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**Russia's Crisis Modernisation Fallacy:
An analysis of the 1998 and 2008 economic crises and their effects
on the development of the Central Bank of Russia**

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List of Common Abbreviations

CBR: The Central Bank of Russia

CEE: Central and Eastern Europe

DIA: Deposit Insurance Agency

FFMS: Federal Financial Market Service

FSU: Former Soviet Union

HBC: Hard Budget Constraint

LAO: Limited Access Order

MF: Ministry of Finance

NPL: Non-Performing Loan

OAO: Open Access Order

PSS: Post-Socialist States

SBC: Soft Budget Constraint

SME: Small and Medium Sized Enterprise

SOE: State Owned Enterprise / State Controlled Enterprise

TFP: Total Factor Productivity

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CHAPTER 1

RUSSIA'S TRANSITION PARADOX

This study seeks to contribute to the literature on Russia's political and economic transition by reframing how we understand the role institutions play in transitioning away from a command economy by examining the effects of economic crises on the development of banking institutions. Attempts to explain the state of Russia's transition often fail to address the institutional influences that shape the polity and society. As such, the common explanation for Russia's present economic and political state is that its transition away from communism and a command economy failed. Most scholars focus on individuals or groups of economic and political agents to understand how and why this transition failed. While this provides vital analysis of the decisions made at the start of transition and their consequences, it fails to examine what led to the decisions in the first place. Furthermore, it also falls short of explaining why genuine attempts at reform are often undermined by the reformers themselves. Even where this contradiction is acknowledged, few scholars attempt to solve this puzzle. This study hypothesises that the clue to solving this puzzle is deeper than individual actions and decisions — it lies in the inability to fully dismantle communist and command economic institutions. As such, Russia's transition has not failed, because it is incomplete. This study argues that Russia is trapped in partial reform equilibrium. This chapter will develop and explore this argument by first outlining the research question, before analysing other scholars' attempts to answer it and why they are incomplete. Next, partial reform equilibrium, its strengths and weaknesses as a theoretical framework, and how it can be used to understand Russia's transition will be defined. Finally, what this study hopes to achieve in the subsequent chapters will be outlined.

1.1 Contemporary Russian Political economy issues and research question

This study's main argument is that Russia's economic transition has stalled because it is trapped in partial reform equilibrium: it is no longer a communist, command economy, but it is not a market economy either. This phenomenon prevents the formation of strong institutions, which is seen most starkly in the development of the banking industry. However, because ideal types of neither communism, capitalism, nor democracy exist, the term 'market' is not very helpful. All market economies are regulated by the state to a certain extent, and all command economies are driven by production. For the purposes of this study, I am concerned with Russia's transformation from a system that is primarily command to one that is primarily market. It is important to clarify that by market economy, I refer to Karl Polanyi's definition

of a market as an institution ‘directed by nothing but market prices... and is capable of organising the whole of economic life without outside help or interference.’¹ In most modern market economies, government regulations prevent the market institution from impinging upon the wellbeing of society, yet this ultimately does not undermine the role the institution is supposed to play. This distinction is important as this study seeks to reframe how we understand the modernisation and transition paradigm as applied to Post-Soviet Russia, by demonstrating that the absence of institutions has stalled the transition. It is far less about the laws and rules that define whether an economy is a market — it is about the strength of institutional practices, or how actors’ expectations that the law will be enforced constrains and influences their behaviour.

As one of the world’s largest and most powerful countries containing some of the most precious natural resources, it was widely assumed that Russia, with the help of international organisations (The IMF, World Bank, EBRD) as political and economic consultants, would complete its transition from a command to market economy in a timely manner. Yet, its transition remains frozen and, in some instances, has even reverted to old command practices. From the late 1990s through the mid-2000s, Russian gross domestic product (GDP) grew rapidly. During Vladimir Putin’s first two presidential terms from 2000 – 2008, the GDP grew by 6.7 percent per year on average.² Because of this, the government was able to repay most of its foreign debt, and the state used its massive budget surpluses to create a stability fund of over \$100 billion in case of economic hardship.³ Furthermore, the average citizen saw an increase in living standards, as GDP per capita rose by an average of 5.5 percent and unemployment fell every year from 2000 to 2012, except in 2009.⁴

However, this economic growth was due to rising gas and oil prices, not economic diversification. As gas and oil prices flagged because of the 2008 economic crisis, so too did Russia’s annual GDP growth, and its stabilisation fund was quickly drawn down. Nevertheless, despite the uncertainty caused by reliance on hydrocarbons, the extent of Russia’s progress towards economic diversification is debatable. The country has plenty of other resources available aside from gas, oil, and other minerals. For example, Russia could foster economic

¹ Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944).

² Michael McFaul and Kathryn Stoner-Weiss, "The Myth of the Authoritarian Model: Putin's Crackdown Holds Russia Back," *Foreign Affairs* 81, 1. (2008): 68 - 84.

³ Hilary Appel, "Is It Putin or Is It Oil? Explaining Russia's Fiscal Recovery," *Post-Soviet Affairs* 24, 4. (2004): 301 - 23.

⁴ The World Bank. "Russian GDP Per Capita 1991 - 2012," 2012. ; The Organisation for Economic Cooperation and Development. "Unemployment Rate 2000 - 2012," 2012.

growth through the creation of small and medium-sized enterprises. However, weak economic institutions undermine this diversification. For example, there is no expectation that private property rights will be enforced, which is reflected in Russia's consistently low rankings in the World Bank's 'Ease of Doing Business' survey.⁵ As such, if Russia's transition to a market was indeed complete, then its economy would more accurately reflect this; not just in the growth of GDP, but also in the fairness and predictability of its institutions. Thus, economic strength is not only measured by growth and living standards, but also by the strength of rule of law: the expectation that laws will be fairly and consistently enforced. Strong rule of law ensures the protection of property rights, which is essential to economic growth. However, rule of law can only be as strong as the institutions that enforce it. If rule of law is weak, then economic growth is easily compromised, and thus not evidence of economic strength or robustness. As such, weak rule of law signifies weak institutions, which undermines the correlation between economic growth and modernisation.

To better demonstrate that Russia's transition is stalled, and to establish it as an outlier, I ran two OLS linear regressions, which illustrated the levels of GDP in predicting the strength of rule of law against other explanatory variables such as income inequality, population, geographical location, and levels of democratisation. Using the World Bank's rule of law indicator, I found that for every \$1,000 increase in GDP per capita, there was a 2.8 percent increase in strength of rule of law.⁶ Although the levels of democratisation, determined using Freedom House's 'free', 'partially free', and 'not free' classifications, also showed strong correlation to the strength of rule of law, it was not as significant a predictor as GDP per capita. This finding is significant because it supports the argument that economic growth will provide incentives to develop a strong rule of law to maintain said growth.⁷ It would follow that if Russia's transition was complete, then the strength of its rule of law would increase as its GDP grows. Yet, as its GDP per capita has grown, Russia's rule of law ranking has remained low, never rising above -.77. The objective of this study is to determine why Russia deviates from

⁵ Richard Sakwa, "Systemic Stalemate: Reiderstvo and the Dual State," in *The Political Economy of Russia*, ed. Neil Robinson (Maryland: Rowman & Littlefield Publishers, Inc., 2013).; The World Bank, "Ease of Doing Business in the Russian Federation," The World Bank Group, <http://www.doingbusiness.org/data/exploreconomies/russia>.

⁶ World Bank governance indicator for rule of law measures the strength of rule of law on a scale of -2.5 being the weakest and 2.5 being the strongest. The results refer to a 2.8 percent increase in the score. 2.8 is not a score itself. See Appendix I for regression.

⁷ Douglass C. North, *Institutions, Institutional Change, and Economic Performance*. (Cambridge: Cambridge University Press, 1990).; Douglass North, *Understanding the Process of Economic Change*, (Princeton University Press, 2005).

the norm. If its GDP has been steadily growing, but its institutions have not strengthened along with the growth, then why do the institutions remain weak?

Most traditional answers to this question, such as the state's dependence on natural resource exports to fund modernisation projects cannot withstand further interrogation. The most compelling arguments are those of Jeffrey Kahn, Steven Levitsky, Lucan Way, Thomas Carothers, Joel Hellman, and other scholars who point to Russia's failure to implement an effective system of the rule of law, thereby allowing political elites to use the system for personal gain. Other scholars, such as Douglass North, Barry Weingast, and others, place the blame on weak institutions, arguing that a strong rule of law depends on strong institutions. Yet, Russia has created and passed multiple policies and laws aimed at strengthening institutions, but these measures have not resulted in actual institutional development. If Russia's economic institutions should strengthen as its economy grows, why has there been little to no change in these institutions over time? The following section examines the more complex and competing theories that attempt to explain Russia's stalled transition.

1.2 Literature review

This section will examine both the contributions to and gaps in the literature to provide a foundation for this study's main argument: that Russia's institutions are trapped in partial reform equilibrium. The challenges Russia faces in its transition to a market economy are complex. The scholars who attempt to unpack these issues span a variety of disciplines, including history, anthropology, economics, and political science. Each of these scholars has made a significant contribution to our understanding of how Russia became what it is today, and the various facets of contemporary problems it faces. However, very little of the literature answers the question of why, despite attempts to change, Russia remains trapped in transition? First, this section will examine the historical and cultural explanations, which explain how Russia reached its current state and how its economy currently functions. Second, it will analyse the various political science and development studies theories on democratisation and what these contribute to our understanding of Russia's transition. Next, we will look at historical institutionalism, how it understands and analyses political and economic transitions, and how we can use this to understand Russia's transition. Finally, the partial reform equilibrium argument, the debates surrounding it, what it contributes to our understanding of economic transitions, and how this study contributes to our understanding of partial reform is clarified and enumerated.

Socio-cultural and historical explanations

This approach examines how historical and cultural practices have both informed and undermined Russia's transition. The historical perspective argues that Russia has reverted to authoritarianism because of the weight of its historical legacy. For example, Gregoire Pop-Eleches, in his statistical analysis to determine influential factors of regime change, found that historical legacy at the outset of transition was the best predictor of successful democratisation.⁸ He argues that because of the lack of experience in democratic practices, Russia and other post-communist and post-Soviet states will be unable to properly undertake elections, adapt to a market economy, or fully throw off the chains of its past regimes. Furthermore, Stefan Hedlund illustrates how various historical practices and behaviours are path-dependent and shape Russia's contemporary political and economic development. Hedlund argues that the critical juncture for these practices are pre-Soviet, often dating back to the dawn of the Russian Empire.⁹ This argument is reinforced by studies of cultural memory, which examine how narratives of oppression by socialist powers have allowed many other socialist states to idealise pre-socialist practices and reinstate them.¹⁰ Russia does not have such a narrative because it does not have the same history. In fact, Russia's historical tradition glorifies strong Russian leaders such as Peter the Great and even Joseph Stalin.¹¹

An extension of the historical perspective is the sociological and anthropological approach to transition, which examines how Russians themselves reinforce these historical practices. For example, Alena Ledeneva's seminal studies on the role of *blat* or one's social network, and *sistema* or what drives social, economic, and political interactions.¹² Ledeneva illustrates how social networks have created informal institutions where formal ones have

⁸ Grigore Pop-Eleches, "Historical Legacies and Post-Communist Regime Change," *Journal of Politics* 69, 4. (2007): 908 - 26. Also see: Richard Pipes, "Fight for Freedom: What Russians Think and Want," *Foreign Affairs* 83, 3. (2004): 9 - 15.

⁹ Stefan Hedlund, *Russian Path Dependence*, Routledge Studies in the European Economy (Oxford: Routledge, 2012).; Stefan Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," *Post-Communist Economies* 12, 4. (2000): 389 - 407.

¹⁰ Rogers Brubaker, *Nationalism Reframed: Nationhood and the National Question in the New Europe*. (Cambridge: Cambridge University Press, 1996).; Richard Esbenschade, "Remembering to Forget: Memory, History, National Identity in Postwar East-Central Europe and after 1989," *Representations* 49, (1995): 72 - 96.

¹¹ Pipes, 2004.; Arkady Ostrovsky, *The Invention of Russia: The Journey from Gorbachev's Freedom to Putin's War* (London: Atlantic Books, 2015). 286.

¹² Alena V. Ledeneva, *Can Russia Modernise? : Sistema, Power Networks and Informal Governance* (2013); Alena Ledeneva, "Telephone Justice in Russia," *Post-Soviet Affairs* 24, 4. (2008): 324 - 50; Alena Ledeneva, *How Russia Really Works: The Informal Practices the Shaped Post-Soviet Politics and Business* (New York: Cornell University Press, 2006); Alena Ledeneva, *Russia's Economy of Favours: Blat, Networking, and Informal Exchange* (Cambridge: Cambridge University Press, 1998).

failed. These practices extend to the government, with Vladimir Putin using his own social networks to protect government interests.¹³ Of course, resorting to *blat* over established rules and institutions weakens the institutions themselves. Importantly, as Ledeneva points out, these actions are often subconscious.¹⁴ People want more political accountability and economic opportunities, but they do not realise that their everyday actions undermine the foundations necessary for those two things.

The historical and cultural arguments illustrate the institutional behaviours and practices that are left over from previous eras, and how they have complicated Russia's transition. This context is an essential foundation for understanding what might be complicating Russia's transition. However, these arguments do little to explain why, despite the genuine attempts to end these practices, they fail. Understanding what complicates or delays Russia's transition is important, but it is only part of the story. All systems change, Russia is no exception. Yet, for those scholars who take historical, sociological, or cultural approaches, change is beyond the scope of their argument. Thus, while this study does indeed seek to understand what is preventing Russia from completing its transition, it is more concerned with why Russia has not been able to move past these legacies and practices despite attempts to do so.

Democratisation and hybrid regimes

The literature on democratisation and regime type provides valuable insight into Russia's transition problems. This body of literature is composed of two competing criteria for evaluating transitions: either by the stage of the transition, or the regime type that has resulted. Democratisation literature is based on the argument that the transition to democracy takes place in stages. For states to undertake a successful transition to democracy, certain preconditions must be met before moving on to each stage, the final stage being a consolidated democracy.¹⁵ These preconditions generally include the need for a strong national identity and national unity, sometimes emerging in the aftermath of civil strife, political struggles, and economic

¹³ Stephen; Kryshanoyskaya White, Olga, "Putin's Militocracy," *Post-Soviet Affairs* 19, 4. (2003): 289 - 306. Joel Hellman, Daniel Kauffman, and Geraint Jones, "Seize the State, Seize the Day' : State Capture, Corruption, and Influence in Transition" The World Bank Group, 2000.

¹⁴ Ledeneva, (2013). Loc. 163.

¹⁵ Rustow Dankwart, "Transitions to Democracy: Toward a Dynamic Model," *Comparative Politics* 2, 3. (1970): 337 - 63.; Philippe C. Schmitter and Terry Lynn Karl, "What Democracy Is...And Is Not," *Journal of Democracy* 2, 3. (1991).; North.

development.¹⁶ Democratisation literature is not concerned with how to catalyse democratic transitions, because its various theories argue that the entire process must be organic and grassroots. As such, transitions are lengthy and complicated. These studies provide a framework through which we can determine what stage of transition Russia is in, or what preconditions it fails to satisfy.

Democratisation literature can be further divided into two schools: sequencing and gradualism. Sequencing contends that states should first construct a strong foundation of rule of law through institutional development before undertaking political and economic competition.¹⁷ Sequentialists argue that ensuring strong institutions are upheld by a strong rule of law is the only way democracy can flourish; not ensuring this risks the formation of an illiberal democracy.¹⁸ Furthermore, they argue that sequencing forces states and international advisors to reckon with historical precedents that would complicate the transition if they were to be ignored, which they argue gradualists do.¹⁹ Gradualists, on the other hand argue that democracy and political competition can take place inside the framework of nascent institutions, which will later develop to meet the needs of the polity and economy.²⁰ The contention is that if democratisation is postponed until rule of law can support strong institutions, then the postponement could become indefinite.²¹ Instead, they argue that it is better to try and democratise from the beginning and focus on adjusting and developing institutions as the transition proceeds.²²

Those who focus on issues of regime type flip the argument and question the necessity of a democratic government as a precondition for strong rule of law and the corresponding political and economic freedoms. These scholars examine the plethora of so-called hybrid regimes, or those states that cannot be classified as either democratic or authoritarian.²³ This

¹⁶ Thomas Carothers, "The "Sequencing" Fallacy," *Journal of Democracy* 18, 1. (2007): 12 - 27.; Thomas Carothers, "The End of the Transition Paradigm," *Journal of Democracy* 13, 1. (2002): 5 - 21.; Dankwart, 1970.; Schmitter and Karl, 1991.; North.

¹⁷ Edward Mansfield and Jack Snyder, "The Sequencing 'Fallacy,'" *Journal of Democracy* 18, 3. (2007): 5 - 10.

¹⁸ Carothers, "The "Sequencing" Fallacy," 2007.; Steven Levitsky and Lucan Way, "Elections without Democracy: The Rise of Competitive Authoritarianism," *Journal of Democracy* 13, 2. (2002): 51 - 65. Levitsky and Way. 2002.

