Investment Company, were created by Boris Eltsin. They both collapsed in a few years under claims of inefficiency and financial scandals. See Ivanter, Aleksandr et al. "Osobaia forma spornogo sodержaniia", *Ekspert*, no.30, 17 August 2009.

<sup>43</sup> See Pak, N. "Gosmonopolii i goskorporatsii – izlechimyie i neizlechimyie", *OPEC*, 10 September 2009.

<sup>44</sup> Though Rosnano, managed by Anatoliy Chubais, plans to become profitable by 2015. See <http://www.rbcdaily.ru/print.shtml?2009/09/21/media/432050>

The *goskorporatsii* control nanotechnology (*Rosnano*), advanced technology (*Rostekhnologii*), communal housing (Zh.k.kh), public works such as *Olimpstroi* in Sochi, foreign credit institutions (*Vneshekonombank*), the state Agency for Deposit Insurance, nuclear energy (*Rosatom*), and motorways (*Avtodor*). They have privileged access to state subsidies. An intricate network linking *goskorporatsii* and other state entities conceals the effective amount of cross subsidisation.<sup>45</sup> Some of these entities, such as *Rosnano* and *Rostekhnologii* that are in control of a huge number of enterprises, have quasi-ministerial functions. To gauge the economic importance of *Rostekhnologii*, it is worth noting that it uses 10% of total energy consumption in Russia.<sup>46</sup> This holding that is in control of some 500 production enterprises has been particularly active in incorporating reputable private companies hit by the credit crunch under the crisis. In contrast to the latter, lending to *Rostekhnologii* has been provided by the state banks under exceptionally favourable terms.<sup>47</sup>

*Goskorporatsii*'s easy access to foreign credit before the crisis contributed to the enormous private foreign debt. Although the CBR records such debt as non-government, it is obvious that foreign credit institutions would consider it as quasi-sovereign debt, given the privileged status of these entities. Restructuring their debts has become a headache for the government and a concern for the CBR, whose vice governor has called the authorities to stem the *goskorporatsii*'s appetites for foreign loans.<sup>48</sup> So far, the *Vneshekonombank*'s arm has been used by the government to restructure foreign debt, but more debt is coming to maturity raising concern in the Presidential administration.<sup>49</sup>

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<sup>45</sup> On the linkages of *Rostekhnologii* with the ministry for Energy, state banks and *Rosatom*, see <http://www.rostechnologii.ru/archive/0/detail.php?ID=243> ; <http://www.rostechnologii.ru/archive/0/detail.php?ID=246> ; <http://www.rostechnologii.ru/archive/0/detail.php?ID=4527> ; <http://www.rostechnologii.ru/archive/0/detail.php?ID=247>

<sup>46</sup> Cfr. <http://www.expert.ru/articles/2009/07/07/birga/>

<sup>47</sup> <http://www.vedomosti.ru/pda/newspaper/articles/2009/04/29/193580.shtml>

<sup>48</sup> *Vedomosti*, 27 April 2009.

<sup>49</sup> Medvedev joined this thorny discussion, blaming the *goskorporatsii* for exporting their problems to the state rather than solving them by themselves. See <http://www.vedomosti.ru/pda/newspaper/articles/2009/05/13/195259.shtml>

A proposal in March 2009 to transform the *goskorporatsii* into commercial structures is being developed for submission for the approval of the Parliament before the end of the year. The idea is to turn such structures into joint stock companies under 100% state control. This could be a prelude to listing the companies in the stock exchange and allow for minority shares by private investors. While it is unlikely that the political goals and preferences will automatically be changed by transforming them into commercial structures, this should lead to more transparency on financial accounts. Underlying this Presidential initiative there may be a struggle for power, the contours and outcome of which remain unclear. Interestingly, despite Medvedev's critical views on such entities, the *Avtodor* was created in July 2009.<sup>50</sup>

The debate on the *goskorporatsii* takes place between alleged supporters of the rule of law close to Medvedev on one hand and high-level government officials interested in the maintenance of the status quo on the other.<sup>51</sup> It is difficult to assess how disturbing to the latter institutional changes would be. According to Anatoly Chubais, head of *Rosnano*, legal changes will not affect the way his company is run. According to deputy manager of *Rostekhnologii*, Aleksei Aleshin, legal changes could entail losing some privileges of the company's representatives abroad that a present enjoy a quasi diplomatic status.<sup>52</sup> By and large, the main concern of the *goskorporatsii* managers is easy access to state funding. Given the command of resources such entities have been able to gather, with the government's complicity, their contractual power will remain strong regardless of any legal change. But, in time a struggle for power could develop between different factions/constituencies. The outcome of such a struggle would be unpredictable.

Medvedev is carrying out collateral projects that could potentially cause further strains. The first concerns the introduction of more transparency into government procurement procedures: an important source of earnings and rent-seeking for privileged state

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<sup>50</sup> <http://www.novayagazeta.ru/data/2009/079/00.html>

<sup>51</sup> See Mikhail Dmitriev's considerations in <http://www.itogi.ru/delo/2009/39/144384.html>

<sup>52</sup> See [www.vedomosti.ru/newspaper/article/2009/10/22/217021](http://www.vedomosti.ru/newspaper/article/2009/10/22/217021)

entities.<sup>53</sup> The second, potentially more damaging to some *goskorporatsii*, includes instructions to the Federal Anti-trust Agency and the General Procurator to start investigating the adequacy and efficacy of financial activities carried out by five *goskorporatsii*, including *Rostekhnologii*.<sup>54</sup> Lately, the head of the Court of Account has been openly critical of such entities blaming them for the lack of modernisation.<sup>55</sup> The control agencies are considering privatising part of the assets and fixing constraints to the nature of businesses and the number of enterprises controlled by the holdings.<sup>56</sup> The MoF also intervened, calling for a comparatively tighter monitoring of these entities' financial accounts.<sup>57</sup> It is worth noting that *Rostekhnologii*'s total debt amounted at 680bn roubles (c. US\$23bn) at the beginning of 2009.<sup>58</sup> But some holdings are probably too big to become concerned. *Rostekhnologii* continues with its policy of acquiring other assets whenever the opportunity arises.<sup>59</sup>