¹⁹ Mansfield and Snyder, 2007.

²⁰ Carothers, "The "Sequencing" Fallacy," 2007.; Mansfield and Snyder, 2007.

²¹ Carothers, "The "Sequencing" Fallacy," 2007.

²² Ibid.

²³ David Collier and Steven Levitsky, "Democracy with Adjectives: Conceptual Innovation in Comparative Research," *World Politics* 49, 3. (1997): 430 - 51.; Larry Jay Diamond, "Thinking About Hybrid Regime " *Journal of Democracy* 13, 2. (2002): 21 - 35.

body of literature argues that the assumption that all states are transitioning to a democracy is false and that it is time to end the 'transition paradigm'.²⁴ It follows that transition has ended in what many still consider transition states. Thus, what we see as a flawed or failed transition is neither, it is just the result of the change that took place. For these scholars, it is more important to look at what influenced the trajectory of development rather than evaluate it on a scale of political aspiration. This allows us to understand that democracy is not the only goal of political transition, and that studying non-democratic transitions is not any less important.

Yet, the literature on democratisation and hybrid regimes does not really satisfy the question of why Russian government drafts and approves reform measures, but cannot implement or enforce them. In the first instance, democratisation literature is too concerned with the conditions necessary for democratisation. While this is helpful in evaluating where Russia may fall along that trajectory given the problem at hand, it does little to resolve it. Second, the literature on hybrid regimes would require the abandonment of the transition paradigm, because it would argue that Russia's transition is complete, but undemocratic. While it is helpful in demonstrating that not all transitions have or should have democratic aspirations, the notion that Russia's transition is complete is false. The beginning of any major political or economic reform requires institutional transformation to support and reinforce change. This transformation is not quick and requires trial and error. It is argued that Russia's institutions are still changing and, therefore, its transition is not yet complete.

Historical institutionalism

Historical institutionalists argue that the success or failure of political and economic transition lies in the strength of a state's institutions. As illustrated by Samuel Huntington, the failure to focus on institutional development during times of transition will lead to political decay.²⁵ Institutions are defined as: '...the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic.'²⁶ Furthermore, these institutional constraints are embodied by organisations or agencies, and enforced by individual agents.²⁷ These organisations are the institutional tools by which regulations and policies are enforced and upheld. As such, institutionalists examine

²⁴ Levitsky and Way, 2002.

²⁵ Samuel Huntington, "Political Development and Political Decay," *World Politics* 17, 3. (1965): 386 - 430.; Samuel Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968).

²⁶ North, (1990). 1

²⁷ *Ibid.*

how institutions shape political and economic behaviour and outcomes.²⁸ By extension, they are also concerned with how institutions are made and strengthened, as well as the sources of weakness and decay. The strength or weakness of institutions translates into the strength or weakness of the rule of law, and how well conflicts are mediated.²⁹ Using this approach to analyse Russia's transition is the most useful. If institutions are weak or underdeveloped, then reforms cannot be implemented despite the good intentions of policy makers.

Samuel Huntington argues that institutional development and modernisation are complimentary goals, as modernisation cannot take place in the absence of strong institutions.³⁰ He lists four measures of institutional strength: adaptability, complexity, autonomy, and coherence.³¹ The more of these criteria that institutions meet, the stronger they are. Thus, Huntington and other institutionalists argue for focusing on institutional development before modernisation. The distinction is important because the reforms and policies formulated during the transition aimed at modernising the Russian economy and government could only be enforced by strong, stable institutions. Without the institutions to support and implement the transition reforms, the transition cannot be completed. The problem is that path dependency reinforces institutional design: 'actors' expectations about institutional enforcement and stability shape their approach to institutional design.'³² Thus, weak institutions are likely to be replicated.

Francis Fukuyama argues that economic growth, stimulated by industrial and economic revolutions or modernisations, forces changes in institutions to protect everything from property rights to labour laws.³³ Furthermore, Douglass North and Barry Weingast explore the intricate relationship between institutional and economic strength, dividing states into limited or open social access orders based on their institutional development. Open access order (OAO) states have strong institutions, a high level of rule of law, and stronger and more prosperous economies.³⁴ In these states, economic laws are clearly stated and imposed equally

²⁸ Sven Steinmo, "What Is Historical Institutionalism," in *Approaches in Social Sciences*, ed. Donatella Della Porta and Michael Keating (Cambridge: Cambridge University Press, 2008).;

²⁹ Kathleen Thelen and Sven Steinmo, "Structuring Politics: Historical Institutionalism in Comparative Analysis," (1992).

³⁰ Samuel Huntington, "The Change to Change: Modernisation, Development, and Politics," *Comparative Politics* 3, 3. (1971): 283 - 322.

³¹ Huntington, "Political Development and Political Decay," 1965. 394 – 403.

³² Steven Levitsky and Maria Victoria Murillo, "Variation in Institutional Strength," *Annual Review of Political Science* 12, (2009): 115 - 33. 127.

³³ Francis Fukuyama, *Political Order and Political Decay* (London: Profile Books Ltd., 2014). 44.

³⁴ Douglass C.; Wallis North, John J; Webb, Steven; Weingast, Barry, "Limited Access Orders in the Developing World: A New Approach to the Problems of Development," *The World Bank* 4359, (2007). 4.

on everyone, which creates an expectation that the laws will be consistently enforced. Limited access orders (LAO), by contrast, limit opportunities of wealth maximisation to a select group of players, who can construct barriers to wealth maximisation by manipulating weak institutions to favour themselves.³⁵ Weak institutions result in laws that are inconsistent and unpredictable, making it impossible for economic players outside the elite to adequately plan and invest in their long-term interests. As such, a general measure of institutional strength could be economic growth or development: the more the economy grows, the stronger its institutions are likely to be.

As illustrated by Claus Offe, the transition that the post-Soviet states must make is unique as it has three objectives: it must simultaneously transition toward a market economy, a democracy, and form a common national identity.³⁶ However, these three goals are divergent, making the transition incredibly difficult. Other states that have transitioned to democracy since the end of WWII have not had to face the geographic disintegration of their country or the complete transformation of their economies.³⁷ When the Soviet Union collapsed, fifteen new governments, nationalities, central banks, currencies, and borders appeared. All formerly communist countries, both Soviet and non-Soviet, have had to completely reorient their economies' incentives that drive economic growth and development from the state to private enterprise, and from a planned to a market economy. Offe points out that undertaking the triple transition of national identity, democracy, and market economy, simultaneously is impossible.³⁸ Combined with Huntington's observations on how modernisation in the absence of strong institutions can cause decay, we can conclude that Russia, in trying to undertake all three tasks simultaneously, has become stuck in partial reform equilibrium, with weak institutions that have stalled its economic transition.

1.3 Partial reform equilibrium

When any state, post-communist or otherwise, enters a phase of economic transition, the immediate result will be a reduction in living standards for most of the population (the so-called 'losers'). This period, as termed by Janos Kornai, is a 'transformational recession' caused by the implementation of hard budget constraints (HBCs): unproductive firms will

³⁵ Ibid. 7 – 8.

³⁶ Claus Offe, "Capitalism by Democratic Design: Democratic Theory Facing the Triple Transition in East Central Europe," *Social Research* 58, 4. (1991).

³⁷ Ibid. 504.

³⁸ Ibid. 509.

close, subsidies will be cut, credit repayment will be enforced, and barter transactions will cease.³⁹ The effects of a transformational recession are rising unemployment and prices, cutting benefits, and closing existing economic loopholes. This was a drastic change for Russia, as there was no official unemployment rate until the 1990s. There was also no such thing as bankruptcy because there were no mechanisms for recalling a debt, only prolonging or forgiving it. For example, the Central Bank of the Soviet Union only accepted payments in kind; they were not allowed to accept monetary payments.⁴⁰ The long-term objective is for the changes created by a transformational recession to eventually result in a robust market economy with more potential. New firms will be created and old firms that avoid liquidation will increase efficiency, quality, and profits. This will lead to job creation, increased wealth, and an increased standard of living.

Just as the transformational recession takes its toll on most of the population, it benefits a select group individuals that Joel Hellman calls ‘winners.’ They are aptly named as they are the select few who benefit economically from the transition: they earn increased profits on goods and resources that maintain production subsidies, but can be sold at the market prices; use influence to gain control of powerful and successful enterprises in order to pocket profits instead of reinvesting them; rack up debt by taking out large loans with the intention of defaulting knowing that the state has no mechanism to enforce repayment; and the list continues. As transition proceeds and reforms are implemented, these loopholes *should* close, and the standard of living *should* increase.

However, Hellman argues that the ‘winners’ can use their influence, economic, political or otherwise, to stall reforms and trap the economy in a halfway state between command and market. Hellman defines this phenomenon as partial reform equilibrium or ‘the selected introduction of market mechanisms into an economy in which substantial spheres of economic activity still operate according to alternative mechanisms of coordination.’⁴¹ In other words, by freezing the transition from command to market economy, contradictory practices from both economic systems exist simultaneously. The result is a limited access order that preserves the loopholes created by the transition and maintains the ‘winners’ ability to profit at the expense of everyone else. Furthermore, it creates an economic incentive to maintain partial reform

³⁹ János Kornai, "Transformational Recession: The Main Causes," *Journal of Comparative Economics* 19, (1994): 39 - 63.

⁴⁰ The Central Bank of the Russian Federation, "The State Bank of the U.S.S.R.," <https://www.cbr.ru/Eng/today/?PrId=gbssr>.

⁴¹ Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50, 2. (1998): 203 - 34. 218 – 219.

equilibrium. Some countries, notably Poland, Czech Republic, and Hungary were able to close these loopholes and prevent the ‘winners’ from having too much influence. This study argues that while Russia is trapped in partial reform equilibrium, it was not deliberately caused by the ‘winners’ and it has been unable to break this equilibrium, which has stalled its transition.

One of the primary criticisms against Hellman’s theory is that it requires collective action on the part of the ‘winners’, or the elites.⁴² While Hellman implies this is the case, he does not state it as an outright condition.⁴³ Upon closer inspection, collective action is not necessary for partial reform equilibrium to take root because ‘winners’ acting individually can cause partial reform. In fact, partial reform is better sustained when the elites cannot act collectively. Studies have found that necessary economic social reforms are more likely to be avoided when socio-economic actors have diverging interests.⁴⁴ This ensures that no consistent measure or reform of any kind can be implemented. Evidence of this is often seen in the piecemeal ways reformers have patched laws together as each ‘winner’ insists that their interests are protected. Partial reform equilibrium could be sustained based on these laws alone. If the ‘winners’ could collectively agree on what to implement and what to exclude, the laws would be much clearer and easier to navigate and enforce.

The second disagreement that scholars have with Hellman is perhaps more substantial. Hellman argues that partial reform equilibrium is a freeze on the further implementation of reforms. These partially implemented reforms prevent further changes to laws or policies. However, this is not an accurate description of partial reform equilibrium. Russia has implemented many policies and changed numerous laws since the 1990s. Many scholars, such as Neil Robinson, use the Russian example to refute Hellman’s theory.⁴⁵ In contrast to these scholars, I argue that policy changes alone do not preclude the existence of partial reform equilibrium. The question driving this research specifically seeks to answer why reforms have not been fully implemented. If partial reform equilibrium did not exist in Russia, then the development of its institutions would have continued unfettered or not been addressed at all. Furthermore, where this study disagrees with Hellman is that partial reform equilibrium is not a problem of agency, but structure. Hellman’s error, as well as that of many of the other

⁴² Neil Robinson, "The Myth of Equilibrium: Winner Power, Fiscal Crisis and Russian Economic Reform," *Communist and Post-Communist Studies* 34, 4. (2001): 423 - 46.

⁴³ Hellman, 1998., 222.

⁴⁴ Alberto Alesina and Allan Drazen, "Why Are Stabilizations Delayed?," *American Economic Review* 81, (1991): 1170 - 88.; Allan Drazen and Vittorio Grilli, "The Benefit of Crises for Economic Reform," *The American Economic Review* 83, 3. (1993): 598 - 607.

⁴⁵ Robinson, 2001.

scholars mentioned above, is his overwhelming focus on the direct intentions of the ‘winners’ and other elites involved in policy making, rather than on the institutional forces that drive them. Decisions are not made in a vacuum — the organisations, agencies, and agents responsible for upholding institutional practices will act upon the incentives provided by the institution itself.

Partial reform equilibrium prevents institutional development from taking place by maintaining practices that undermine and contradict each other. As mentioned above, if path dependency sets in, these partially reformed institutions will be weak and self-replicating, making them extraordinarily difficult to develop and strengthen. This is likely to happen in states where modernisation is undertaken at the expense of institutional development, à la Huntington. Thus, if states, like Russia, become more preoccupied with implementing reforms such as privatisation and democratisation in the absence of strong institutions, then modernising reforms will continue to undermine the very institutions required for their implementation. Even before the collapse of the Soviet Union, modernisation reforms were prioritised over institutional reform and development. This drive for modernisation over development increased once Russia was an independent state and attempted to meet various conditions set by international advisors.⁴⁶ In fact, implementing ‘borrowed institutions’, or institutions that were not formed and developed by the state or culture in question, is one of the key causes of institutional weakness.⁴⁷ Thus, it is the endurance of partially reformed institutions that undermines genuine attempts to upset partial reform equilibrium.

The ‘not-so-great’ transformation

Karl Polanyi’s seminal work *The Great Transformation*, provides a framework through which we can understand and analyse partial reform equilibrium. The premise of Polanyi’s book is that a market economy is not a natural phenomenon. Market economies were constructed by man and society beginning in the late eighteenth century. A market economy, according to Polanyi, is an institution and thus must be developed and strengthened.⁴⁸ He defines a market economy as a self-regulating system that is ‘directed by nothing but market prices... and is capable of organising the whole of economic life without outside help or interference.’⁴⁹ Furthermore, Polanyi differentiates between an economic system and a market economy. In

⁴⁶ Stiglitz. 2000

⁴⁷ Levitsky and Murillo, 2009. 124.

⁴⁸ Polanyi, (1944). 40.

⁴⁹ Ibid. 45.

economic systems that are not markets, the economy is merely a function of the social order, whereas a market society is subordinated to market institutions.⁵⁰ The market determines the most efficient way to produce and distribute goods and services based upon their supply and demand.⁵¹ Furthermore, to reinforce what was stated above, Polanyi demonstrates that governments intervene such that the market does not impinge upon the wellbeing of society, as market institutions do not consider things like environmental and human safety. Although no perfect market exists, the economy is primarily subordinated to market institutions.

Market institutions have not fully developed in Russia since the collapse of the Soviet Union, and many of the economists advising Russia on its transition did not take previously existing norms and practices into consideration. The reformers subscribed to a ‘one size fits all’ mentality, believing that if certain reforms could work for states like Hungary and Poland, then why not for Russia?⁵² This is because many of the reformers belonged to the classical school of economics, which believes that people will rationally respond to changes in price signals.⁵³ However, Polanyi explains that ‘Only in the institutional setting of a market are market laws relevant’, and price signals are fundamental market laws.⁵⁴ Thus, market economic laws can only be imposed by corresponding institutions. As such, a command economy cannot satisfy the requirements of a market economy. The problem Russia faces is that its economic institutions are primarily command, while the laws and policies they are supposed to enforce or implement are primarily market. These two things contradict each other, and prevent institutional reform or economic transition from taking place, resulting in partial reform equilibrium.

It follows that Russia’s institutions cannot accurately, reliably, or consistently reproduce predictable behaviour, which warps the economic incentives of all agents, and perpetuates the reconstruction of weakened institutions. The result is a dual set of economic incentives within society and the government — that of reciprocity (*sistema* or *blat*), but also of personal interest. Furthermore, we can categorise the two types of incentives by the contradictory types of economic systems: those that drive reciprocity, or systemic corruption, stem from both the feudal and command economies that were the root of Russian and Soviet economic life; those that drive personal interest, or venal corruption, stem from the market

⁵⁰ Ibid. 74.

⁵¹ Ibid. 71.

⁵² Hedlund, *Russian Path Dependence* (2012). 11.

⁵³ Ibid. 7.

⁵⁴ Polanyi, (1944). 40.

institutions that have crept into the economic system.

Furthermore, written laws do not always constrain political and economic behaviour, and constraints on said behaviour do not always come from written laws.⁵⁵ Because of the weakness or absence of institutions to uphold reforms, new expectations and social / behavioural norms cannot be formed. As Polanyi notes, no society could exist without an economic system, but not all economic systems are market economies. Russia's economy has been through many systems. Before communism and the Soviet Union, one could argue that the economy remained feudal.⁵⁶ This economic system was characterised by the importance of social relationships because individuals did not act 'to safeguard their material possessions, but to safeguard their social standing, social claims, and social networks.'⁵⁷ The Soviet government then spent a lot of time building command economic institutions, yet even those could not completely subordinate social relationships to the economy as a market can. As a result, what continues to generate expectations are pre-existing social norms, or what was referred to earlier as *sistema*.⁵⁸

In her book '*Can Russia Modernise?*' Alena Ledeneva describes *sistema* as a system of social relations and obligations that drive various aspects of Russian politics and economics.⁵⁹ *Sistema* is the adherence to the informal and unwritten rules of what has come to be known as the 'shadow' or 'informal' economy. Ledeneva explains that *sistema* emerged to fill voids left by weak or non-existent institutions in the Soviet era 'to compensate for the defects of the command economy', and in the post-Soviet era to compensate for the ineffectiveness of the nascent and weak market institutions.⁶⁰ Ledneva acknowledges that *sistema* has evolved and changed overtime, but its overall purpose has not.

There are five main tenants of *sistema*: '1) The members of each network are tied together by an unwritten code; 2) members are recruited and kept based on loyalty; 3) all members are compromised in some way or another; 4) rewards and punishments are extra-legally administered; 5) formal appointments to powerful positions support and reinforce the entire network.'⁶¹ The underlying social responsibilities of *sistema* are self-reinforcing and self-replicating by constructing obligations to remain loyal to the network and the system. The

⁵⁵ John Carey, "Parchment, Equilibria, and Institutions," *Comparative Political Studies* 33, 6 / 7. (2000): 735 - 61. 737.

⁵⁶ Hedlund, *Russian Path Dependence* (2012). 223, 230.

⁵⁷ Polanyi, (1944). 48.

⁵⁸ Ledeneva, (2013).

⁵⁹ Ibid. loc. 160

⁶⁰ Ibid. loc. 702, loc. 217

⁶¹ Ibid. loc. 400

second and third points are particularly useful: membership is based on loyalty — all members of a group could be compromised at any time. If anyone in the group fails to uphold their obligations, the group could disavow and compromise them by turning the person in for any crimes they committed. This self-replicating system then falls into Polanyi's definition of an economic system that is merely a function of social order as social ties and loyalty are far more important than economic profit (of course, the two are not mutually exclusive).

There are several examples of how *sistema*, or the social economy, was reinforced as the Soviet Union collapsed. This is important because many of the reforms and programmes initiated both by Mikhail Gorbachev and the reformers after him, aimed to end these practices as they undermined the economy's potential.⁶² Yet, by focusing on modernisation over institutional development, the reforms could not be properly implemented because social institutions intervened to protect the status quo. However, to start building a market economy, the status quo must be upset as hard budget constraints (HBCs) are imposed. HBCs lead to social disruption and a decline in standards of living for most people, as Hellman notes. Polanyi reinforces this throughout the rest of *The Great Transformation* by analysing how the construction of a market economy causes massive social dislocation.⁶³ Therefore, if the difference between a market economy and a social economy is that in the latter is a function of society, and the former subordinates social relations and interactions to the supremacy of the market, then the transition from one to the other necessitates the destruction or transformation of the social economic relations. The next chapter will outline the methodology for illustrating how this transformation has failed to take place at the expense of Russia's economic development. The most important implication being that the Russian economy is not a market economy — it never has been. While it is no longer a command economy, it has not yet become a market economy.

Argument

This study argues that Russia has not been able to complete its economic transition and is not a market economy, because its institutions are trapped in partial reform equilibrium. Partially reformed institutions cannot implement or enforce the reforms necessary to complete the transition from a command to market economy. Furthermore, the focus on economic modernisation over institutional development perpetuates weak institutions as reformers and

⁶² Gilles Favarel-Garrigues, *Policing Economic Crime in Russia: From the Soviet Planned Economy to Privatisation* (London: C Hurst & Co., 2011). 111.

⁶³ Polanyi, (1944). 39.

politicians are more concerned with pushing through reforms than ensuring economic institutions have the capacity to implement them. Partial reform equilibrium results in parchment institutions, or institutions unable to undertake the tasks they have been set, and parchment rules, laws that cannot be implemented because there is no institutional capacity to do so.⁶⁴ This results in a weak rule of law as there is no change or improvement to predicted behaviours or general expectations. This is evidenced by the inability of Russian banking institutions to strengthen and develop since the collapse of the Soviet Union.

If institutions are the socially constructed practices that determine how transactions and exchanges are undertaken, then laws are the codification of these practices, which are enforced by agencies and agents. As such, a strong rule of law is reflective of strong institutions. Conversely, weak institutions fundamentally prevent the development of the rule of law as informal practices clash with formal, written regulations. As a result, the law is not consistently enforced, and does not generate new or change pre-existing expectations. Jeffery Kahn outlines the three main principles of rule of law as: 1) there can be no crime without law; 2) the law is universally applied — no one is above or out of reach of the law; 3) the law will be analysed and enforced by a neutral third party.⁶⁵ Weak institutions do not abide by these principles. The defining characteristic of parchment rules are laws that have been written to solve a problem or reach an objective, yet their full enforcement is not possible because there is no institutional precedent to do so. Either the institution cannot provide the agency with mechanisms to enforce the law, or the mechanisms it possesses do not have the intended effects. Thus, weak institutions are unable to provide agents with the tools or guidelines to undertake the tasks they have been set, which renders laws vague and able to be widely interpreted.

Examining how Russia violates all three of these principles illustrates how weak institutions cripple the rule of law. To begin, parchment rules create new laws that are not supposed to be broken, but their implementation often obscures what is or is not legal. Rarely do regulations become obligatory as there are always exceptions. In chapter three, it will be demonstrated that while these exceptions greatly benefit some individuals, the most important implication is in how they affect social norms and attitudes. The second principle is undermined by the inability of weak institutions provide agents with the foundations to consistently and predictably enforce laws. For example, elites use their *blat* or *sistema* to avoid

⁶⁴ Carey, 2000.; Levitsky and Murillo, 2009. Vladimir Gelman, "The Unrule of Law in the Making: The Politics of Informal Institution Building in Russia," *Europe-Asia Studies* 57, 7. (2004): 1021 - 40.

⁶⁵ Jeffrey Kahn, "The Search for the Rule of Law in Russia," *Georgetown Journal of International Law* 37, 2. (2006): 353 - 410.

prosecution. It must be said that rarely do these individuals outright break the law, but they violate its spirit and bend it to their purposes, further obfuscating the purpose and efficacy of the law.⁶⁶ Further complicating matters is the tendency towards rule by law, or the selective implementation of laws, a defining feature of the social economy. Rule by law is a tool used to penalise defectors in *sistema*: everyone is guilty of something, but only those that betray the group are punished. Those who are prosecuted receive punishments that are not commensurate with the crime they committed.

Importantly, the third principle is undermined because judges cannot create legal precedence when legal interpretation varies widely and implementation is selective. Ledeneva demonstrates that while politicians and elites do not actively make phone calls to judges to sway verdicts, *sistema* encourages judges to rule in their own interest as well as that of the social network to which they belong.⁶⁷ Judges know that anything can be used to indict them, thus forcing them to make decisions that will not bring down the proverbial sword of Damocles.⁶⁸ Outside the judicial system, weak institutions further obfuscate the enforcement of laws. As institutions are incapable of properly enforcing laws, either because they do not possess the tools and mechanisms for enforcement or because the laws have too many loopholes. These parchment rules prevent neutral third parties from properly analysing and enforcing laws, thus making a consistent interpretation and application of the law to be difficult if not impossible.

The result of weak economic agencies and rule of law is that institutional development is a painstaking and time-consuming process. Command economy institutions have not been destroyed, and market economy institutions have not yet been developed. Yet, a market economy requires strong institutions, as they generate expectations about the various possible outcomes of economic transactions. If laws are written and not enforced, then no new behavioural expectations can be formed. Thus, weak economic institutions mean that Russians cannot form expectations about how other economic agents will act. As a result, they consistently find it within their immediate interests to make decisions that will maximise their profits in the short-term. This undermines incentives to make long-term economic investments. Instead, reliance on old social economic functions remain — individuals will only interact with and do business with other known and trusted entities.

⁶⁶ Ibid.

⁶⁷ Ledeneva, "Telephone Justice in Russia," 2008.

⁶⁸ Ledeneva, *How Russia Really Works: The Informal Practices that Shaped Post-Soviet Politics and Business* (2006).

This study focuses on Russia's underdeveloped banking institutions, which clarifies how the transition has progressed very little even in the presence and creation of seemingly sound policies and laws. Weak institutions have resulted from a clash between informal and formal behavioural constraints, with the former undermining the latter.⁶⁹ This allows differing individual preferences to become a priority and prevents collective action from achieving desired change.⁷⁰ For example, transition reforms aimed at introducing market economy mechanisms such as privatisation and liberalisation fail to do so, because they have two contradictory goals: to allow for some privatisation and some liberalisation, but to also maintain the status quo and protect the social economy. The result is that command economy institutions are trying, and failing, to implement and enforce market economy laws. This is because command institutions are not founded upon the same practices and expectations as those in a market, and thus do not have the coordination mechanisms necessary to enforce market economy laws. Therefore, we arrive back at partial reform equilibrium, or the existence of command and market institutions simultaneously contradicting and undermining each other and halting Russia's transition.

The result is that Russia's banking institutions struggle to perform their intended functions. As the laws banking agencies are supposed to enforce are constructed from institutional practices, weak institutions are self-replicating. The degree of law and policy enforcement often comes down to either the tools at the disposal of the organisation and its agents, and / or their interpretation of the law rather than a clear and consistent interpretation by all enforcement parties (police, lawyers, judges, etc.). This lack of consistency undermines the legitimacy of the institution. Furthermore, weak institutions provide agencies with tools that are ineffective and do not reflect social norms and practice. This incentivises the use of social networks to compensate for the agencies' incompetence, and to exploit institutional weaknesses that further undermine institutional legitimacy. Therefore, I submit that the political and economic elites are not necessarily maintaining partial reform equilibrium out of a selfish desire to maximise individual rent-seeking behaviour. Rather, they have been acting upon the skewed incentives these institutions provide, which reinforces their partially reform state. In fact, this is what maintains the equilibrium of partial reform: a combination of circumstances from which no actor has an incentive to deviate.⁷¹

Thus, partial reform equilibrium stems from the incomplete transition of command

⁶⁹ Hedlund, *Russian Path Dependence* (2012). 163.

⁷⁰ *Ibid.* 163.

⁷¹ Carey, 2000. 736.

institutions, rather than the individual decisions of political elites. *Perestroika* reforms set out to change economic practices, such as encouraging enterprises to maximise profits, but the Soviet Union collapsed before these new institutions could be fully developed. As such, the Russian Federation inherited an economic system that was already partially reformed. Partial reform equilibrium ensures that many Soviet institutions and practices are now functioning within the context of an ersatz market economy. These weak institutions maintain practices like state subsidies and poor tax and debt collection, which prevents the formation of new expectations, such as the necessity of meeting debt obligations. Furthermore, as weak institutions fail to provide an effective and efficient means of conflict resolution, people continue to defer to personal networks and the informal economy. Consequently, the Russian economy today operates much like a ‘Potemkin village’: the appearance of a market economy on the outside, but in fact a command economy on the inside.

The parchment rules that make up weak institutions are what differentiate partial reform equilibrium from the process of prolonged political and institutional decay outlined by Samuel Huntington and Francis Fukuyama.⁷² In a process of political decay, the leaders and elites of a formerly functional political system maintain their positions of power as new social groups emerge. These groups and other external forces cause institutions to decay because they stop responding to the changing needs of society and can no longer provide long-term predictability and stability. As elites embed themselves in and use agencies, both for their own political purposes and to satisfy their social networks, the institutions stop reflecting social norms and needs.⁷³ Therefore, society demands change and new institutions in one form or another, and this change is rarely smooth. Successful institutional change occurs, Fukuyama says, ‘when outsiders become insiders’, signalling an opening of organisations to new blood or perspectives from emerging social movements or groups, and the changing of institutions based on the inclusivity of those perspectives.⁷⁴

This has happened in Russia. Fukuyama and Huntington might argue that the reason there was no institutional change in the early 1990s was not because of partial reform equilibrium, but because the old *nomenklatura* became the privatisers and managers of the new capitalist economy. In other words, there was no opening of the agencies to outside members because the old members from the Gorbachev era simply changed their formal titles. I would argue that this is not the case in two points, which will be elaborated in chapter three. First,

⁷² Fukuyama, (2014). 463.

⁷³ Ibid. 462.; Huntington, "Political Development and Political Decay," 1965.

⁷⁴ Fukuyama, (2014). 463.

while one could argue that the delay in Russia's institutional development is caused by extended political decay, it does not explain why this decay then continued when outsiders started to become insiders in the mid-1990s with the privatisation and loans-for-shares programme. Specifically, loans-for-shares introduced new bankers and other new faces to the political arena, but it did not change or otherwise strengthen the institutions. Second, the most drastic infusion of new blood into Russia's political and economic agencies, namely the coming to power of Vladimir Putin's network, also has not resulted in stronger institutions or further institutional development. Who the elites are is irrelevant because they can only work within the framework of the weak institutions they inherit, and they act upon the incentives the institutions provide. All modernisation policies will be ineffective so long as institutions remain weak and partially reformed. Thus, what differentiates partial reform equilibrium from more general political decay is that the addition of 'new blood', or the inclusion of new actors, in the process of governance does not result in institutional change.

It could be argued that the perseverance of these institutions through regime change could be a sign of institutional strength because strong institutions endure. However, this would be an oversimplification and a fallacy. Strong institutions endure because they provide the foundation for a strong rule of law, which allows actors to predict what will get them into trouble, and what will benefit them. But because Russia's institutions are weak, actors still live in a primarily rule by law state where loyalty to social networks trumps formal laws and regulations, institutions remain weak.⁷⁵ As will be demonstrated, the selective use of law to punish individuals or social groups undermines the rule of law, prevents actors from forming consistent expectations, and undermines the strengthening of new institutional practices. The only thing that can be expected, at this stage, is that betraying one's social network is more likely to bring trouble than breaking the law.⁷⁶

This argument builds on the work of Hellman and others to demonstrate that Russia's banking institutions are indeed trapped in partial reform equilibrium, which has retarded the development of the banking industry, and by extension affects economic development more generally. This study demonstrates that Russia's stalled economic transition is caused by weak institutions, rather than the actions of the elites. While individual interests contribute to and exacerbate partial reform, they do not cause it outright; collective action on the part of the 'winners' is not necessary to either create or maintain partial reform equilibrium. While Russia

⁷⁵ Richard Sakwa, *Putin Redux: Power and Contradiction in Contemporary Russia* (New York: Routledge, 2014). 28.

⁷⁶ Gelman, 2004. 1023, 1026.

is indeed a limited access order, it is only a symptom of partial reform equilibrium, and the two are not synonymous. Partial reform equilibrium is caused by conflicting and obstructive institutional incentives. An LAO is a social order created by the exclusion of most economic players from the economy by the elites. The two often work in tandem, but they are not the same. This distinction is important because it explains why economic incentives alone are not enough to break either partial reform or transform a limited into an open access order.

If partial reform equilibrium were a phenomenon brought about solely by Russia's political and economic agents, then the equilibrium would indeed be broken with the implementation of new policies. However, although there have been numerous policies and laws that have been drafted and approved, organisations remain incapable of fully implementing them as they are not supported by any institutional foundation. As such, there has been no appreciable change to long-term economic development. Thus, the equilibrium is one in which economic institutions are stuck in a partially reformed state — they have not made significant development toward a market economy. For example, the partially reformed banking sector has made little progress toward fulfilling the role it should play in a market economy. This demonstrates how partial reform equilibrium is not of the variety described by Hellman, as it does not result in a long-term policy freeze. However, the fact that a myriad of banking laws and policies have been updated and enacted since the late 1990s with no actual improvement in long-term sectoral stability, shows that barriers to completing transition remain. Thus, Russia's banking institutions are stuck in partial reform equilibrium, not because the elites have decided so, but because its foundations remain fundamentally unreformed.

The Russian economy is neither command nor market. Weak institutions have prevented the rigid imposition of hard budget constraints on firms and enterprises, resulting in the continued operation of many under efficient firms and industries at the expense of entrepreneurship and the development of small and medium sized businesses. This has further damaged long-term investment prospects for the economy. Thus, not only do existing enterprises struggle to re-invest in their own businesses, but the development of new companies and industries remains stifled.⁷⁷ This is because the rules of the game are not clear, due to institutional weakness and a correspondingly low level of the rule of law. The more deeply entrenched partial reform equilibrium is, and the more opaque the rules of the game are, the higher the risk is for all economic actors.

⁷⁷ Evidence for this is given in chapters five, six, and seven.

1.4 Analysing partial reform equilibrium

This study will analyse the development and trajectory of partial reform equilibrium in Russia, focusing specifically on banking institutions and the agencies that embody them. The strength of banking institutions is one measure of a strong and robust economy, which is positively correlated with stronger rule of law. As specified above, because GDP per capita is positively correlated with the strength of rule of law, it is a more important predictor of strong institutions than democracy or other political measures. While a democracy cannot exist without a strong rule of law, a state does not have to be democratic to have a strong rule of law. It also follows that the combination of a high GDP per capita and high rule of law rankings is indicative of a strong market economy. Russia's GDP per capita is strong, but its rule of law is weak, signifying weak economic institutions and the lack of a market economy. Therefore, this study analyses the development of Russia's banking institutions as one example of how Russia's economic institutions have developed. Because this study exclusively examines banking institutions and its agencies, it cannot generalise for the development of the entire Russian economy. Instead, it provides an insight into the development (or lack thereof) of a vital market institution.