Presidential advisors ponder modernisation and creating more room for private businesses, while the President claims that economic and industrial diversification should be supported by the government, though not forced from above. However, diversification in Russia meets three formidable obstacles. The first is the government's obsession with security: there is an inner contradiction between the goal of economic diversification that entails the reallocation of resources to the best use on one hand, and on the other the persistent focus on security that provides

<sup>53</sup> See <http://www.prime-tass.ru/news/0/%7B7AE32EED-FF46-44FD-9216-9155A0E75DEE%7D.u> accessed 7 August 2009 and on control and working out of procedural requisites, <http://www.kremlin.ru/text/news/2009/08/220533.shtml>

<sup>54</sup> In this context, the expulsion of Chemezov, head of *Rostekhnologii*, from the Commission on Modernisation at the beginning of August 2009 was interpreted as a move against Putin's close circles. See <http://www.kremlin.ru/sdocs/news.shtml#220580> e [http://www.gazeta.ru/politics/2009/08/06\\_a\\_3233840.shtml](http://www.gazeta.ru/politics/2009/08/06_a_3233840.shtml)

<sup>55</sup> See Stepashin's statement in [http://www.gazeta.ru/news/lenta/2009/10/20/n\\_1416048.shtml](http://www.gazeta.ru/news/lenta/2009/10/20/n_1416048.shtml)

<sup>56</sup> See the comments of the head of the Anti-trust Commission and other officials in <http://www.rbcdaily.ru/print.shtml?2009/09/14/focus/430908>

<sup>57</sup> See Kudrin's views in <http://www.prime-tass.ru/news/0/%7BC496C7EA-30D4-4FFB-B12A-5CEE133ADC3B%7D.uif?print=1>

<sup>58</sup> See <http://www.polit.ru/> accessed on 15 October 2009.

<sup>59</sup> See the plan of *Rostekhnologii* that holds 37.8% of Kamaz' (heavy transport) shares to acquire from Troika Dialog a further 13% and gain majority control "Gruzoviki dliia Chemezova" in *Vedomosti* 10 September 2009 in <http://www.vedomosti.ru/newspaper/article/2009/09/10/213608>

the foundations for state control over strategic assets and natural resources and the guidelines for government policy. This contradiction is mirrored in the unclear division of labour between the President and the government.

Second is rent-seeking that the existing economic structure provides to the power elite. The government's policies are intertwined with those of the *goskorporatsi* and state monopoly companies in control of energy and its transport routes. Given the power structure and Russia's strategic goals, it is difficult to imagine that independent economic entities could replace the existing framework.

Third, economic and industrial diversification is hampered by structural legacies and lack of infrastructure. Mono-company towns, a heavy Soviet legacy, are in a dire state. Taking into account that there are more than 400 such agglomerations hosting some 25 million people in the country, their restructuring poses a major problem in economic and social terms. About half of these monotowns, many of which are related to defence, are bankrupt and continue to operate only thanks to state and local subsidies. There is no way to solve these problems in a short time. On one hand, it is difficult to change the profile of these companies; on the other commuting or migration of skilled labour to dynamic areas is hampered by insufficient transport, the shortage of housing and the cost of accommodation.<sup>60</sup>

The infrastructure is largely Soviet-era and the financial crisis has dramatically exposed its inadequacy, particularly transport infrastructure, for a country that extends over two continents. Some figures highlight the problem. With a surface that is 1.8 times that of the US the total length of motorways (federal and regional) is only 574,500km.<sup>61</sup> If paved local transit routes are included, the total length is 755,000 km (compared to 4,210,000 in the US). The number of airports is 1,232 compared to

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<sup>60</sup> For an appraisal of these problems, see <http://www.vedomosti.ru/newspaper/article/2009/09/23/214555>

<sup>61</sup> Federal Highway Agency of Ministry of Transport of the Russian Federation, <http://www.rosavtodor.ru> accessed on 25 September 2009.

14,951 in the US. There are 87,000km of railways compared to 226,000 in the US.<sup>62</sup>

Shying away from radical change, Medvedev seems to be considering options that could help preserve some entities and maintain his popularity. Like Putin, Medvedev pressured Russian companies to retain workers and local governments to assist crumbling companies eventually hiring laid-off workers in social works.<sup>63</sup> Such policies help sustain the popularity of both leaders. But they hardly help the modernisation that is apparently at the top of Medvedev's agenda.<sup>64</sup> His political agenda also includes a number of reforms that should establish the fundamentals for a "horizontal" industrial policy according to best international practices, i.e. the fight against corruption, development of Small and Medium Enterprises (SMEs), accountability at all levels of the government, efficient and independent justice, increased cultural and political awareness of the population and other noble purposes. But, apart from stirring a lively debate in small circles, Medvedev's initiatives do not seem to stimulate the necessary mobilisation.<sup>65</sup>

Doubts about the leadership's political will and uncertainty about who is in charge of setting economic guidelines disorient the markets.<sup>66</sup> Protection of intellectual property rights (IPR) - an essential condition for accession to WTO - does not make visible progress. The enforcement of individual property rights is hampered by the government's preferential treatment of state companies, illustrated by the breaching of several contracts with foreign companies engaged in energy projects. From 2005, major strategic companies, such Yukos, Sibneft, Russneft, Vankor, United Heavy Machineries, VSMPO Avisma, Sakhalin Energy and Rusia (Kovykta) have been acquired by either state controlled or state

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<sup>62</sup> Figures published in *CIA World Factbook*: 2008 estimates.

<sup>63</sup> On employment policies, see <http://www.kommersant.ru/news.aspx?DocsID=1268619>

<sup>64</sup> See <http://www.prime-tass.ru/news/0/%7BF4D10699-FEC6-4FC9-AF1A-B9D24CB07125%7D.uif>

<sup>65</sup> Malle, S. "Soviet legacies", op. cit. pp.262-265.