Although the study will make brief references and comparisons to other post-Soviet and post-socialist states, the study itself is interested only in Russia. Most comparative studies seek to analyse most similar or most different systems.⁷⁸ However, it is not so simple when looking at the former Soviet Union (FSU). Russia was the core region that composed the Russian Empire and later the Soviet Union. This is crucial because it explains why the Warsaw Pact and the Baltic states have come much farther in their institutional modernisation than Russia, but why Russia and the remaining former FSU countries are still struggling. As illustrated by Francis Fukuyama, former colonies often inherit the institutions of the coloniser, either in attempts to mimic the coloniser or as a direct implant of the colonising power to ease administration.⁷⁹ These institutions often are what the new states use when the colonisers leave.⁸⁰ The Russian Empire did not have strong institutions, and the Soviet Union did little to strengthen them when they took power. In fact, the Bolsheviks were successful in dismantling the few solid institutions the Empire did have, such as the central bank, but failed to properly rebuild them and make them autonomous. Thus, while FSU states inherited these institutions,

⁷⁸ John Gerring, *Case Study Research: Principles and Practices* (Cambridge: Cambridge University Press, 2007). 131 – 134, 139 – 142

⁷⁹ Fukuyama, (2014).

⁸⁰ *Ibid.*

the Baltic and the Warsaw Pact states did not. The latter two groups had strong, pre-existing institutional practices that were co-opted by the Soviets and Communists, and re-developed when these states overthrew their socialist regimes.

As such, there are not enough similarities at the outset to undertake a most different systems design analysis comparing Russia and the states of Central and Eastern Europe. Yet, former Soviet States that may have similar outcomes, do not have enough differences at the outset. Therefore, because of the nature of the Soviet Union and its satellite states, the traditional most similar or most different systems design analyses are not particularly helpful. Similar states are similar because they were once part of the same country. But, different states did not have similar institutional settings at the outset, and thus have had very different outcomes. Furthermore, while there are commonalities, finding them among a wide range of states creates generalisation. This is the opposite of what this study is trying to achieve: an in-depth understanding of the development trajectory of Russia's banking institutions, and why they have been able to help Russia complete its transition. Although a larger study examining the same or similar institutions in other countries to distil the similarities and create a generalisation would be useful, it would be a large undertaking beyond the scope of this study.

Finally, Russia is the focus of this study because it presents an interesting research puzzle: it has all the conditions of a state that should want to and be able to construct strong banking institutions, but it has not. It has a lot of economic potential due to the country's geographical size, population, and natural resources, and a strong banking industry could encourage the growth of small and medium sized enterprises, which would increase the size of the middle class and overall economic growth. Even if the government was purely interested in rent-seeking, the state could increase its natural resource rents if banking institutions were stronger and favoured long-term investment for updating technology and increasing efficiency. However, this is not the case. Although the situation has somewhat improved since the economic chaos that characterised the 1990s, it has not changed much. In fact, according to North, this unpredictability should have led Russians to construct institutions as a means of creating order out of chaos.⁸¹ Yet, while capital flight has slowed, asset stripping is still common — it now takes the form of hostile takeovers, known in Russia as raiding.⁸² Furthermore, in the 1990s, many of these activities were the work of independent oligarchs,

⁸¹ North. Loc. 1394.

⁸² Sakwa, "Systemic Stalemate: Reiderstvo and the Dual State," 2013.; Michael Rochlitz, "Corporate Raiding and the Role of the State in Russia," *Post-Soviet Affairs* 30, 2-3. (2014): 89-114.; Ledeneva, (2013).

but today these activities are undertaken by the state, further eroding institutional foundations.⁸³

The study uses process tracing to demonstrate that *perestroika* reforms are the genesis for partial reform equilibrium, and then analyses their effect on institutional development. *Perestroika* was specifically aimed at restructuring the country's economic institutions to make economic activities profitable. It was the most drastic attempt at change in the former Soviet Union, and later in the Russian Federation, and one that required a complete reorientation of economic institutions and incentives. However, *perestroika* failed in its mission and instead became the starting point for partial reform equilibrium. Thus, it was the Soviet Union's changes to the economy that had the most lasting impact on the Russian Federation and its attempts to transition to democracy and a market economy. Furthermore, this study will use economic institutions and incentives to show why Russia's democratic institutions are also weak. Although there is no debate that the attempted change from an autocracy to a democracy was also drastic, Russia's status as a 'democracy' is debated, as it too is in transition. Yet, because of the correlation between strong economic institutions and political liberalism, economic institutions are vital completing the political transition whatever the outcome. As such, the weakness of Russia's banking institutions is more illustrative of why Russia's democratic institutions are weak than focusing on democratic institutions alone.

At the heart of this study is an analysis of the effects of partial reform equilibrium on the development of The Central Bank of Russia (CBR) and its regulation of the commercial and investment banking industry and financial markets. Specifically, the case studies in chapters five and six test the hypothesis that the 1998 and 2008 economic crises resulted in institutional development as the CBR emerges a stronger agency. The CBR is the perfect organisation to study for evidence of partial reform equilibrium. The banking industry and financial market constitute a purely market institution, one that is unfamiliar to the Russian economy. Thus, Gosbank, a vital command agency needed to fulfil the economic plan by softening budget constraints, is now a vital organisation that must to mediate and regulate the backbone of a market economy: banks. The study will explore the contradiction of these two roles in chapter four. It will investigate how the CBR has changed, superficially or otherwise, since the collapse of the Soviet Union by comparing the roles of the Gosbank and the CBR. Such a comparison provides a clear illustration of how the CBR has contributed to the

⁸³ Chrystia Freeland, *Sale of the Century: The inside Story of the Second Russian Revolution* (London: Little, Brown Book Group, 2000).; Lilia Shevtsova, *Russia: Lost in Transition* (Washington D.C.: Carnegie Endowment for International Peace, 2007).

maintenance of partial reform equilibrium in the banking industry, and provides an insight to the consequences for general economic development. It will also distinguish those institutional practices and incentives that have changed versus those which still exist and are contributing to the persistence of a quasi-market economy. The partial reform of Soviet banking institutions has led to weak and underdeveloped Russian banking institutions, and has diminished the role banks play in the Russian economy.

This overall study has two objectives. The first is to analyse the reforms and policies that affect banking institutions and its corresponding organisations: what the main responsibilities, restrictions, and powers of enforcement are; how independent they are and how this independence is protected; and what external influences exist. For each reform, the circumstances in which it was enacted and who was involved in the process are weighted. This allows the study to analyse how the effectiveness and efficient banking organisations are. Where they fail, it seeks to demonstrate how institutional weakness causes this. Building on this, the second objective seeks to understand if the CBR can fulfil its role, by examining those regulatory powers that are effective and those that are not. This will allow for a rich understanding of how banking organisations are supposed to function on paper, versus the institutional limits of their regulatory abilities. This will shed light on how these organisations function in theory and practice. To do this, we analyse key reforms undertaken from *perestroika* through the 2008 economic crisis, how they were enacted, and whether any change resulted. Understanding the degree of change that has resulted gives evidence for the influence of weak institutions on the effectiveness of regulatory agencies, and the impact this has in providing long-term economic stability or maintaining partial reform equilibrium.

This study contributes to the literature by providing a richer understanding of the development and contemporary functioning of fiscal and monetary institutions in Russia, which is understudied. Additionally, most studies on partial reform equilibrium examine legal and political institutions: elections, regional reforms, the passing of laws, crime rates, and corruption levels, whereas the studies that focus on economic institutions tend to be far more concerned with the corruption of individual agents and how this affects trust in institutions, as well as broader economic stability and growth.⁸⁴ Furthermore, studies that focus on fiscal and

⁸⁴ William Tompson, "The Political Implications of Russia's Resource-Based Economy," *Post-Soviet Affairs* 21, 4. (2005): 335 - 59.; Hellman, Kauffman, and Jones, 2000.; Appel, 2004. William Tompson, "Putin's Challenge: The Politics of Structural Reform in Russia," *Europe-Asia Studies* 54, 6. (2002): 933-57.; Philip Hanson, "The Russian Economic Puzzle: Going Forwards, Backwards, or Sideways?," *International Affairs* 83, 5. (2007): 869 - 89.; Philip Hanson and Elizabeth Teague, "Big Business and the State in Russia," *Europe-Asia Studies* 57, 5. (2005): 657 - 80.

monetary policy seem to have peaked in the 1990s, and focus solely on policy and international conditionality, and the corresponding social and political implications.⁸⁵ While these studies are indeed important, they do not address the incentives driving the agents under observation, which is what this study intends to do.

This study further contributes to the literature by looking beyond the intentions of reformers, advisors, and politicians, and by looking at their constraints; it argues that the problems with transition stem from structure, rather than agency. As such, the framework it uses to analyse transition is different. Instead of looking at how Russia's transition failed, it examines why it is still incomplete. Most studies focus on the agents of change: reformers, politicians, oligarchs, neo-liberal Western advisors, and so on. Yet, many scholars take institutions for granted without realising that even weak institutions are influential, as they form the fundamental framework within which agents must work. Thus, while the agency factor cannot be ignored, this study is more concerned with the institutional influences that motivate and constrain these agents beyond a selfish desire to maximise personal rents. This study will illustrate how institutions became partially reformed, and how this has endured by constraining the changes the agents can make. It illustrates that partial reform equilibrium is a far more endemic phenomenon than a mere disinclination to address structural economic problems. Finally, the study aims to provide an understanding of what motivates political and economic actors to act contrary to the state's long-term economic interests, as well as their own.

Elites and average Russians alike want more long-term economic stability and prosperity even as their actions continually undermine attempts to create it.⁸⁶ Key evidence for this is presented in the case studies in chapters five and six. To provide a better understanding of how this contradiction has evolved, chapter three provides a general history and analysis of partial reform equilibrium from *perestroika* to the second Putin presidency starting in 2004. This will allow us to understand both the beginning of partial reform equilibrium and how institutional constraints and incentives have prevented agents from breaking it. Specifically, the chapter will analyse the general effects of liberalisation reforms and key policies of the

⁸⁵ William Tompson, "The Politics of Central Bank Independence in Russia," *Europe-Asia Studies* 50, 7. (1998): 1157-82.; William Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," *Europe-Asia Studies* 49, 7. (1997): 1159-85.; Juliet Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," *Europe-Asia Studies* 46, 6. (1994): 971-95.; Randall Stone, *Lending Credibility: The IMF and the Post-Communist Transition* (Princeton: Princeton University Press, 2002).

⁸⁶ Ledeneva, (2013).; Richard Sakwa, "The Dual State in Russia," *Post-Soviet Affairs* 26, 3. (2010): 185-206.

Putin era on the economy and society. Examining the effects of partial reform equilibrium on the CBR will be the subject of chapter four. Before we can analyse this, however, we must first understand the arguments surrounding the development of banking institutions. The following chapter will analyse the literature on how economic crises affect banking institutions in order to construct an analytical framework, through which the case studies will process the shocks and reforms that Russia endures during the transition period and how they have affected institutional development.

CHAPTER 2

CRISIS MODERNISATION

The basic research question at hand is: why has Russia not completed its economic transition? Why, despite many genuine attempts at reform and modernisation does the economy remain trapped in partial reform equilibrium? This study argues that because Russia's economic institutions are stuck in partial reform equilibrium, it is not a market economy as defined by Adam Smith and Karl Polanyi. This causes dissonance as the government requires the agencies, such as the Central Bank of Russia (CBR), to undertake tasks for which it is not equipped, while also providing it with ineffective coordination mechanisms. This paradox explains why Russia has drafted well-meaning economic and political reforms over the past twenty years, but still resembles a state in transition.

Russia has very little historical experience with a market economy because there has never been an incentive for the state to relinquish control to market forces, as industrialisation was always a threat to political stability.¹ By retaining control over the economy, the market premise of self-regulation is undermined. This led the state to develop the economy in fits and starts whenever it was necessary. Historically, has coincided with military threats, which required the state to undertake several economic development reforms simultaneously to produce arms and equip the military.² However, this resulted in the immediate changing of formal rules, with no way to control the informal norms undermining the implementation of said rules.³ This pattern would continue even through the Soviet era. Thus, why the Soviet Union could send a man into space but not produce quality goods of any significant retail value.⁴ The result was a very lopsided economy that had a strong military industrial complex, but was otherwise economically underdeveloped.

Scholars argue that economic crises can catalyse institutional development in developing states, or states in transition. These crises serve as critical junctures that reveal unknown or ignored institutional weaknesses, which must be addressed to exit the crisis. This is known as crisis modernisation. János Kornai's transformational recession is one example of this.⁵ The generally accepted logic is that the 1998 crisis was a period of crisis modernisation

¹ Hedlund, *Russian Path Dependence* (2012). 223.

² Ibid. 230.

³ Ibid. 230.

⁴ Ibid. 290.

⁵ Kornai, 1994.

for Russia, because it forced the state to implement the necessary hard budget constraints to complete its transition. Since the 1998 financial crisis, Russia has experienced 5.25 percent average growth per year, despite the global economic crisis of 2008.⁶ In fact, in the 16 years since Russia's economic implosion, the only year it has experienced any kind of negative growth was in 2009, when its GDP contracted by 7.82 percent.⁷ If economic growth picked up after the 1998 crisis, then the necessary economic institutions must have been developed to support said growth.

However, using evidence from the banking industry, this study demonstrates that this is a fallacy. The data does not consider measures of institutional weakness. For example, Russia's strength of rule of law over the same period has averaged a total score of -0.89, placing them in the bottom 20 percentile internationally.⁸ So while Russia's economy is growing steadily, its rule of law is not improving. Because rule of law is a measure of institutional strength, this calls the stability and source of Russia's economic growth into question. If economic growth is not due to institutional development, then what is it? That question can be answered fairly quickly: natural resource rents. If this is the case, then what is the state of Russia's banking institutions and why has it been unable to develop?

In a 2013 conference paper, Kenneth Arrow describes how the bankers responsible for the 2008 financial crisis were not blind to the potential consequences to their actions, but their incentives for taking the risks that they did were obvious; thus, their actions were not surprising.⁹ Similarly, in Russia, it confounds Western economists and observers that Russia does not actively pursue policies required to support a market economy, because the former see the benefits of doing so. What many economists see as irrational behaviour is, in fact, very rational because the incentives for maintaining underdeveloped institutions are higher than those for changing the system.¹⁰ This is because over time, Russia's economic institutions have generated expectations about the various possible outcomes of economic transactions. If agents expect institutions to be weak, and they find it within their immediate interests to maximise their profits in the shortest possible term. This reinforces partial reform equilibrium by creating

⁶ Averaged from: The World Bank. "Percent Change in Russian Federation GDP Per Year 1991 - 2012," 2012.

⁷ The World Bank. "Percent Change in GDP Per Capita for Russian Federation 1991 - 2012," 2012. ; The World Bank. "Percent Change in Russian Federation GDP Per Year 1991 - 2012." 2012.

⁸ Data averaged from: The World Bank. "Rule of Law," 2013. Rule of Law score is used to classify the strength of rule of law in a country with -2.5 being the lowest score and 2.5 being the highest.

⁹ Arrow (2013), 8.

¹⁰ Michael McFaul, "Lessons from Russia's Protracted Transition from Communist Rule," *Political Science Quarterly* 114, 1. (1999): 103 - 30.

path-dependent incentives for replicating weak institutions as economic actors ‘expectations about institutional enforcement and stability determine their approach to institutional design.’¹¹ Instead using formal institutions to resolve conflicts, agents rely on informal social networks.

This chapter will break down what crisis modernisation is and how it works. First, it analyses various theories of institutional change and where crisis modernisation fits into this. It then argues that crisis modernisation has not taken place in Russian banking institutions because the mechanisms necessary to undertake reforms are underdeveloped or non-existent. Thus, using policy implementation as a measure of institutional strength, three hypotheses are established to test the degree that the CBR experienced crisis modernisation because of the 1998 and 2008 economic crises. Finally, the methodology for testing the hypotheses and the analytical framework for evaluating the results will be developed. This sets up the foundation upon which we will analyse the history of partial reform in chapter three, the development of the CBR in chapter four, and the case studies on the 1998 and 2008 crises in chapters five and six.

2.1 Crisis modernisation

How and under what conditions institutions change is hotly debated. Many argue that weak economic institutions are most effectively changed through crisis modernisation: a crisis that forces agents to strengthen institutional weaknesses. Others look to individual actors and their desire to change, or the historical role of the institution. The agent-centric arguments put forth that institutions are reformed via policies and political actors.¹² This school of thought believes that the most efficient way to change institutions is to focus on formal laws and reforms that increase or decrease the powers and purposes of existing institutions, or that destroy old and create new ones. The rationale is that new laws will change agents’ expectations and behaviour. This is considered a rational choice argument whereby change will occur when doing so maximises the agent’s potential gains. Additionally, these scholars argue that it is possible to draft legislation that will sway agents’ cost / benefit analysis in favour of adhering to formal laws.¹³ Thus, institutions will change when it is in the interest of agents to change them. However, implementing formal laws does not ensure change will take place. It might express the desire or intent to change, but actual change will take a very long time.