<sup>66</sup> See the editorial "Putin v Medvedev", *Financial Times*, 22 September 2009.

influenced companies.<sup>67</sup> There is no certainty that similar action will not take place in the future.

Struggling to create his own political constituency, Medvedev has drafted a list of candidates to high level government and institutional positions, a curious move that is reminiscent of Soviet mobilisation campaigns.<sup>68</sup> What seems to be missing is a serious rethinking of the procedures needed for the selection of public officials on competitive grounds. Medvedev's criteria for the selection and appointment of governors and presidents of courts of justice are obscure, suggesting that he is trying to consolidate his own power, rather than improve the rules of the game.<sup>69</sup> A certain number of reform-minded advisors have contributed to a better image of the President in charge compared to Putin's. But their practical influence on government policy remains to be seen.

Economic restructuring should be based on private risk and undertakings that can only develop in a sound and competitive economic environment, where individual and intellectual property rights are protected and the credit system works according to credit risk assessment and proper incentives: such conditions are missing. The peculiar division of power between Medvedev and Putin suggests that Medvedev's think-tank InSOR (Institute for Contemporary Development) is more of a club for discussion than an incubator of change. While the think(ing) is confined to the President, the tank(ing) is firmly in Putin's hands.

InSOR has been very critical of the anti-crisis measures and the "manual management" of the crisis.<sup>70</sup> But no major alternatives have been proposed. Neither the use of energy as a political weapon nor the lack of a proper system of *checks and balances* have been questioned. Consequently, pronouncements by Medvedev and his advisors sound like

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<sup>67</sup> Cfr. Aslund, A. "The Russian economy: More than just Energy?", *Peterson institute for International Economics*, Testimony for the Committee on Foreign Affairs of the European Parliament, April 2009, p.5.

<sup>68</sup> More than 30,000 people, cfr. <http://newizv.ru/news/2009-08-04/112753/>. On little approval for Medvedev's list in the provinces, see [http://www.ng.ru/politics/2009-07-21/1\\_rezerv.html](http://www.ng.ru/politics/2009-07-21/1_rezerv.html)

<sup>69</sup> Ibid.

<sup>70</sup> On projects and declarations see <http://www.riocenter.ru/en/>



petitions rather than guidelines for reforms. By setting up a number of Commissions mainly composed by high-level bureaucrats to address structural and institutional problems,<sup>71</sup> Medvedev again resorts to old practices. Micromanagement on the part of both the Premier and the President has not helped business environment improve: in 2009, Russia's ranking in competitiveness fell to 63<sup>rd</sup>, 12 places below the previous year.<sup>72</sup> Heavy government's interference with credit policies has not helped either. An example of such interference can be found in the Opel's saga, in which government authorities heavily intervened to press the Sberbank to form a consortium with International Magna for the acquisition of 35% package of shares in Opel on behalf of the almost bankrupt car company GAZ, despite Sberbank admitting no interest in becoming a strategic investor in the field.<sup>73</sup> All through the complicated negotiations with General Motors (GM), the majority shareholder of Opel, Medvedev assisted this operation in his meetings with the German chancellor.<sup>74</sup> The GM's withdrawal from the deal on 4 November 2009<sup>75</sup>, following early signs of recovery in the world economy, came as a shock to the government's ambitions to gain access to foreign technology on the cheap, but probably as a relief to Sberbank that still needs to cope with a large number of problem loans. The government's costly and ineffective micromanagement during the crisis, in an effort to guard 'national champions' against foreign competition, has taken place alongside Russia's questionable strategies as a regional and global player.

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<sup>71</sup> Such as the Commission on Modernisation and the Commission against the Falsification of History, see Medvedev's respective Ukaz in <http://graph.document.kremlin.ru/doc.asp?ID=52509> & <http://archive.kremlin.ru/text/news/2009/05/216476.shtml>

<sup>72</sup> Competitiveness Index in <http://www.weforum.org/pdf/GCR09/GCR20092010fullrankings.pdf>

<sup>73</sup> Significantly, German Gref, head of Sberbank, later leaked to the press that the bank's package of Opel shares could eventually be sold to AvtoVAZ, the other major car company under *Rostekhnologii's* control, that is also in a dire state. see <http://www.vedomosti.ru/companies/news/2009/09/25/846228>

<sup>74</sup> See <http://top.rbc.ru/economics/25/09/2009/332260.shtml?print>

<sup>75</sup> See *Financial Times*, November 4, 2009.

## **RUSSIA'S STRATEGIES AND THE FORMER SOVIET UNION**

Russia's goals to become a world player amongst the G8 have been seriously affected by the crisis, forcing the authorities more towards being a major regional player in the Former Soviet Union (FSU). This is highlighted by government's action in world and regional integration policies, the great deal of improvisation in the field, and the abortive effort to raise the rouble to the status of reserve currency.

The Plan for the Long-Term Socio-Economic Development of the Russian Federation in the period to 2020 (below Strategy to 2020), approved by the government on 17 November 2008,<sup>76</sup> was built on the pride of economic achievements and ambitions to lift the ranking of Russia among the G8 members. In 2008, GDP in purchasing power parities was above US\$2 trillion placing Russia sixth on the scale of major powers. By 2009 it was expected that GDP would be twice its size in 1999 raising expectations that it would not take long before Russia attained the ranking of 5<sup>th</sup> within the G8. With a projected fall in 2009 GDP estimated at -8.7% by the OECD (see above), and comparatively better performance of other major players, expectations are now that Russia's ranking could fall to 7<sup>th</sup> or lower.<sup>77</sup> Despite the poor performance in 2009, the Strategy to 2020 remains indicative of the goals Russia set to herself and seems still determined to pursue.