¹¹ Levitsky and Murillo, 2009. 127.

¹² Juliet Johnson, "Path Contingency in Postcommunist Transformations," *Comparative Politics* 33, 3. (2001): 253-74. 254.

¹³ Thelen and Steinmo, 1992.; Steinmo, 2008.

The second school of thought is the structuralist school. This line of argument contends that institutions are nearly impossible to change due to the overwhelming weight of historical and cultural legacy.¹⁴ It is helpful for explaining why formal laws and reforms alone cannot change an institution overnight; that the sheer will of people and the government cannot change an institution. As formal rules do not change behaviour or expectation, agents revert to using informal practices.¹⁵ At the very least, new regulatory powers must be tried and tested again and again to determine how to best use them in accordance with the rule of law.¹⁶ However, if this school of thought were to be believed, no institutional change would ever take place because the weight of history would keep pulling the institutions back.

North explains that institutions will change through a combination of changing formal rules and their enforcement, and informal norms.¹⁷ Most scholars who study institutional change agree that the most important variable is time.¹⁸ Institutions do not change quickly, and this cannot be rushed. However, historical institutionalists argue that most institutions remain stable until major events force them to change, in what they call punctuated equilibrium.¹⁹ While they do not disagree that institutions and agents both need time to adapt, they argue that exogenous shocks provide the critical junctures needed to create the most change. One of the biggest criticisms of this approach is that it leaves little room for human agency.²⁰

Yet, this is not mutually exclusive. Historical institutionalism generally seeks to explain the how and why institutions change and it looks both at agency and historical factors. It is possible for agents to implement new rules that are either ineffective, do not address or fail to resolve the problem at hand. Concerning how institutions constrain incentives and behaviour, historical institutionalists equally weigh both agency and institution in times of change. If change takes place gradually over time, then it is likely that institutions are strong and can reflect the needs and values of agents. If change takes place due to an exogenous shock, then institutions are weak and the shock exposes and exacerbates the weakness.²¹ This draws on the

¹⁴ Pipes, 2004. Johnson, J. 2001. 254.

¹⁵ Carey, 2000.

¹⁶ Carothers, "The "Sequencing" Fallacy," 2007.

¹⁷ North, (1990).; Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," 2000.

¹⁸ Huntington, "The Change to Change: Modernisation, Development, and Politics," 1971.; Carey, 2000.

¹⁹ Steinmo, 2008. 129.; Thelen and Steinmo, 1992.

²⁰ Steinmo, 2008.

²¹ Charles Calomiris, Daniela Klingebiel, and Luc Laeven, "Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience," in *Systemic Financial Crises: Containment and Resolution*, ed. Patrick Honohan and Luc Laeven (2003).

agent centric need to acknowledge and attempt change, and the path dependent nature of institutions from the structuralist school of thought. Agents pass laws, but it is only at critical junctures that these laws and reforms are legitimised.

The result is what this study refers to as crisis modernisation: the strengthening of institutions because of an endogenous or exogenous shock, such as an economic crisis. In fact, there are numerous studies that look at the effect of economic crises on developing countries, and most of them find that crises do lead to much needed reforms.²² This is because developed economies with strong institutions can coordinate enforcement mechanisms more efficiently and resolve crises more efficiently than economies with weak institutions.²³ For example, the Inter-American Development Bank found that economic crises, especially debt crises, led to lasting reforms despite the hypothesis that states would revert to old patterns once the crisis resolved.²⁴ The exception was banking crises, yet this too disappeared when banking crises were combined with debt crises.²⁵ Laeven and Valencia found that debt crises are easier to resolve, whereas banking crises are more complex and require stronger institutions to mitigating disputes over bankruptcy and property rights.²⁶ It could be that when banking crises and debt crises occur simultaneously, it is in the best interest of all agents to cooperate to resolve the crisis, but a banking crisis alone affects one group disproportionately. This is generally supported by Drazen and Grilli, who found that only when the stakes are high for all agents will reforms occur.²⁷ While Drazen and Grilli specifically look at problems of inflation, the same principle applies

Many scholars point to evidence for crisis modernisation in Russia. Historically, the Russian Empire became invested and interested in economic infrastructure and productivity when there was a military threat.²⁸ Since the collapse of the Soviet Union, scholars have argued that while the liberal reforms of the initial transition period were ineffective, 1998 economic crash resulted in crisis modernisation for Russia. It is generally accepted that the 1998 crisis forced the Russian economy to implement hard budget constraints and complete the transition

²² Kornai, 1994.; Mark Hallerberg and Carlos Scartascini, "Economic Crisis and Fiscal Reforms in Latin America" Inter-American Development Bank, 2011.; Luc Laeven and Fabian Valencia, "Systemic Banking Crises: A New Database," *IMF Working Paper Series* 224, (2008).; Drazen and Grilli, 1993.

²³ Laeven and Valencia, 2008. 4.

²⁴ Hallerberg and Scartascini, 2011.

²⁵ Ibid.

²⁶ Laeven and Valencia, 2008.

²⁷ Drazen and Grilli, 1993.; See also, Carey, 2000.

²⁸ Hedlund, S (2005). 219.

to a market economy.²⁹ However, much of the evidence used to reach these conclusions were drawn based on economic data alone. The problem, as has been established, is that much of the positive economic data can be attributed to rising oil and gas prices, not the expansion of a market economy or the development of corresponding institutions. Thus, using evidence from the banking industry, this study argues that Russia has not experienced crisis modernisation and banking institutions remain trapped in partial reform equilibrium.

As such, examining responses to economic crises in Russia provides crucial understanding for how and why Russia's banking institutions remain poorly developed and trapped in partial reform equilibrium. This study will do this in two steps. First, the type of crisis and its cause will be identified. This is important because it allows us to evaluate the appropriateness of the response to the crisis. As previously discussed, the type of crisis will necessitate certain reforms or laws to resolve it. Logically, the second step will evaluate the responses to the crisis: is the scope of the reforms appropriate to resolve the crisis? Are the reforms realistic? The cause of each crisis warrants specific policy responses. For example, if the state is dealing with a monetary crisis, it is likely that bank restructuring, although potentially helpful, will not be the main driver of recovery. The first step is to understand the three main types of economic crises, sovereign debt, currency, and banking, in order to understand the most common and appropriate responses to said crises.

Sovereign debt crises occur when the government or public-sector defaults on its foreign and domestic financial obligations: debt payments, contracts, and so on.³⁰ The causes of debt crises vary. Hallerberg and Scartastini, and Reinhart and Rogoff find that sovereign debt crises precede or coincide with banking crises.³¹ Additionally, high levels of inflation can cause debt crises as the cost of meeting debt obligations rises.³² These crises are often preceded by surges in public and external borrowing, which worsen the overall crisis.³³ Laeven and

²⁹ Anders Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," *Social Research* 76, 1. (2009): 1- 28.; Anders Åslund, "Russia," *Foreign Policy* 125, (2001): 20 - 25.; Neil Robinson, "The Global Economy, Reform and Crisis in Russia," *Review of International Political Economy* 6, 4. (1999): 531 - 64.; William Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," *Europe-Asia Studies* 52, 4. (2000): 605-25.; Philip Hanson, "The Russian Economic Crisis and the Future of Russian Economic Reform " *Europe-Asia Studies* 51, 7. (1999): 1141 - 66.

³⁰ Carmen Reinhart and Kenneth Rogoff, "From Financial Crash to Debt Crisis," *The American Economic Review* 101, 5. (2011): 1676 - 706. 1681.

³¹ *Ibid.*; Hallerberg and Scartascini, 2011.

³² Reinhart and Rogoff, 2011.

³³ *Ibid.*

Valencia find that sovereign debt crises are more expensive than banking or currency crises.³⁴ And in states with weak institutions, these crises can often be caused by poor fiscal discipline. For example, in Russia's case, poor revenue collection mechanisms.

Banking crises occur when corporate and financial sectors experience several successive defaults as banks and corporations struggle to make contracted payments, non-performing loans increase, and financial market capital is exhausted.³⁵ The causes of banking crises are complex. Laeven and Valencia demonstrate that banking crises often coincide with currency crises.³⁶ Yet, when preceded by a currency crisis or sovereign debt crisis, banking crises are caused by a decline in investor confidence, a subsequent run on banks, and a rapid decline in liquidity.³⁷ Additionally, banking crises can lead to a sovereign debt crisis as the state struggles to compensate for and / or bailout failing banks. Banking crises can also be caused by poor microeconomic policies, such as lax lending policies that result in asset bubbles, poor sector regulation, and bad assets; or poor macroeconomic policies that create general economic weaknesses and vulnerabilities to external crises.³⁸ Furthermore, banking crises are difficult to resolve, and this is made more difficult when the state owns most of the sector.³⁹ Specifically, Laeven and Valencia found that banking crises are more likely to happen in countries where at least 31 percent of the sector is state-owned because these banks tend to delay restructuring and own poor assets.⁴⁰

A currency crisis occurs when a currency loses 30 percent of its value, at a depreciation rate of 10 percent faster than the previous year.⁴¹ This requires a currency not only to decline in value, but to do so at a rapid pace. This can have various causes. One of the most common is inflation from poor fiscal discipline. As governments print money to fund public spending, it declines in value. States will often try to hide, peg, or otherwise mitigate the inflation rate, but the failure to bring it down in the long run could spark a crisis. Additionally, a currency crisis could be caused by speculative attack on a country's currency that can result in a forced

³⁴ Luc Laeven and Fabián Valencia, "Systemic Banking Crises Database," *IMF Economic Review* 61, (2013): 225 - 70.

³⁵ Laeven and Valencia, 2008. 5.

³⁶ *Ibid.* 18.

³⁷ David Hoelscher and Marc Quintyn, "Managing Systemic Banking Crises" The International Monetary Fund, 2003. 3.

³⁸ *Ibid.* 4.

³⁹ Laeven and Valencia, 2008. 19.

⁴⁰ *Ibid.* 19.

⁴¹ *Ibid.* 6.; Jeffrey Frankel and Andrew Rose, "Currency Crashes in Emerging Markets: An Empirical Treatment," *International Finance Discussion Papers* No. 534, (1996). 2.

devaluation and possible default.⁴² As mentioned above, the effects of a currency crisis can be compounded if it sparks a sovereign debt and / or banking crisis. While typically one of the easier and least costly crises to resolve, this ceases to be the case should the currency crisis trigger another crisis.⁴³

In the event of any crisis, governments will normally undertake two kinds of measures to resolve the it: crisis containment and crisis resolution. The former is concerned with containing the immediate effects of the crisis, such as preventing wide scale economic displacement and contagion to other parts of the economy. For example, a currency crisis can easily spark a double or triple crisis if it also leads to a sovereign debt and / or banking crisis. Crisis containment policies are easy to implement efficiently because they do not require new or strong institutions to do so.⁴⁴ As such, these measures will aim to prevent this from happening. This is important as ‘poorly chosen containment policies undermine the success of long-term crisis resolution.’⁴⁵ Crisis resolution measures are long-term policies aimed at addressing those weaknesses that caused the crisis in the first place. If poor banking regulation and lending policies led to a banking crisis, then crisis resolution measures should seek to improve both. Thus, each of three crises just described, sovereign debt, banking, and currency, all have specific crisis containment and crisis resolution measures aimed at minimising the effects of the crisis and exiting from it as quickly and efficiently as possible.

Crisis containment

Government liquidity assistance is when capital is injected into banks to stabilise liquidity and reserves, thereby maintaining investor and consumer confidence and preventing bank runs.⁴⁶ For the purposes of this study, government liquidity assistance includes measures such as debt forgiveness as well as capital injection by the government.⁴⁷ This can include the forgiveness of debt or arrears, assistance meeting loan obligations, or offering currency loans and exchanges. Government liquidity assistance is a common response to the onset of a crisis. Liquidity assistance measures are successful when they a) prevent banks and businesses from

⁴² Abbigail Chiodo and Michael T Owyang, "A Case Study of a Currency Crisis: The Russian Default of 1998," *Federal Reserve Bank of St. Louis Review* 84, November/December 2002. (2002). 7.

⁴³ Laeven and Valencia, 2013. 226 – 227.

⁴⁴ Calomiris, Klingebiel, and Laeven, 2003. 28.

⁴⁵ Laeven and Valencia, 2008. 7.

⁴⁶ Hoelscher and Quintyn, 2003. 6.

⁴⁷ Many studies examine debt assistance as a separate measure. Because both liquidity and debt assistance are undertaken at the cost of the government and have the same objective, they have been combined here since the effectiveness of policy objectives is what this study is investigating.

failing, and b) allow them to start fresh instead of dragging out the crisis.⁴⁸ However, these measures are only successful when they are accompanied by conditions that require recipients to restructure in a manner that makes them less susceptible to cause or be victim of a future crisis.⁴⁹ Studies have shown that providing liquidity assistance to banks and enterprises can be counterproductive in the long run, because they increase moral hazard by offloading the cost of the crisis onto the government instead of the bank.⁵⁰ Additionally, governments need to try and limit the amount of liquidity assistance provided to prevent negative macroeconomic effects, such as inflation.⁵¹ Liquidity assistance is used for all crises, but is more likely to be used in a banking crisis since macroeconomic pressure caused by this policy could increase the risk of debt and currency crises.

Regulatory forbearance policies ease regulations or restrictions that might otherwise cause banks to become insolvent if implemented at the time of the crisis or at its immediate resolution.⁵² Generally speaking, forbearance allows banks to delay the recognition of loan losses or capital shortfall in order to maintain investor confidence and give the banks time to recapitalise.⁵³ Additionally, regulatory forbearance allows banks to ‘overstate their equity so as to avoid contractions in the loan supply’ without fearing punishment or fines from the regulatory overseer.⁵⁴ Most central banks prioritise stability over cost at the onset of a crisis, so costs stemming from liquidity assistance and regulatory forbearance are not a major concern.⁵⁵ Forbearance can only be successful when regulations are re-introduced, which often leads to bank restructuring.⁵⁶ The problem is that regulatory forbearance rarely recognises or repairs systemic problems, and thus is only a crisis containment measure.⁵⁷ Where it can result in the implementation of new regulations as a crisis resolves, it can also be classified as a crisis resolution measure.⁵⁸ For the purposes of this study, the definition of regulatory forbearance will be the suspension of any regulatory requirements, including those rules aimed at preventing or reducing moral hazard, increasing or maintaining reserve requirements, or the reporting loan / capital losses. These measures are mostly implemented to mitigate banking

⁴⁸ Calomiris, Klingebiel, and Laeven, 2003; Laeven and Valencia, 2008.

⁴⁹ Hoelscher and Quintyn, 2003. 12.

⁵⁰ Calomiris, Klingebiel, and Laeven, 2003.

⁵¹ Hoelscher and Quintyn, 2003. 11.

⁵² Laeven and Valencia, 2008.

⁵³ Calomiris, Klingebiel, and Laeven, 2003. 31.

⁵⁴ Laeven and Valencia, 2008.

⁵⁵ *Ibid.*

⁵⁶ *Ibid.* 22.

⁵⁷ Calomiris, Klingebiel, and Laeven, 2003. 34.

⁵⁸ Laeven and Valencia, 2008. 22.

crises, but can be implemented anytime the financial sector is likely to be affected by a crisis.

Deposit freezes and bank holidays are extreme measures of crisis containment that are undertaken as a last resort to keep banks solvent and maintain monetary control.⁵⁹ Deposit freezes are devastating because they destroy investor confidence by announcing that the banking sector is insolvent. These policies are not taken lightly, because enacting them is extremely costly in the long-term as it requires the implementation of sound, tangible crisis resolution policies over a long period of time to rebuild investor and consumer confidence. These measures range from restricting the amount commercial customers can withdraw from their accounts, to currency freezes that disallow investors, banks, and others to exchange currency and take it out of country. Deposit freezes can be used in any crisis, but due to its extreme nature, it is only used in twin or triple crises.

Crisis resolution

Government owned asset management is the transfer of private, non-performing banks or enterprises to government management and ownership to accelerate restructuring.⁶⁰ This is meant to be a crisis resolution policy as government ownership and management would restructure the bank or enterprise such that it becomes more efficient and profitable.⁶¹ In the long-run, this makes banks and enterprises less vulnerable to the effects of economic crises and less likely to cause them. Realistically, governments rarely have the skills or knowhow necessary to restructure assets in an efficient and effective manner that will generate profits.⁶² Furthermore, where the government already has a vested interest in or connection to a company, they are less likely to restructure properly.⁶³ Asset management policies can be enacted during currency and banking crises, but is more often during the latter. For the purposes of this study, policies that allow for or encourage government asset management will be considered, as will those cases and instances of forcible takeover and management by the government.

Bank restructuring is the changing of practices and restructuring of debts and assets to help a firm more efficiently maximise profits. This is done by implementing stricter

⁵⁹ Hoelscher and Quintyn, 2003. 7.

⁶⁰ Calomiris, Klingebiel, and Laeven, 2003. 48.

⁶¹ Laeven and Valencia, 2008.

⁶² Calomiris, Klingebiel, and Laeven, 2003. 53.; Daniela Klingebiel, "The Use of Asset Management Companies in the Resolution of Banking Crises.," *Working Paper 2294* (2000).; Hoelscher and Quintyn, 2003.

⁶³ Klingebiel (2000).

requirements and regulations that force banks and enterprises to restructure.⁶⁴ These reforms often increase or change capital / liquidity requirements, place more stringent and consistent guidelines for lending, call for changes to moral hazard and transparency regulations, and force firms to merge, liquidate or otherwise recapitalise.⁶⁵ Bank restructuring usually follows a period of regulatory forbearance. Restructuring can take place by the bank itself, by an asset management company or government intervention as a condition for liquidity assistance, or via sale to foreign or other investors.⁶⁶ Restructuring is most likely to take place after a banking crisis, but can also take place in enterprises after currency crises. This study will analyse the process of restructuring, who undertakes it, and how successful it is. It will also analyse those policies that aim to encourage restructuring.

Government sale of assets is the selling of government owned or managed assets to foreign or domestic investors.⁶⁷ First, this achieves crisis resolution as it rids the government of its own unproductive assets and enterprises. Second, it achieves crisis resolution by selling those dead assets it acquired through intervention to prevent it from failing. This helps the government save and reallocate liquidity to other parts of the economy, as well as raise money in selling the enterprise. Additionally, privatising these assets also inject momentum into the economy by increasing the enterprises' efficiency, output, and profits. The problem is that while foreign owners can use new capital to rejuvenate firms and banks, it is not a substitution for domestic investment as foreigners are more likely to flee at the sign of a crisis.⁶⁸ Furthermore, foreign banks are less likely to lend widely and only lend to low risk clients, which undermines potential economic growth and investment opportunities.⁶⁹ This policy is used for crisis resolution in debt and currency crises when the government was the primary owner of the asset, and during banking crises when the government gained the asset through intervention. This study will examine how the government sells and privatises assets to achieve crisis resolution, paying attention to whom banks are sold.

2.2 Argument and hypotheses

This study argues that economic crises have not resulted in institutional development in Russia's banking sector, because the mechanisms necessary to undertake crisis resolution

⁶⁴ Laeven and Valencia, 2008. 22.

⁶⁵ Hoelscher and Quintyn, 2003. 19.

⁶⁶ Laeven and Valencia, 2008.; Hoelscher and Quintyn, 2003.

⁶⁷ Calomiris, Klingebiel, and Laeven, 2003. 55.

⁶⁸ Ibid. 57.

⁶⁹ Ibid. 56.

measures are inherently market mechanisms, which have not yet been established. Therefore, Russia's banking sector remains partially reformed as the CBR is too weak to enforce formal rules over informal norms. This provides evidence for an alternative explanation for Russia's failed transition: it is not yet complete. In market economies, these mechanisms reside in strong institutions, thereby enabling governments to resolve the crisis with little intervention.⁷⁰ Any successful crisis resolution reform in Russia would necessitate institutional development, as strong institutions are a prerequisite for the CBR implementing the reforms' aims. As such, where crisis modernisation does result, it is expected that the implementation of crisis resolution reforms would be a protracted process, but have tangible results. However, in the absence of strong institutions, it is anticipated that the government and CBR will primarily rely on crisis containment policies to stabilise the economy until the crisis passes, since they do not require strong institutions to implement. Consequently, where institutions are partially reformed there will be a focus on crisis containment over crisis resolution measures.

Crisis modernisation can be both quantified and qualified, but because we seek to determine if economic crises constitute critical junctures in time, the most appropriate methodological approach for this study is process tracing. Process tracing is described as 'an analytic tool for drawing descriptive and causal inferences from diagnostic pieces of evidence often understood as part of a temporal sequence of events or phenomena.'⁷¹ Furthermore, because quantitative economic data, such as economic growth, obscures the strength of Russia's institutions, then the burden of evidence must be qualitative. Thus, process tracing is a far better approach than a purely quantitative study, as numerical data measures how much things have or have not changed, but it cannot explain how that change happened, what the implications might be, or other unmeasurable factors. This study will indeed use existing statistical data alongside qualitative evidence to analyse the sequence and process of change or stagnation in Russia's banking institutions — snapshots of before, during, and after an economic crisis alongside the government and CBR's crisis containment and resolution policies will be analysed. The more efficiently and effectively the measures can be implemented, the stronger the banking institutions and CBR are.

This provides for three testable hypotheses. To begin, null hypothesis states that any observation made is purely coincidental and that no pattern or correlation between economic crises and institutional development exists:

⁷⁰ Ibid. 27.

⁷¹ David Collier, "Understanding Process Tracing," *PS: Political Science & Politics* 44, 04. (2011): 823-30.

H₀: Economic crises have no impact on institutional development in Russia.

This hypothesis would be the result of one of two things. First, that the economic crisis has no impact on institutional development because the crisis does not elicit a response from the government. It is often argued that market economies are self-regulating and would naturally adjust without much government intervention.⁷² In fact, in a pure market economy this would likely be the case. However, as there is no such thing as a perfect market, most states will enact some containment and resolution measures. The second way one could arrive at the null hypothesis would be if crisis measures had no effect. If by the time resolution policies have taken effect the system has naturally corrected itself, or they were ineffective in the first place, then the measures are moot, if not counterproductive. Finally, if the government relies on crisis containment measures, then the null hypothesis would hold as crisis containment measures do not require strong institutions to implement them.

Second, because Russia's institutions are partially reformed and their coordination mechanisms have already been disrupted, it is likely that the government and CBR would struggle to implement crisis resolution reforms. As illustrated by Hoelscher and Quintyn, poor policy coordination raises the costs of crises because it undermines efforts to resolve it.⁷³ Thus, the first testable hypothesis for institutional development measures whether coordination mechanisms can resolve the crisis at hand by examining which crisis containment and resolution policies are implemented:

H₁: The government and Central Bank of Russia will undertake the appropriate policy responses to resolve the crisis at hand.

This hypothesis measures institutional development by determining whether policy objectives appropriately stabilise and manage the crisis, and whether they address institutional weaknesses that caused it in the first place.⁷⁴ Additionally, it analyses what new institutions, if any, the resolution measures seek to construct. For this hypothesis to be true, the state needs to implement the appropriate containment and resolution measures, and seek to strengthen institutional weaknesses in order to better enforce these measures.

Next, countries with weaker institutions struggle to implement crisis resolution reforms.⁷⁵ As such, the second testable hypothesis looks at the efficiency of institutions by measuring how long it took to implement resolution measures:

⁷² Calomiris, Klingebiel, and Laeven, 2003. 27.

⁷³ Hoelscher and Quintyn, 2003. 4.

⁷⁴ Laeven and Valencia, 2008. 11.

⁷⁵ Ibid.19.

H₂: The Central Bank of Russia is strong enough to implement crisis resolution measures effectively and efficiently. Reforms also seek to improve institutional efficiency.

This hypothesis tests the efficiency and effectiveness of institutions by measuring how long it takes the government and CBR to address institutional weaknesses, and then the length of time for policies to be implemented. Additionally, it measures institutional development by analysing whether resolution reforms seek to improve efficiency. The caveat is that this study will not rely on the resolution of the crisis as a measure of efficiency, because data used to reach this conclusion do not seek to understand the role of institutions. Because economic growth alone is not a reliable indicator for institutional strength in Russia, the length of time it takes to resolve a crisis is similarly unreliable on its own. Furthermore, because it takes longer to develop new institutional practices, the analytical timeframe must be extended beyond the crisis itself. Thus, for this hypothesis to be true, the CBR and government must implement reforms within three years of the crisis's onset.

Finally, the best predictor of institutional strength is how fairly and predictably the new laws and regulations are enforced, and thus how stable they are.⁷⁶ As such, the final testable hypothesis measures the effectiveness of the resolution measures, and how much they have strengthened institutions:

H₃: New regulations will be fairly and universally enforced, leading to reliance on formal rules and organisations to resolve conflicts.

This hypothesis measures institutional development by analysing how behaviours and expectations have changed. If new regulations are properly enforced, then they would incentivise agents to use formal instead of informal institutions. This hypothesis also measures the stability and durability of institutions. The better regulations are enforced, the stronger institutions are, and the more durable they will be.

The best way to test these hypotheses is to examine those crises that have posed major systemic challenges to the Russian banking industry. Laeven and Valencia differentiate crises from regular economic downturns when there is significant distress in the banking system (defaults, runs, liquidations), and the state enacts three or more crisis response measures.⁷⁷ This distinction is important because Russia has experienced many episodes of financial distress since the collapse of the Soviet Union, but not all of them have resulted in crippling economic

⁷⁶ Levitsky and Murillo, 2009.; Carey, 2000.; Huntington, "Political Development and Political Decay," 1965.

⁷⁷ Laeven and Valencia, 2013. 227 – 229.

crises. This narrows down potential crises to two: the 1998 economic crisis and the 2008 global financial crisis. Additionally, both crises have different catalysts, and each necessitate different resolution measures. Thus, studying each crisis provides more evidence for evaluating the capacity of institutions and the government to resolve them. As such, the study will focus on the CBR's role, or lack thereof, in Russia's crisis modernisation.

2.3 Methodology

Because the Central Bank of Russia is partially reformed, it is difficult for it to enforce or implement crisis resolution policies. Although it has gone through many changes since the collapse of the Soviet Union, the CBR's economic roles and regulatory capacities remain poorly developed. Therefore, economic crises in Russia cannot result in crisis modernisation. Historical institutionalism alone does not provide an analytical framework to understand how this fails to happen.⁷⁸ As such, this study employs process tracing to understand and explain how and why economic crises have not spurred institutional development in the banking sector. Process tracing, like historical institutionalism, identifies those critical junctures during which change is most likely, and thus provides an instance to analyse institutional development or stagnation.⁷⁹

Process-tracing is a methodology developed by economists to identify those choices producers make that commit them to using specific technologies.⁸⁰ Those commitments then go on to determine the trajectory of the producer in question. As such, it allows us to identify those critical junctures that lead to path dependency. This study seeks to do something similar: isolate those instances in time that theoretically should incentivise new economic practices in Russia.⁸¹ These critical junctures highlight how crisis resolution measures attempt to break with traditional norms and behaviours, but fail to do so. Specifically, process tracing is particularly necessary when looking at post-Soviet institutional change. Timothy Frye explains that 'students of post-communism struggle to make causal inferences about the impact of institutions on outcomes due to endogeneity problems... identifying the impact of any particular institution on any particular outcome presents special challenges.'⁸² For this study, process tracing provides an analytical framework that specifically isolates the role and ability

⁷⁸ Steinmo, 2008.

⁷⁹ Carey, 2000. 755.

⁸⁰ Hedlund, *Russian Path Dependence* (2012). 16.

⁸¹ Drazen and Grilli, 1993. 598.

⁸² Timothy Frye, "In from the Cold: Institutions and Causal Inference in Postcommunist Studies," *Annual Review of Political Science* June, (2012). 2.

of the CBR before, during, and after a crisis, to single out the effects, or lack thereof, of the crisis itself. In each crisis, the weaknesses that led to crisis will be analysed to evaluate the appropriateness and effectiveness of the CBR's response, and how those responses have failed to result in institutional development.

This study will test the three hypotheses enumerated above to measure the CBR's development as a response to the 1998 and 2008 crises. When studying institutional development, the key elements of analysis are rules and expectations.⁸³ Specifically, this study is concerned with the effectiveness of formal rules over informal practices, or institutions versus the social economy, as the interaction between them shapes agents' motivations.⁸⁴ As such, each hypothesis is testing a crucial stage in institutional development: policy planning and objectives, implementation, and enforcement. Do the resolution measures appropriately address the cause of the crisis? Are the objectives of the measures met? How long did it take to implement the resolution policies, and how far reaching is the change? How effectively and fairly are the measures implemented? Do they change agents' expectations? Each of these tests, what they measure, and how they evaluate the dynamics of institutional change are detailed below.

Policy objectives

This will test the first hypothesis by evaluating what policies the CBR undertakes to resolve the crisis. Additionally, measures that aim to strengthen institutional coordination mechanisms are more likely to break partial reform equilibrium by making the institutions more effective. This will be measured by looking at the CBR's policy objectives, and measuring how well they have been met. This is an important, if elementary starting point, because it tests the capacity of the organisations that embody the institutions, and whether or not they can undertake the task at hand. For example, if the policy aims to increase revenue collection, then revenue collection must increase. Furthermore, the construction of new institutions to resolve the crisis, where necessary, will also be evaluated. This will be measured by examining the role the institution is supposed to fulfil, and how well it undertakes its purpose. This evaluates institutional development versus modernisation paradox, because new institutions can only be as strong as the pre-existing ones with which it interacts.⁸⁵ Therefore, modernisation policies are less likely to be implemented than those that focus institutional development; not because

⁸³ Steinmo, 2008.123 – 124.

⁸⁴ Laeven and Valencia, 2008.; Hallerberg and Scartascini, 2011.; Steinmo, 2008.

⁸⁵ Huntington, "Political Development and Political Decay," 1965.

of lack of desire, but of capacity.

It is often assumed that institutional development has occurred when policy objectives are achieved. However, although fulfilling policy objectives is not itself a sign of institutional development, it is an integral first step for change. How well policy objectives are met will be measured by data collected from various think-tanks and international organisations, such as The Levada Centre, The International Monetary Fund, The World Bank, and so on. For this hypothesis to stand, the basic objectives of the policy must be met. The degree to which policy objectives have been met strengthens the first hypothesis. Additionally, the ratio of crisis containment to crisis resolution policies will be evaluated. A reliance on crisis containment policies signifies that institutions are too weak to undertake crisis resolution, since the former does not require strong institutions. If policy objectives are not achieved, then there is no change and the other two hypotheses are likely to be false. The policy fails and the null hypothesis is correct.

Implementation time

Evaluating how long it takes the CBR to implement resolution policies will test the second hypothesis. This will be measured by the difference in time it takes the government and parliament to agree on and implement the policies. The longer it takes to approve and implement crisis resolution measures, the less effective they are likely to be. This is because the longer a policy sits, the more time there is to re-draft and amend the policy such that the final product contains many loopholes, making it difficult to enforce. Additionally, the longer it takes to implement the policy, the more likely it is that informal norms will develop to compensate for effects of the crisis, thereby making formal rules less effective and harder to implement. However, there is a caveat for policies that have been approved and implemented, but are revised. These revisions do not count against the time it takes to implement the policy, nor are they considered new policies either. Amendments are a normal part of gradual institutional change as laid out in the sequencing arguments, as well as in the literature on transitioning from a limited to an open access order.⁸⁶

If a resolution measure takes more than three years after growth has resumed to be implemented, or is never implemented, then the null hypothesis would be correct: policy objectives are unlikely to strengthen systemic weaknesses and the chance for institutional

⁸⁶ Thomas Carothers, "Misundersanding Gradualism," *Journal of Democracy* 18, 3. (2007): 18 - 22.; Fukuyama, (2014).; Douglass North et al., "Limited Access Orders in the Developing World: A New Approach to the Problems of Development," *The World Bank* 4359, (2007).

development disappears. For the hypothesis to be confirmed, policies must be approved and implemented in three years or less. The more quickly the policy is implemented, the stronger the institution is likely to be. Considering that the time from implementation to resolution is evaluated at a two-year mark, this measure is generous.⁸⁷ Economies with strong institutions normally see crisis resolution in this time because they do not have to develop coordination mechanisms in addition to managing the crisis; they can make use of the institutions they already have. Yet, Russia does not have strong institutions. By extending the time-frame for resolution measures to be adopted, this study allows time for the state to contain the crisis, then work out how to strengthen institutional weaknesses. If this hypothesis is true, then institutional development is more likely to result from the crisis.

Enforcement

The third hypothesis will test the extent to which new reforms are fairly and universally enforced and complied with, and whether they endure through time and change.⁸⁸ This is the most crucial step to achieving institutional change: the fair and predictable enforcement of the law encourages all economic agents to comply with the new regulations. This creates a new, stable set of expectations — the laws should be followed, and if they are broken, there will be consequences. Ultimately, this is testing for a change in agents' behaviours and expectations, and whether they use formal institutions or informal norms to mediate transactions and conflicts.⁸⁹ However, measuring this hypothesis is complicated. It would be expected that where firms are caught undertaking illegal activity, the law will be enforced. These expectations lower barriers to entry by allowing all economic actors to know how the system works and what to expect. It also builds investor confidence and encourages long-term investment.

As such, data such as rule of law indicators, levels of foreign direct investment and domestic investment (where available), and other policy specific measurements will be evaluated. Additionally, we will look at ethnographic and other kinds of descriptive evidence, such as interviews, surveys, and current events to better understand how expectations have or have not changed. This is important because it provides context to the data and allows us to

⁸⁷ This is an average across studies. All agree that the stronger the institutions, the more quickly the crisis is resolved. Laeven and Valencia, 2013.; Laeven and Valencia, 2008.; Hallerberg and Scartascini, 2011.