Plans to become a world leader and a major regional player in the Strategy to 2020 included further integration in the Eurasian economic space, the formation of a Customs Union with Belarus and Kazakhstan, the creation in Russia of a major International Financial Hub, the transformation of the rouble into a (CIS) regional reserve currency and the progressive use of the rouble in foreign trade. Interestingly, the

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<sup>76</sup> See *Rasporasheniya Pravitel'stva RF ot 17 noiabria 2008g. n 1662-r* in the Ministry of Economic Development's website: <http://www.comission.economy.gov.ru>

<sup>77</sup> See <http://www.ng.ru/printed/233140>

Strategy to 2020 also focused on the leading role of Russia as a supplier of energy and the country's interest in the creation of a global energy infrastructure as well as in fixing the rules that would apply to this network. The crisis may have impaired schedules and deadlines of a number of projects disseminated in this document but not altered the aims.

The June 2009 decision to set up a Customs Union with Belarus and Kazakhstan, as discussed below, meets strategic goals, but also reflects, given its timing, the government's desperate efforts to stem competitive pressures and accommodate protectionist policies by increasing control of regional markets. As such, this decision exposes a fatal contradiction: the country's low comparative competitiveness, on one side, and its ambition to be seen as pre-eminent, if not in the world arena, at least in its "own" economic space, on the other.

Tariffs have been increased in many sectors, but particularly so in the automotive branch that was in bad shape before the crisis and collapsed thereafter.<sup>78</sup> Non-tariffs barriers have been introduced on a number of consumer products imported from the west and from the so-called near abroad.<sup>79</sup> Together with the effects of rouble real depreciation, protectionist policies were supposed to favour import-substitution and protect employment. Such policies are understandable in a time of crisis and Russia is not unique in stepping up protectionist barriers. However, in Russia, these measures may backlash, as they make it more difficult for enterprises to gain access to better performing foreign technology and to cut production costs in a context of low capacity reserves and shortage of both skilled labour, due to negative demographic trends, and working capital, due to the credit crunch.

It was at the apex of the protectionist drive that unravelled from early 2009 that Putin announced on 9 June 2009 the interruption of negotiations for the entry in WTO (to which Russia had applied in 1993). This was to be replaced by work on a Customs Union (CU) with Belarus

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<sup>78</sup> Tariffs on used cars have been raised from 48% to 54% <http://www.finiz.ru/auto/article1260409>

<sup>79</sup> Such as, for example, poultry from the US, beer and dairy products from Belarus, wine and other products from Moldova and Georgia.

and Kazakhstan, intending joint application for WTO entry, after completing the harmonisation of tariffs within the union that Russia tried to speed up, despite the different levels of preparation for accession that each country has.<sup>80</sup> The necessary change in the existing WTO procedures that do not contemplate accession by customs unions to this organisation was met with a clear veto from both the organisation and its major partners. Putin's announcement came as a surprise in Russia (not even the President was informed) and abroad. The motivations behind it have been questioned.

Following the proclamation of privileged interests in the so-called near-abroad by Medvedev on 31 August 2008, after the conflict in Georgia, the dismissal of the WTO could find a reason in Russia's primary concern for (re)conquering an economic space where political influence could be used, when necessary, to solicit post-Soviet states to concur to her ambitious agenda of regional economic and military leadership. By accelerating the creation the CU, Russia would take advantage of the largest OECD economies' weaknesses to challenge the existing equilibrium, regardless of how costly concessions to her regional partners in the pursuit of this strategy could be. To be viable, the CU would require, as planned in the *Strategy to 2020* intra-regional financial deepening and monetary policy coordination to prevent exchange rate shocks, eventually leading to the utilisation of a single currency in commercial transactions.

Being taken after the conciliatory, but still conditional, tones that characterised the visit of President Obama in Moscow in May 2009, Putin's decision could also be seen as a tactical move meant to speed up the solution of still pending obstacles on the part of the US Congress to Russia's entry into WTO. The resumption of separate Russia-WTO negotiations decided in Geneva in mid-October,<sup>81</sup> after the world leaders friendly talks at the G20 meeting in Pittsburgh, would support this hypothesis if the remaining obstacles to the entry of Russia into WTO,

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<sup>80</sup> See Shuvalov in Alma Ata on September 25, 2009, <http://www.vedomosti.ru/politics/news/2009/09/25/846158>

<sup>81</sup> See <http://www.prime-tass.ru/news/articles/-201/%7B24FFB8A1-C97F-429D-8AEC-4FBE2BD99736%7D.uif>

that also include unresolved disputes with Ukraine and Georgia are about to be overcome.

More likely, however, the explanation of contradictory foreign economic policies is more complicated. There may have been resistance on the part of Belarus and Kazakhstan to Russia's conditions regarding tariff and non tariff barriers issues and/or the use of the rouble as a customs union (CU) currency. Concerning the former, one may recall the stalemate on dairy products, tractors and beer between Russia and Belarus in mid-2009. With regard to the latter, it is worth noting that Belarus stubbornly resisted the offer by the Russian MoF to release part (US\$500m) of the promised aid in roubles.<sup>82</sup> The details of what the negotiations for the CU entail may become clearer in the future. As mentioned above, the tripartite CU was planned in the Strategy to 2020. Russia's ambitions may go beyond what suggested by the bureaucratic language of the Strategy. Interestingly, Igor Panarin, a likely old "comrade"<sup>83</sup> and advisor to Putin, considers the tripartite CU as a step towards the creation of a Eurasian Union under Russian leadership, the timing of which is being accelerated under the impact of the crisis and the weakening of the US economy.

It cannot be ruled out at this stage that attempts to shape a Common Eurasian Space (CES) that is perceived to work to Russia's advantage are met by hostility on the part of would-be partners. Anders Aslund argues that the dominant concerns among CES countries are: Russia's lack of respect for the territorial integrity, gas policy, trade conflicts and financial issues.<sup>84</sup> Thus, the deadlines hoped for the formation of the CU more specifically (January 2010) may be simply not attainable. This would appear as a setback for Russia's regional projects. In the light of these developments, one may also question the rationale of other Russia's ambitious goals in the financial market, such as

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<sup>82</sup> See <http://www.izvestia.ru/economic/article3129201/?print>

<sup>83</sup> A KGB formed official and a specialist in Information War: see a short biography in <http://www.kommersant.ru/doc.aspx?DocsID=669611> and his comment on Russia's Eurasian strategy in the interview with Panarin, I. "Gosudarem postsovetskogo prostranstva stanet Vladimir Putin", published on 1 April 2009 in <http://www.finiz.ru/economic/article1254343>

<sup>84</sup> See Aslund, Anders, "The Leader of the CIS is Lonely and Weak", *The Moscow Times*, 28 October 2009.

establishing a major international financial hub in the country and lifting the rouble to the status of reserve currency that the government seems determined to pursue.