⁸⁸ Levitsky and Murillo, 2009. 115.

⁸⁹ Gelman, 2004. 1024.

understand what motivates agents. The more evenly a law is enforced, the stronger the institution is. Furthermore, the stronger the institution the more autonomous it is, and the less likely it is to be swayed by individual interests. If the reform has failed from the start or cannot be enforced at all, then the null hypothesis is accepted. If the policy is evenly enforced, then the primary hypothesis is accepted. If this were the case, we would expect to see banks that break the law or fail to comply with regulations penalised.

2.4 Conclusion

Crisis modernisation occurs when economic crises encourage institutional development in developing countries. Studies show that crises can act as critical junctures, providing governments with an opportunity to strengthen institutions, and by proxy the economy. Many scholars have argued that this is the case for Russian banking institutions, and that the major economic crises that have occurred since the collapse of the Soviet Union have helped complete the transition from command to market. The crisis of 1998 forced the state to implement hard budget constraints and cut its own spending, and the crisis of 2008 encouraged the Central Bank of Russia to crack down on small, undercapitalised banks, and those non-performing banks handing out risky loans. These reforms, they argue, have strengthened market institutions in Russia.

This study argues that this is a fallacy. While the state and Central Bank indeed undertook genuine reforms to resolve the conflicts, institutional mechanisms were too weak to enforce them. The economic crises of 1998 and 2008 were challenging for Russia, but they did not break partial reform equilibrium. As a result, Russia's transition to a market economy is stalled as weak institutions encourage agents to defect from formal institutions and strengthen the informal social economy. To better understand this phenomenon, this chapter has outlined how to test for and measure institutional development resulting from economic crises. This analytical framework will be applied to the 1998 and 2008 crises, the subject of the chapters five and six. Analysing the target policy objectives, the ability of these policies to address institutional weaknesses, the efficiency with which this is done, and the effectiveness of policy enforcement, will shed light on how the CBR has responded to these crises, and whether it has been strengthened because of them.

CHAPTER 3

THE ‘NOT-SO-GREAT’ TRANSFORMATION

Before we can examine how partial reform equilibrium is manifest in Russia today, it is necessary to understand how the command economy functioned and how attempts to transition away from it have failed. As such, this chapter will analyse and describe the critical junctures where attempts at reform failed to fully achieve their objectives and set partial reform equilibrium in motion. This highlights how and where former institutional practices continue to undermine present institutional strength. Although quantitative data will be used where possible and applicable, partial reform cannot be fully understood through quantitative analysis alone. Process tracing allows this study to demonstrate how partial reform became entrenched in Russian economic institutions by highlighting critical junctures of change. As such, it will show how changes of regime and modernisation programmes have not spurred institutional reform or strengthening. To begin, we will analyse the main practices of command economics and how Gorbachev tried to reform them by examining the various *perestroika* reforms and why they failed. This is important, as it forms the foundation upon which Yeltsin and the reformers strove to build a market economy. We will then assess how Yeltsin’s endeavours failed to break partial reform and instead confirmed it. Finally, we will observe how the economic policies of the Putin era reinforced the partially reformed institutions, and failed to break the equilibrium.

3.1 Gorbachev and the command economy

Partial reform equilibrium began when Gorbachev attempted to introduce the laws of supply and demand to the command economy while simultaneously preserving its nature. To better understand how this happened, this section will first examine how the Soviet economy worked starting with the difference between hard and soft budget constraints. This allows us to analyse the *perestroika* reforms, focusing specifically on the *Law on State Enterprise*. The implementation of this law illustrates how the failure to implement hard budget constraints hampers *perestroika* reforms and creates the shaky economic foundation that the Russian Federation inherits. This era is crucial in understanding the genesis of partial reform equilibrium, as the failure to complete *perestroika* reforms ensures the replication of weak institutions after the collapse of the Soviet Union.

Soft budget constraints vs hard budget constraints

The command economy was based on fulfilling planned targets instead of demand. In a market, supply and demand drives businesses to provide goods and services that the economy needs and wants. Command economies fulfil planned targets set by the state rather than consumer demand. To meet planning objectives, the state, acting as CEO and accountant, would soften the budget constraints as necessary. Most economies operate on hard budget constraints (HBC), which are determined by the laws of supply and demand. HBCs are the day-to-day operating costs for an enterprise. If the enterprise cannot earn enough to maintain those operating costs, then the enterprises will close. HBCs drive enterprises to maximise their profits so that they can remain operational. Conversely, soft budget constraints (SBC) allowed the Soviet command economy to function on a day-to-day basis by allowing it to ignore the forces of supply and demand. SBCs allow businesses that are indebted or unprofitable to stay afloat, whereas hard budget constraints would have forced them to close. János Kornai lists the four main soft budget constraints that ordered Soviet economy as soft subsidy, soft credit, soft administrative pricing, and soft taxation.¹

Kornai defines soft subsidies as funds granted to enterprises by the state. The amount and repayment of the grant are negotiable and, thus, not repayable.² In practice, a soft subsidy is a grant from the state to enterprises to cover production costs and reduce the public selling price of the finished product. Enterprises could negotiate with the state on the total subsidy needed, and then use it to repay past arrears or fund current needs and impending payments. Furthermore, this was money that never needed to be repaid. In the rare case where repayment was a condition for dispensing the subsidy, the enterprise was often allowed to choose the terms of repayment. Soft subsidies are detrimental to an economy, command or otherwise, because they undermine the laws of supply and demand, and obscure pricing mechanisms. This is detrimental to both the enterprise and the state as neither earn any profit. The state spent a large amount of money to subsidise enterprises' production processes, but earned very little in return, because the prices of the finished products were also subsidised. This created a vicious cycle, whereby firms became wasteful and inefficient because they were not required to maximise their profits either as a condition for receiving subsidies or staying in business. Thereby requiring the state to extend subsidies to cover wasted time and funds.

Soft credit is when the state loans money to an enterprise with the explicit condition

¹ János Kornai, "The Soft Budget Constraint," *Kyklos* 39, 1. (1986): 3 - 30.

² Ibid.

that the loan be repaid, without enforcing repayment.³ Like soft subsidies, soft credit was a way to ensure that firms could continue production regardless of its profit margins — it allowed the firm to stay in business even if they were not profitable. Firms avoided repayment by negotiating favourable and flexible terms, or asking for forgiveness if profits were low or negative. Additionally, even if the state wanted to enforce credit repayment, there were no mechanisms to do so. The result of soft credit was that the state was, again, losing more money than it was making. The repercussions of this practice were that there was no precedent for debt repayment after the Soviet Union collapsed. If there is no expectation that loans will be repaid, and there are no tools to enforce repayment, then banks will struggle to both lend and ensure loans are repaid.

Soft administrative pricing refers to a practice in which prices for raw materials are determined by a ministry rather than the laws of supply and demand.⁴ These prices were highly subsidised so that enterprises could afford them. Soft administrative pricing for natural resources and raw materials amounted to an additional form of soft subsidy. Soft administrative pricing created two problems. First, it promoted waste.⁵ Because prices were kept artificially low and enterprises were not profit driven, there was no need to maximise the use of primary inputs. If materials were misused, accidentally destroyed, or damaged, they could be replaced. However, this same inefficiency and waste also characterised raw materials firms, which led to a production backlog. The delays, inefficiency, and waste at all stages of the production process led to scarcity and rationing, as production could not meet demand. Second, and more importantly, the practice completely obscured the pricing mechanism, making it difficult to determine the actual value of goods. This would later hinder the attempts of reformers to harden budget constraints by liberalising prices, because there was no mechanism to determine what the prices should be.

Soft taxation refers to the paying of taxes in kind by individuals and enterprises, or receiving a tax-exempt status.⁶ Many Soviet enterprises avoided paying taxes, because it would have constituted a hard budget constraint. This would have forced enterprises to reduce employment or production, neither of which was in line with either socialist ideology or Soviet planning policies. As such, many enterprises bargained with the state for lower tax rates, tax exemption, or forgiveness of tax arrears. The problem is that taxation was one of the few

³ Ibid.; The Central Bank of the Russian Federation.

⁴ Kornai, 1986.

⁵ Alec Nove, *Socialism, Economics and Development* (Allen & Unwin: London, 1986).181 – 186.

⁶ Kornai, 1986. 6.

sources of domestic income that the Soviet Union had to cover the costs of soft subsidies, soft credit, and soft administrative pricing, but soft taxation prevented them from maximising this revenue. Soft taxation is also an example of how Soviet institutional practices perverted the development of Russian economic institutions. Not only were Russian individuals and firms unaccustomed to paying taxes, so too was the state unaccustomed to collecting them.⁷ Thus, although the state attempted to construct institutions that would collect taxes, the tools the institutions had were ineffective at creating new practices and expectations.

One of the effects of soft budget constraints is that it reduced firms' efficiency and the incentive to improve technological innovation. Gorbachev wanted to increase productivity, efficiency, and innovation by creating incentives for enterprises to maximise profits, without completely hardening budget constraints.⁸ As such, this was one of the *perestroika* reform's many objectives: to restructure the economy. However, many of the *nomenklatura* opposed or undermined Gorbachev's reforms wherever possible, requiring him to make concessions that weakened the reforms he was trying to implement.⁹ This combination resulted in policies that aimed to introduce hard budget constraints, but contained loopholes to prevent social dislocation or damage to elite interests. The result was that enterprises had no cues from which to work. Under the command economy, they would have worked to meet the party's plan. In a market economy, theoretically, they would work to meet public demand. Yet, there were no more party plans, but they were insulated from demand. As the command economy was being dismantled, with no market mechanisms in place, efficiency fell even lower than it was before.

Perestroika

When Mikhail Gorbachev became the General Secretary of the Communist Party of the Soviet Union, the Soviet economy was struggling. The estimated Soviet growth rate had declined from around five percent in the 1950s and 1960s, to between one percent and three percent in the 1980s.¹⁰ With a continual decline in growth and soft budget practices providing no incentive for enterprises to maximise profits and undermining the state's ability to collect revenue, the economy would continue to decline. Gorbachev knew that economic growth was

⁷ Jorge Martinez-Vazquez et al., "IMF Conditionality and Objections: The Russian Case," *The American Journal of Economics and Sociology* 60, 2. (2001): 501 - 17. 508.

⁸ Archie Brown, *The Gorbachev Factor* (Oxford: Oxford University Press, 1996).; Robert Service, *History of Modern Russia: From Tsarism to the Twenty-First Century*, 3 ed. (London: The Penguin Group, 2009). 485. Hedlund, *Russian Path Dependence* (2012).;

⁹ Brown, (1996). 269 – 276; Service, (2009). 442, 488 – 491.

¹⁰ Brown, (1996). 134.

necessary for the state to survive, and that growth could only come from investment and a drive to maximise profits.¹¹ For example, ‘At the Twenty Seventh Party Congress in 1986, he argued that it was time to “overcome prejudices regarding commodity-money relations and the underestimation of these relations in planned economic guidance.”’¹² Without intending to, by advocating the commodification of production, Gorbachev was arguing for hardening the budget constraints. Thus, Gorbachev devised *perestroika* — a series of reforms to stimulate profit maximisation incentives in the Soviet command economy. These reforms took place alongside the civil and political reforms. However, as this study is concerned with the stalled development of economic institutions, this section will look only at economic reforms.

A very strong believer in socialist values, Gorbachev wanted to simply tweak the system rather than replace it with market institutions, because it would cause worry over unemployment and the affordability of necessities, such as food and housing.¹³ He wanted to find a way to slowly, but consistently increase economic growth each year.¹⁴ In 1987, Gorbachev introduced *Basic Positions*, which spelled out the reform’s objectives: to increase profits by reducing micromanagement, but maintaining central planning from above, soft administrative pricing, and soft subsidies.¹⁵ It succeeded in removing the bureaucrats who oversaw and enforced production plans by 1988 when Gorbachev disbanded the economic branches of the Communist Party.¹⁶ Yet, it failed to harden budget constraints by requiring firms to pay for their production costs and take responsibility for their losses. The result was that factory and enterprise managers were given more control over production with few of the consequences or constraints one would face in a market economy. Thus, the reforms failed to harden budget constraints that apply market pressures and drive production. Without the need to maximise profits, firms were not motivated to become more efficient or increase production.

For example, *The Law on State Enterprise* (1987) began removing many of the committees that oversaw economic activities and devolved power to firm managers, many of whom were *nomenklatura* or political elites.¹⁷ The law also allowed for the creation of a private services and small-scale industry, and managers could set their own wholesale

¹¹ Service, (2009). 441.

¹² Richard Sakwa, *Communism in Russia* (Basingstoke Palgrave Macmillan, 2010). 18.

¹³ Mikhail Gorbachev, *Perestroika* (London: Collins, 1987). 30 – 31; Stephen Hanson, *Time and Revolution: Marxism and the Design of Soviet Institutions* (Chapel Hill: University of North Carolina Press, 1997). 181.; Brown, (1996).

¹⁴ Hanson, (1997). 190.

¹⁵ Gorbachev, *Perestroika*. 64 – 65. Brown, (1996). 140.

¹⁶ Archie Brown, *The Rise and Fall of Communism* (London: Vintage, 2009). 489.

¹⁷ *Ibid.* 495.

prices and produce what they like once state targets had been met.¹⁸ As a result, the *nomenklatura* were able to acquire primary and other raw materials for a subsidised price, and then resell the products for higher prices even though the goods were of no better quality or produced more efficiently.¹⁹ Furthermore, the maintenance of soft taxation enabled enterprises to avoid paying taxes on their profits. This allowed firms to pocket the difference between the subsidised production cost and the market selling price. Thus, *The Law on State Enterprise* constituted a critical juncture for economic institutional development by creating a financial incentive for the *nomenklatura* to maintain institutional weaknesses.²⁰ This obscured the rules of the game for all but the *nomenklatura*, creating and perpetuating a weak economy ruled by a low level of rule of law. As a result, the laws of supply and demand were unable to coordinate with soft budget constraints and generate economic growth.

Examining the *perestroika* reforms illustrates how the introduction of market economy practices unintentionally weakened institutions by stripping them of the coordination mechanisms that made the economy work, and replacing them with mechanisms that are ineffective — like trying to put a square peg into a round hole. Because the formal institutional enforcement mechanisms had become useless, officials resorted to whatever practices helped them undertake their responsibilities, often using social networks. This was vital to the development of partial reform equilibrium, as it ensured that the elites could interpret and use the institutions and laws to their advantage. If rule by law leads to the selective application of law, then there will be no expectation that institutions will be fair.²¹ Thus, an incentive to replicate weak institutions emerged, both from the desire to seek personal rents, but also from a lack of trust.

Huntington proposes that rapid social and economic change resulting from modernisation over institutional development forces societies to question existing values and behaviours, and the institutions that embody them.²² Claus Offe supports this argument by highlighting how undertaking three transitions simultaneously undermines the effectiveness of all of them, because it undermines the existing system and causes decay.²³ The Soviet Union exemplifies this notion. Gorbachev attempted to undertake political, economic, and social

¹⁸ Service, (2009). 452.

¹⁹ Brown, (2009). 495 – 496.; Hanson and Teague, 2005. 660.

²⁰ Archie Brown, *Seven Years That Changed the World* (Oxford: Oxford University Press, 2007). 199.

²¹ Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," 2000. 401.

²² Huntington, "Political Development and Political Decay," 1965. 407.

²³ Offe, 1991.

reform all at once, which eroded the foundation of the state.²⁴ As *perestroika* sought to change the Soviet economy, it confirmed what many had believed for a long time: that the command economy, and foundation upon which it was constructed, was crumbling. This culminated in the collapse of the Soviet Union in 1991. *Perestroika* focused on implementing formal laws, without trying to change the structural issues causing problems in the first place.

3.2 The Yeltsin years: stumbling through transition

The collapse of the Soviet Union should have fit Schumpeter's 'creative destruction' theory — tear down the Soviet command economy and build a market economy in its place.²⁵ However, Soviet institutional legacies complicate this. After the USSR collapsed, the Russian Federation attempted to modify rather than replace the former Soviet political and economic institutions they inherited, such as the Supreme Soviet and the Central Bank. However, this meant they also inherited what remained of the partially reformed the Soviet economic institutions, which were neither command, nor market, nor anything in between. Russia's early reformers were tasked with reigning in this anarchical system and trying to make it work. This was an enormously complex task as little of the traditional wisdom of political science and economics was applicable. Additionally, Soviet economists had not received the same training that Western economists did, which made it difficult the latter to effectively advise politicians on how to reform the system.²⁶ Jeffrey Sachs said he 'felt like a surgeon who sliced open a patient only to discover nothing that was supposed to be there.'²⁷ Economic advisors from all over the world had a different approach to reforming the system and speeding up the transition process. While there are many debates surrounding the success or failure of the 1990s reforms, this study will demonstrate that the reforms failed, as they did not break partial reform equilibrium. The next section will examine the key reforms of price liberalisation and privatisation (including loans-for-shares), what their objectives were, and the extent to which those objectives were achieved. It will also examine the various arguments surrounding the efficacy and legacy of these early reforms. Finally, we will analyse how Putin both changed the game, but failed to break partial reform equilibrium by placing vested interests in strategic economic sectors, specifically the gas and oil industry.