Plans for the creation of a financial hub in Russia are included in the Strategy to 2020. The global crisis may have bolstered Russian leadership's ambitions. Indeed, a conception for the formation of an international financial centre in Russia and a specific plan setting steps for appropriate legislation and listing agencies in charge were approved in July 2009.<sup>85</sup> According to this plan, the final piece of legislation concerning measures to strengthen the competitiveness of Russia in the field should be approved by February 2011, setting the stage for the rouble as a reserve currency. Such programmes conceived in the years of rapid economic growth and foreign appetite for portfolio investments in emerging markets find new impulse from the current debate on a new financial architecture where the US\$ would lose its dominant role.

In the context of US\$ weakness and protracted uncertainty about US monetary policy, the idea that alternative international currencies should be playing a major role finds several supporters. The UN "Trade and Development Report 2009"<sup>86</sup> discusses in some depth the need for a reformed international exchange rate system and calls for strengthening the role of SDRs (Special Drawing Rights) to become the main form of international liquidity and means of reserve holding. China and Japan are also discussing the opportunity of setting up a regional currency in alternative to the USD. In theory, given the large and financially deep economic markets in Asia, the idea of a regional currency may find some substance. In practice, though, selection of the Japanese yen or the Chinese renminbi as *the* regional currency necessarily would entail not only economic, but also political resolve that would be far from easy to generate.<sup>87</sup> Russia has also been a vocal supporter of a new financial architecture. The idea that the rouble should become a reserve currency

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<sup>85</sup> See *Kontseptsiiia sozdaniia mewhdunaronogo finansovogo tsentra v Rossiskoi Federatsii* and *Rasporazhenie Pravitel'stva RF ot 11 iulia 2009 g. No.911-r* in the MED's website <http://www.comission.economy.gov.ru>

<sup>86</sup> See United Nations Conference on Trade and Development, "Trade and development Report" Overview 2009, pp.IX-XIII

<sup>87</sup> <http://www.banki.ru/news/bankpress/?id=1451373>

has been evoked by Medvedev in preparation of the G20 meeting in London in April 2009 and at the Saint Petersburg meeting with businessmen on 7 June 2009.<sup>88</sup> First Deputy Premier Igor Shuvalov mentioned it again at the Pittsburgh G20 meeting mid-September 2009.<sup>89</sup>

But the ambition to transform the rouble into an international reserve currency meets a number of obstacles. In the light of Russia's stage of development, and even more clearly in the light of crisis developments discussed above, this project sounds increasingly like unsubstantiated wishful thinking. Russia has neither the necessary economic power with a GDP equal to c.2.5% of the global economy, nor the fundamentals for a reserve currency. The Eurozone and the US economy are 10 times larger than the Russian economy, which is why the dollar and the euro are the most attractive reserve currencies, before the yen, the pound and other currencies. A reserve currency must also be a store of value that implies low inflation to prevent its real depreciation. The exchange rate policy should be transparent and predictable, meaning that the exchange rate responds to capital movements in the balance of payment rather than to protectionist pleas. All these requirements are missing in Russia.<sup>90</sup>

Inflation in Russia has remained double-digit (11.7% according to the latest OECD estimates for 2009) even under economic recession. The CBR continues a policy of managed exchange rate under pressure from the government not to let the exchange rate appreciate.<sup>91</sup> But, more importantly, there is no confidence in the currency on the part of either companies or households. As discussed above, some 30% of the Russian household savings are still held in foreign currencies. As argued by Vladimir Mau, if Russian oil companies were forced to accept the rouble

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<sup>88</sup> See Malle, S. "Soviet Legacies", cit., p.254.

<sup>89</sup> See Predlozheniya RF k sammitu "Gruppy dvatsati" v Londone (aprel' 2009 goda) <http://kremlin.ru> published on 16 March 2009. <http://www.rg.ru/printable/2009/09/23/shuvalov.html>

<sup>90</sup> See the sharp comments by Aslund, A. "The Rouble as a Global Reserve Currency? No!", *The Moscow Times*, 23 September 2009.

<sup>91</sup> According to high level government official, exchange rate appreciation at 27 roubles per US\$ would be damaging for the Russian economy. See <http://beta.novoteka.ru/?s=economics#nnn14999190>

as a means of payment in their contracts, their first move would be converting them in foreign currency at the Russia's Central bank.<sup>92</sup>

Last but not least, the depth of the financial market matters considerably in both absolute and comparative terms. While the economic crisis has entailed the depreciation of the US\$ - this occurred also in the early seventies after the first oil crisis – the current flight from the dollar (mainly in favour of the Euro) is unlikely to last long. The US\$ recovered, indeed, after the first oil crisis and is likely gradually to strengthen in the foreseeable future with the turn around in the world economy. A fundamental reason for confidence in the US\$, despite the current financial turmoil, is that the US financial market is still the largest in the world and the most attractive also thanks to a regulatory framework that, while not perfect, is comparatively more transparent and apt to adjust to new requirements and to the protection of property rights under the rule of law. Besides, in the short term, it would not be in the interest of any country holding their reserves in US\$, and specifically China whose reserves attain c. \$US2.3 trillion, to dampen US\$ treasury certificates in the international market that would entail a tremendous loss in reserves. The CBR holds 30% of reserve in US\$.<sup>93</sup> That it is in the interest of nobody in Russia to get rid of US\$ is well known to Russian investors.<sup>94</sup>

There are also well regulated financial markets in Europe and in Asia with which any new financial hub will have to compete to attract funds.<sup>95</sup> This is why, despite the fall-out from the financial crisis, petrol-states, Russia included, continue to prefer investing their earnings in mature financial markets away from their own financial institutions that their companies *in primis* regard with disdain. Less robust financial markets may attract speculative capital, and this happens indeed in Russia and other emerging markets, but portfolio investments are fast to retreat at the first sign of trouble.

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<sup>92</sup> Cfr. exchanges with readers by Vladimir Mau in <http://www.rosbalt.ru/print/673439.html>.

<sup>93</sup> See <http://top.rbc.ru/economics/23/10/2009/339763.shtml?print>

<sup>94</sup> See <http://denga.ru/articles/85/248>

<sup>95</sup> Not surprisingly, *Rosnano* is planning to register in the UK its first international investment fund, see <http://www.vedomosti.ru/tech/news/2009/10/22/867250>



The Russian financial market is weak in terms of depth, capitalisation and liquidity.<sup>96</sup> Only 309 companies are listed in the MMVB and 413 in RTS – the two main stock exchanges. Total market capitalisation in 2007 was equal to US\$1342bn compared to US\$51.2 trillion market capitalisation in the US. Liquidity (ratio of trades value to capitalisation) in 2007 was 103% compared to the UK’s 268% and Germany’s 205%, and below China (110%). A striking feature of the Russian market is also little diversification with oil, electrical energy and metallurgy altogether counting for 74% of market capitalisation, and concentration with largest companies counting for 66% of capitalisation and 90% of stock exchanges. In sum this shows that Russia has a long way to go before it could form an international (or regional) financial hub that uses the rouble as a reserve currency. According to Yuri Gusev, there are other competitive financial markets in the region, such as Kazakhstan, that offer investors attractive tax schemes.<sup>97</sup>

Indeed, the chances for the rouble to become a regional currency are also weak. While in the context of the credit crunch and fall in foreign reserves caused by the financial crisis, some post-Soviet countries may have accepted the rouble in commercial transactions, that does not mean that they would be ready to store it as a reserve currency. As long as Russia will not be determined to tame double-digit inflation, there is no chance for the rouble to become a reserve currency either at home or abroad. To fight inflation, Russia should let the exchange rate float and adopt a transparent regime of inflation targeting. The latter seems to exist in the projects of the CBR, but implementation is being delayed. A further obstacle to stabilisation as a pre-condition for increasing confidence in the currency is the economic structure: a resource-based economy is comparatively more exposed to price and exchange rate shocks, as highlighted by the devastating effects of the financial crisis on

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<sup>96</sup> Data on Russia are from the Russian MED’s plan to create an international financial hub in Russia, cited above (*Rasporazhenie Pravitel’stva RF ot 11 iulia 2009 g. No.911-r* in the MED’s website <http://www.comission.economy.gov.ru> and on the US from <http://www.reuters.com/article/idUSL2144839620070321>.

<sup>97</sup> See Yuri Gusev, “Tri kita finansovoi industrii” in <http://www.rg.ru/2009/11/03/fincentr.html>; <http://www.rg.ru/2009/11/03/fincentr.html>.

the Russian economy and its related financial turmoil. There are ways out, predominantly through economic and industrial diversification. But a virtuous path out of the “natural resource curse” needs time and consistent political will.

## **THE RUSSIAN MODEL OF DEVELOPMENT IS BEING QUESTIONED, THE POLITICAL STRUCTURE REMAINS**

Russia remains a resource-based economy, the fragility of which has been exposed by the crisis. The immediate effects of the financial turmoil are likely to deepen the weaknesses of Russian economic structure, unless policy provides a business environment friendly to private initiative, innovation and foreign investment. The Russian model of development is being increasingly questioned not only by individual experts, but also within the Presidential administration by the experts of InSOR, as discussed above, and by the President himself.<sup>98</sup> It remains to be seen how large the support for structural/institutional change could be.

The driving engines of Russian growth from 2000 to mid-2008 have been external factors: the rising international demand and prices for energy commodities, sustained by world economic growth and trade. Energy and other natural resources provided some 80% of the Russian export revenues; almost 40% of the budget revenues came from energy export duties, excise and various tax payments. Economic collapse caused by the financial crisis has badly affected exports that fell by almost 45% January-August 2008/2009,<sup>99</sup> and hampered fiscal balances as discussed above. But the economic structure has remained by and large the same, despite ups and downs in specific branches - oil output increased by 0.6% and gold by 8.9% January-September 2008/2009 compared to a 13 to 20% fall in other extractive industry - since non-export sectors have been hit by the fall in domestic demand (consumer goods and investment) despite the large fiscal stimulus provided by the

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<sup>98</sup> See Medvedev's article "Rossia, vperyod" at <http://www.kremlin.ru/news/5413> and the message to the nation on 12 November 2009 at <http://www.kremlin.ru/transcripts/5979>

<sup>99</sup> For national statistics on foreign trade see: [http://www.gks.ru/bgd/free/b04\\_03/IssWWW.exe/Stg/d03/204.htm](http://www.gks.ru/bgd/free/b04_03/IssWWW.exe/Stg/d03/204.htm).

budget, with import substitution limited to few food processing branches.<sup>100</sup>

The model of development is now being questioned, even criticised.<sup>101</sup> Economic diversification as articulated in the Strategy to 2020 is becoming more problematic under the effects of the crisis. International competition is rising, driven in the manufacturing and service sectors by China, India and South-East Asia and, in technology by advanced OECD economies. The issue is not only about dependence on oil and commodity prices, but also about reforms capable of finally eradicating Soviet legacies that range from lack of transparency in decision-making to inward looking nationalism and preference for state control and dominance of large-scale companies.<sup>102</sup>

The way Medvedev addresses the problem of modernisation, however, is not much different than in the past. At the first meeting of the Commission for Modernisation on 18 July 2009, Medvedev addressed the primary need for technological break-through,<sup>103</sup> i.e. innovation that was included in his “four ‘i’”s (institutions, innovation, investments and infrastructure) agenda on the eve of his mandate.<sup>104</sup> According to Medvedev, the three priority areas for innovation – branches with competitive advantages, sectors that could become catalysts for modernisation and the defence sector – should be subject to direct presidential control. As it happens, it is in natural resources that Russia has comparative advantages and the defence sector was always a priority for the government. The missing point in the meeting was who will be the actors and their incentives. One can also doubt that a commission composed mainly of bureaucrats and high level officials, by itself a Soviet-style measure, will help solve these problems. Unsurprisingly, Gorbachev is often evoked when the presidential initiative is discussed.<sup>105</sup>

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<sup>100</sup>See national statistics in: [http://www.gks.ru/bgd/free/B04\\_03/IssWWW.exe/Stg/d03/200.htm](http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d03/200.htm)

<sup>101</sup> This plan is discussed in Malle, S. “Economic Transformation in Russia and China: How Do we compare success?” *Eurasian Geography and Economics*, 2008, 49, no. 4.

<sup>102</sup> A wide number of legacies are discussed in Malle, S. “Soviet Legacies”, op. cit.

<sup>103</sup> [http://eng.kremlin.ru/text/speeches/2009/06/18/2019\\_type82913\\_218096.shtml](http://eng.kremlin.ru/text/speeches/2009/06/18/2019_type82913_218096.shtml)

<sup>104</sup> The Commission on Modernisation was established in May 2009, see <http://www.rian.ru/economy/20090521/171811977-print.html>

<sup>105</sup> See *The Economist* 17 September 2009.

The few people gathered in Medvedev's Institute of Contemporary Development are unlikely to provide the necessary constituency for reforms that either society or public officials in charge of large strategic branches are keen to accept. Though more targeted measures could follow in due course, it is difficult to believe, as argued by one commentator, that a strong demand for market reforms is about to come from above or below.<sup>106</sup> The existing economic structure mirrors political power. The large majority of the population is in favour of nationalisation.<sup>107</sup> According to Sergey Aleksashenko, a former deputy minister of Finance and deputy Governor of the CBR and a sharp observer of Russian developments, the only chance for Russia decisively to implement an agenda of institutional change is the conditions of a crisis of long duration. If the economic recovery will start soon following a turnaround in the world economy, the Russian economy will not change path.<sup>108</sup>

There is a third possibility, however: Russia may further distance itself from a path of development based on private undertakings and fair rules of the game, an economic model that is being increasingly challenged by vocal critics of the market economy also in the west. This option would be consistent with political developments before and during the crisis.

In the course of his two Presidential terms, Putin succeeded in centralising power. The representational influence of regional governments weakened. Businesses became more subservient to government interests. As a result the political space is now occupied by unchallenged power elites. The role of the state in the economy has strengthened: the government promoted itself as a mediator in any relevant economic initiative that would entail agreements with foreign

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[http://www.economist.com/world/europe/displayStory.cfm?story\\_id=14460297](http://www.economist.com/world/europe/displayStory.cfm?story_id=14460297)

<sup>106</sup> See comments by Andrei Kolesnikov, "Politekonomiia: Dovol'no illiuzii, in <http://www.vedomosti.ru/newspaper/article/2009/09/23/214510>; & in Grajauskas R. et al., "The Prospects for the Liberalization and diversification of Russia's economy", CEGS Report 2009:3, Vilnius 1009/08/05. The conclusion is that if market reforms are undertaken from above, this would jeopardise the equilibrium of power between the state and large companies subservient to it.

<sup>107</sup> [http://www.rian.ru/crisis\\_news/20090716/177590705-print.html](http://www.rian.ru/crisis_news/20090716/177590705-print.html).

<sup>108</sup> On exit strategies, see <http://www.liberal.ru/articles/4322>.

investors. And despite occasional tensions, Russian politics remains stable under the Putin-Medvedev tandem.

The nature of the Russian financial crisis and measures put in place to withstand its effects cannot be understood without taking into account the stake of the power élite in the economy and its underlying geopolitical strategies. Two presidential terms were necessary for Putin to build a constituency that would lead in few years to increasing economic and political centralisation. While under his first term, a number of institutional changes were implemented, his second term was characterised by increased state intervention under the premise of the emergence of a corporate state. In a few years the new power élite succeeded in divesting Yukos, the oil giant company managed by Mikhail Khodorkovsky, of all its assets and transferring them to state companies. But more importantly Putin ended efforts of private businesses to have a voice in political decision-making through the funding of lobbies, NGOs and political parties.<sup>109</sup> By sentencing Khodorkovskii to 8 years in prison on fiscal fraud, the government sent a powerful signal to the Russian business community that no challenge to the power élite would be tolerated.

Control over the media and assigning the selection of candidates for regional governors to seven district plenipotentiaries nominated by the President were also essential to centralisation of power.<sup>110</sup> Correspondingly, the autonomy of the Federation Council was reduced. With the creation of the party *Edinaya Rossiia* (United Russia) and its overwhelming majority in the Duma, Putin, who is the president of the party, succeeded in gaining control of the parliament. Reformist parties have disappeared from the political scene, also owing to a successful policy of cooptation of some eminent figures carried out by Medvedev.<sup>111</sup>

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<sup>109</sup> For a detailed reconstruction of the Yukos affair, Fortescue S., *Russia's Oil Barons and Metal Magnates*, Basingstoke: Palgrave, 2006, pp.149-179.

<sup>110</sup> See Aslund, A. & A. Kuchins, *The Russia Balance Sheet*, Washington, D.C. Peterson Institute for International Economics. Center of Strategic and International Studies, 2009, p.31.

<sup>111</sup> This is discussed in Malle, S. "Soviet legacies", p.264.

Until 2008 robust economic growth (more than 7% on average from 2000) and improving social welfare sustained Putin's popularity (which remains high) and an assertiveness in domestic and foreign policy. During Putin's two presidential terms and subsequently, Russia has gradually distanced itself from the western world, publicly claiming her own distinctive values and interests with the support of the population. The head of the Supreme Council of the party in power United Russia, Boris Gryzlov defines this approach as "Russian conservatism", where return to traditional values remains pre-eminent.<sup>112</sup>

Economic success, even if largely dependent on favourable world economic trends until mid-2008, and dependence on energy resources from many European countries, including "new" Europe, are the ingredients of the spirit of 'revanche' that characterised political action until late 2008. Economic collapse in 2009 should have helped mitigate these sentiments. But the perception among leading figures is still that, compared to OECD countries, Russia may both suffer less and recover earlier, and that, at any rate, the "West" has lost its status, compared to large emerging economies.

Inclusion in the G8 has not entailed improved cooperation with the western countries, but rather increased self-confidence. In trying to re-establish influence in the FSU, Russia resorts to either threat and blackmail (Georgia, Moldova, Ukraine and occasionally Belarus), or enticement (Kirghizistan, Uzbekistan, Kazakhstan).<sup>113</sup> Economic support – in the form of tied credit of some US\$3.8bn to Bulgaria and 1bn Euros to Serbia – is also used to lure into Russia's projects European members and would-be members, seeking to undermine the EU's influence.<sup>114</sup>

From this point of view, there are no significant changes between the Presidential and the Governmental positions. President Medvedev, often portrayed as a moderate reformer, has quickly adapted to Putin's

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<sup>112</sup> See Gryzlov's manifesto in <http://edinros.er.ru/er/text.shtml?10/3515,110041>

<sup>113</sup> For the sums pledged by Russia to strengthen cooperation, some US\$10bn to support CIS economies, and US\$2bn of credit to Kyrgistan, plus a US\$ 150m donation, as a reward for cosing down a US milliary basse, see Malle, S. "Soviet Legacies", p.254.

<sup>114</sup> While earlier projects in favour of Ukraine and Belarus have been dropped, see <http://top.rbc.ru/05/10/2009/334702.shtml?print>

strategies, claiming in some cases full responsibility for action, such as in the case of military action in Georgia, and intensifying the agenda of bilateral and multilateral meetings meant to consolidate strategic alliances with Eurasian countries. Cooperation agreements, in which Russia claims primacy, range from security cooperation to economic integration. Though Russian ambitions are often frustrated by post-Soviet states' reticence to agree on Russia's immediate goals, as noted above, it would be wrong to underestimate the potential of such agreements as vehicles of medium-long term strategies. "Russian conservatism" may further distance Russia from European values as the country's attention appears to be moving visibly towards the East.<sup>115</sup> But it may also make it more problematic economic diversification away from focus on natural resources.

On 27 August 2009, the Russian government approved a new Energy Strategy articulated in three stages to 2030. New oil and gas production centres to be located in East Siberia and the Far East are planning to become fully operational in the second stage (2020-2022).<sup>116</sup> As new exploitations will be costly, Russia hopes for funding from foreign investors, China in particular. At the beginning of 2009 an oil-for-loans deal was agreed between the two countries, almost entirely financed by China.<sup>117</sup> In October 2009 the two countries signed a programme of cooperation 2009-2018 for a total amount of 3.5bnUSD.<sup>118</sup> The programme includes 250 key joint projects located in the border regions, covering primarily energy and other natural resources on the Russian side.<sup>119</sup>

While Russia's politics turns gradually to the East, concerns to keep control of Russian energy routes to the West will remain pre-

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<sup>115</sup> See Jos Boonstra, "Russia and Central Asia: from Disinterest to Eager Leadership", *EU-Russia Centre*, Issue 8, October 2008. pp.70-79.

<sup>116</sup> *East Week*, Issue 29 (179) 3 September 2009 and on recent deals, including a number of joint projects with China, for a total of some 3,8bn US\$ <http://www.vedomosti.ru/newspaper/article/2009/10/12/216003>

<sup>117</sup> Malle, S., "Soviet Legacies in Post-Soviet Russia: insights from crisis management", *Post-Communist Economies*, Vol. 21, No.3, September 2009 p.254.

<sup>118</sup> Such as Russia's position on the new US missile defence plan and western sanctions on Iran. See *Financial Times*, 13 October 2009.

<sup>119</sup> See <http://www.vedomosti.ru/newspaper/article/2009/10/12/216003>,



eminent in the short-medium term, casting a shadow on the sincerity of Russia's commitment to strengthen international cooperation. Despite friendly noises occasionally coming from Medvedev, whether Russia will cooperate *de facto* with the international community on a number of thorny issues remains to be seen.<sup>120</sup> The concentration of political and economic power may turn to be a formidable obstacle to appeasement.

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<sup>120</sup> On the unclear position of Russia on the new missile defence plans and action against Iran, see *Financial Times*, 20 October 2009 on the mixed messages reviving Kremlinology.

## CONCLUDING REMARKS

The window of opportunity offered by almost a decade of rapid growth and healthy fiscal balances that could have been used to address problems has been lost. In the context of the crisis and worsening fiscal balances, there is little room for public funding. Due to a perverse combination of legacies from the past and costly economic strategies, Russia has suffered comparatively more than advanced OECD economies and other large emerging economies from the impact of the crisis. And while the crisis has highlighted Russia's distinctive weaknesses, there is little room for institutional change. Mutually supportive economic and power structures have strengthened under increasing state control in the economy. Radical changes that could be disruptive to both are resisted by vested interests in the status quo. Private businesses have been hit comparatively more than state companies and holdings whose share in the economy has increased. No exit strategy has been worked out by the government during the crisis.

However, while there is room for swift economic recovery the strength of which would depend on the turnaround of the world economy, there is little chance that the Russian path of development will change as long as energy and natural resources remain under government command. With Russia's pendulum moving to the East, elements of "oriental despotism" that never died in the country may resurface. Furthermore, despite its impact, the crisis has not moderated Russia's ambition to regain a pre-eminent role in international affairs. On the contrary, while Russian plans for regional economic integration, a restructuring of the international financial architecture and establishing the rouble as a reserve currency are significantly undermined by Russia's own economic problems, the economic weakening of advanced economies is perceived as a welcome opportunity for Russia to increase its influence and status in the region and beyond. There is a clear tension, therefore, between Moscow's intentions and its resource base. While Moscow is unlikely to moderate its foreign policy intentions significantly, it appears that the implementation of such plans will be postponed and Russian policy will be based on "muddling through".



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