²⁴ Service, (2009). 466.

²⁵ Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (London: Routledge, 1947).

²⁶ Michael Alexeev, Clifford Gaddy, and Jim Leitzel, "Economics in the Former Soviet Union," *Journal of Economic Perspectives* 6, 2. (1992): 137 - 48.

²⁷ Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," 2000. Hedlund, S. 2000. 391.

Liberalisation 1992

The aim of liberalisation was to free the artificial prices that reflected state planning rather than supply and demand. Most arguments over liberalisation begin with the methods for undertaking it: shock therapy or gradualism. Gradualists and sequentialists argued that shock therapy was doomed to fail because the necessary institutions for enforcing it were not yet in place.²⁸ Gradualism 'seeks to find a way for countries where few circumstances favour democracy to take incremental but definite steps toward open political competition while simultaneously pursuing state-building and rule of law reforms.'²⁹ However, feeling like there was no other choice, then Prime Minister Yegor Gaidar pursued shock therapy, or the 'rapid liberalisation of prices, removal of subsidies, expenditure cuts, and severe reductions in the money supply.'³⁰ This study will not debate the difference between the two and which may have been better for Russia. While both options had their shortcomings, debating which would have been the best way forward sheds no light on how partial reform equilibrium has been maintained. Instead, this study examines the route that Russia did take, shock therapy, and the effects of this decision. An analysis of the fiscal and monetary effects of liberalisation is included in the following chapter.

Shock therapy is drastic and difficult. The argument was that the economic effects would be harsh, but measureable improvement would come more quickly than with a gradualist approach. Several other countries, such as Poland, had experimented with shock therapy and had been successful. As such, it was considered a viable means of reorienting Russia's economy in a timely and efficient manner. Yet Poland and other countries in Central and Eastern Europe (CEE) that were also transitioning to a market cannot be compared to Russia. In the first instance, most CEE states had command economies forced upon them in the aftermath of the Second World War.³¹ These states had well-established market economy institutions prior to the Communist takeover, and a desire to return to them. Additionally, the influence of the European Union cannot be ignored, as prospective EU membership is strongly correlated stronger institutional development.³² Thus, it is unlikely that shock therapy would

²⁸ Ibid.; Hedlund, *Russian Path Dependence* (2012).

²⁹ Carothers, "Misundersanding Gradualism," 2007. 21.

³⁰ Richard Sakwa, *Russian Politics and Society*, 4 ed. (New York: Routledge, 2008). 291- 292.; Robinson, "The Global Economy, Reform and Crisis in Russia," 1999. 536.

³¹ For more, see Brown, (2009); Service, (2009). Some would argue that Czechoslovakia would be the exception since it was willingly communized. However, the Prague Spring is evidence of rebellion against the economic tenants of the Soviet Union.

³² David R. Cameron, "Creating Market Economies after Communism: The Impact of the European Union," *Post-Soviet Affairs* 25, 1. (2009): 1-38.

have had the same effects on Russia as it did on other states even if it had been properly undertaken.

In theory, Gaidar envisioned a plan that would take place over three years and would focus on monetary policy, price liberalisation, and privatisation.³³ The first major focus, and the only one Gaidar would see implemented, was the end to soft administrative pricing and subsidies on 2nd January 1992. However, this caused concern among many firms as it would require them to pay for their raw materials and inputs without any guarantee of earning enough to stay in business. To offset this, those factory managers who belonged to the Supreme Soviet's *nomenklatura* fought with Gaidar to make exceptions for certain subsidies, notably energy prices, fuel, transport, and communications.³⁴ The justification was that in the confusion created by sudden price increases, it was necessary to ensure that certain companies and industries would not flounder under hard budget constraints, and that consumers could still afford necessities.³⁵ For example, a year after liberalisation, gas prices in Russia remained at eight percent of the world market price.³⁶ As such, the economy was only partially liberalised as budget constraints remained soft and many subsidies were maintained.³⁷

While there was genuine concern about the effects of liberalisation on social well-being, the managers and *nomenklatura* also profited greatly from these reforms, and thus had an interest in maintaining its partial state.³⁸ For example, hydrocarbon and metal production enterprises bought commodities for a subsidised price, then sold the products at the world market price and pocketed the difference.³⁹ Additionally, those industries and enterprises that were not granted subsidies were able to escape the implementation of hard budget constraints by borrowing money from the Central Bank. As neither *perestroika*, nor liberalisation addressed the issues of soft credit, these enterprises could borrow money and avoid repayment. As such, the *nomenklatura* advocated for, and ensured that Gaidar was fired and replaced by Viktor Chernomyrdin before further reform could take place.

However, continuity was essential to the success of the Russian programme because it

³³ For more on the three-fold liberalisation plan as set out in Sakwa, *Russian Politics and Society*. 2008.

³⁴ Freeland, (2000). 34.; Anders Åslund, Why Has Russia's Economic Transformation Been So Arduous. The Annual World Bank Conference on Development Economics, Washington, D.C. 1999 8.

³⁵ Freeland, (2000). 33.

³⁶ Åslund, 1999. 8.

³⁷ Arye Hillman, "The Transition from Socialism: An Overview from a Political Economy Perspective," *European Journal of Political Economy* 10, (1993): 191 - 225. 202 – 203.

³⁸ Hanson and Teague, 2005. 660.

³⁹ Åslund, 1999. 8 – 9.

needed consistent implementation to bear fruit. Gaidar's dismissal guaranteed this would not happen. Liberalisation resulted in neither shock therapy, nor gradualism. Prices were raised or otherwise changed, but not actually liberalised.⁴⁰ Shock therapy would have seen all prices liberalised and most subsidies ended simultaneously, whereas gradualism probably would have liberalised prices and discontinued subsidies incrementally over time. However, by labelling policy as 'shock therapy', and thereby insinuating that the task has been completed, it blunted the need to end those practices that would undermine future attempts to fix the system. This was detrimental to the formation of a market economy, because hard budget constraints were not imposed and enterprises remained insulated from the market forces of supply and demand. Therefore, partial reform equilibrium was maintained.

Anders Åslund has argued that Russia's liberalisation attempt was not a failure, rather that the economic troubles and corruption that have resulted are due to poor reform efforts.⁴¹ If other formerly socialist states successfully undertook shock therapy, then Russia's failure to do so lies with the reformers and policy makers. Yet, this study argues that this is an over-simplified analysis. To begin, money was tangential to Soviet economic practices because most people relied on barter and social connections to undertake economic transactions.⁴² Moreover, shock therapy was the rapid implementation of formal rules with no enforcement mechanism, and thus did not affect informal practices.⁴³ Liberalisation addressed the market aspirations of price liberalisation, without considering the need to limit or constrain former economic practices, such as bribing officials, using social networks, and bartering.

Even though the use of money was a relatively easy adjustment, the use of social networks and maintenance of subsidies undermined the liberalisation and perpetuated corrupt practices. While Åslund may be right in pointing out that liberalisation did increase the abilities of elites to seek rents, he fails to recognise that this corruption is a symptom of a larger problem: the neglect to address ingrained institutional practices. Liberalisation was drafted by focusing on the intended outcome, without taking considering the institutional capacities to implement it. Therefore, it is the failure to complete the process of liberalisation that is the cause of corruption, not the inherent nature of the elites.

⁴⁰ Sakwa, *Russian Politics and Society* (2008). 292.

⁴¹ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009; Åslund, 2001. 21.

⁴² Neil Robinson, "The Economy and Prospects for Anti-Democratic Development in Russia," *Europe-Asia Studies* 52, 8. (2000): 1391 - 416. 1399.

⁴³ Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," 2000. 399 – 400.

Privatisation 1992 – 1994

Anatoly Chubais was the designer of Russia's privatisation programme. Like Gaidar, he had to make concessions to the Supreme Soviet for the programme to be implemented, which resulted in further entrenchment of partial reform equilibrium. Privatisation is essential to stimulating economic growth, because it redistributes state-owned assets to private owners and incentivises the new owners to maximise profits by restructuring and improving production capacity.⁴⁴ Additionally, without the state subsidising production, privatisation would introduce competition, thereby encouraging enterprises to maximise their potential or perish. In theory, this would provide new incentives for strengthening institutions: owners and managers will lobby for stronger rule of law to protect their long-term interests.⁴⁵ If successful, this would have led to a more robust and dynamic economy that would have promoted and sustained economic growth in Russia. Instead, privatisation resulted in enterprise directors becoming managers who, for the most part, did not know how to function in a market economy. Those that did were constrained by the informal practices necessary for transactions with other businesses. Rather than rooting out Soviet practices, the privatisation reform legitimised them. Furthermore, privatisation created what Chrystia Freeland calls 'the loophole economy', which made asset-stripping and rent-seeking easier.⁴⁶

The means of privatisation was determined by the size of the enterprise. Small firms were to be auctioned off or otherwise sold. Medium-sized enterprises could choose between going to auction or becoming corporations. Large enterprises were to become corporations by one of three options: 1) employees and managers would receive 25 percent of non-voting shares for free and could purchase up to an additional 10 percent of voting shares at a reduced rate; 2) companies could purchase 51 percent of voting shares in closed auction; 3) a managing group could privatise a medium-sized company by purchasing 30 percent of the company's voting shares and selling 20 percent to existing managers and employees at a discount.⁴⁷ Many large enterprise managers were the *nomenklatura* with whom Chubais had to draft the reform, and they used their positions to ensure that the privatisation reforms would be favourable to them. For instance, the second option initially allowed companies to purchase up to 40 percent of

⁴⁴ Martinez-Vazquez et al., 2001. 503 – 504.

⁴⁵ Douglass North, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *The journal of economic history* 49, 4. (1989): 803-32.; T. Frye, "Markets, Democracy, and New Private Business in Russia," *Post-Soviet affairs* 19, 1. (2003): 24-45. 27.

⁴⁶ Freeland, (2000).

⁴⁷ Sakwa, *Russian Politics and Society* (2008). 296.

voting shares, but Chubais had to increase the maximum amount to 51 percent before the reform was approved.⁴⁸ As a result, 70 percent of enterprise managers used the second option to purchase their enterprises in a closed, rigged auction for a very, very low price.⁴⁹

The consequence of this negotiation was that medium and large enterprises were not taken over by market-oriented, profit-maximising, managers and CEOs. Instead, managers who favoured inefficient Soviet practices remained in charge and prevented necessary restructuring.⁵⁰ This only reinforced the disincentive to restructure and the incentive to exploit the loopholes between command and market institutions. For example, in addition to their ability to retain company profits, enterprises were also allowed to borrow from the banks. However, the reforms thus far had not addressed the maintenance of soft credit and means of enforcing loan repayment.⁵¹ Moreover, when the Central Bank of Russia (CBR) appealed to the state to force delinquent enterprises to repay their loans, the state sided with the enterprises and absolved them of their debts.⁵² Additionally, enterprises that were privatised often became market enterprises in name only. In practice, these enterprises remained inefficient and unproductive. They maintained the command economy practice of soft-administrative pricing by doing business directly with each other through non-cash transactions. Furthermore, those managers who were market-oriented were constrained, because they were forced to undertake economic transactions via informal practices in order to do business with other enterprises.⁵³

Some argue that the privatisation programme was successful.⁵⁴ The overall goal was to redistribute property from the state to entrepreneurs who would restructure the businesses and make them profitable.⁵⁵ It also aimed to make the labour market more flexible by reallocating workers from inefficient to productive enterprises.⁵⁶ Private sector employment grew from 13

⁴⁸ Freeland, (2000). 55.; Hanson, 1999.; McFaul, 1999.

⁴⁹ Enrico Perotti, "Lessons from the Russian Meltdown: The Economics of Soft Legal Constraints," *International Finance* 5, 3. (2002): 359 - 99. 380.; Hanson, 1999. 1143.; McFaul, 1999. 119.; Robinson, 2000.

⁵⁰ Perotti, 2002. 380.

⁵¹ Kathryn Hendley et al., "Observations on the Use of Law by Russian Enterprises," *Post-Soviet Affairs* 31, 1. (1997): 19 - 41. 20, 30 - 31.

⁵² Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 981. This dynamic will be further explored in the following chapter.

⁵³ Robinson, 2000.

⁵⁴ Theodore Gerber, "Structural Change and Post-Socialist Stratification: Labor Market Transitions in Contemporary Russia," *American Sociological Review* 67, 5. (2002): 629 - 59.; Åslund, 2001; Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009.; Daniel Treisman, "The Politics of Soft Credit in Post-Soviet Russia," *Europe-Asia Studies* 47, 6. (1995): 949-76.; Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009.

⁵⁵ Michael Alexeev, "The Effect of Privatization on Wealth Distribution in Russia," *Economics of Transition* 7, 2. (1999): 449 - 65. 450.

⁵⁶ Gerber, 2002. 632.

percent in 1991 to 40 percent in 1997.⁵⁷ Additionally, the private sector accounted for 65 percent of Russia's GDP in 2007.⁵⁸ However, if enterprises that were privatised by insiders are included in that count, then their employees would be counted as working in private industry without having changed jobs. Here we see the trouble with the formal reform versus informal practices. Formally, many enterprises have been privatised, because on paper this is true. Informally, the picture is different, as insiders are still at the helm.⁵⁹ Therefore, a far more effective analysis of privatisation is the extent to which the practice supports moving toward a market economy by: 1) redefining the state's role in the economy; 2) using formal institutions to resolve problems; 3) and being able to make long-term investments.

As with liberalization, the failure of privatisation is due to the implementation of formal laws that have little effect on informal practices. The very concept of private property was unfamiliar, and the institutions needed to enforce private property rights were foreign.⁶⁰ For example, enterprises still drafted contracts based on Soviet templates, not realising they were at liberty to set their own terms.⁶¹ Additionally, enterprises resorted to private enforcement (e.g. mafia) instead of contracts and courts to enforce or resolve inter-enterprise issues primarily because that was how contracts were enforced in the Soviet economy.⁶² As the practice of using *sistema*, or the social economy, to enforce contracts and resolve disputes in the command economy continued, it undermined attempts to develop market institutions. Therefore, privatisation only helped to reproduce weak, partially reformed economic institutions.

Loans-for-shares

By 1995, the government was struggling to collect enough revenue to maintain its spending, because the state had difficulty collecting taxes from individuals and businesses. The problem was three-fold. First, many enterprises hid profits to obscure the amount of tax they owed. Second, tax collectors were easily bribed to write-off arrears. Finally, the government's tax collection policies were ineffective, and the institutions charged with collecting taxes did not have clearly defined enforcement powers. When collection cases were brought before the

⁵⁷ Ibid. 633.

⁵⁸ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009. 4.

⁵⁹ Alexeev, 1999.

⁶⁰ Hedlund, "Path Dependence in Russian Policy Making: Constraints on Putin's Economic Choice," 2000. 60

⁶¹ Hendley et al., 1997. 24.

⁶² Ibid. 27 – 28.

government or other tax authorities, the government erred on the side of forgiving arrears so that businesses could remain open.⁶³ This upheld the command practice of soft taxation. Doing so not only deprived the state of badly needed revenue, it also reinforced the incentive for firms not to restructure. Furthermore, because the CBR's charter specifically forbids it from financing the government's budget or budget deficit, the state had no way to fully finance its own budget aside from printing money and increasing inflation.

While the government used treasury bonds, or GKO bonds, to help alleviate the pressure on the budget, it was still parched for funds.⁶⁴ At the same time, Russia's newest banks were desperate for liquidity and business.⁶⁵ So, those authorised banks that were part of larger financial industrial groups (FIGs) used their political connections to strike a deal that would help both the state and the banks. This deal became known as the loans-for-shares programme. The programme called for the government to auction its controlling share in select enterprises in exchange for a loan from an FIG or entrepreneur. Once the loan was repaid, the government would regain its controlling stake in the enterprise. Because the Duma had banned these enterprises from taking part in the first round of privatisations in 1992, the bidders could not purchase the shares.⁶⁶ Rather, they would be held as collateral to be returned when the government repaid the loan. Only if the government defaulted would the investor own the shares. In theory, this programme was a way for the government to profit from privatisation without privatising, and earn much needed revenue in the process.

In practice, the loans-for-shares programme robbed the government of billions of dollars and only increased the problem of insider privatisation.⁶⁷ For the programme to be successful, the government should have held open auctions and selected the winner with the highest bid, and who was more likely to restructure the enterprise to maximise its potential. Yet, the auctions were closed and rigged to favour a predetermined bank or individual. This further undermined the attempt to create a market economy by intervening where market mechanisms should be allowed to function unfettered.⁶⁸ For example, Mikhail Khodorkovsky won a 78 percent controlling share in Yukos, a company worth at least \$1 billion, for a mere

⁶³ The European Bank for Reconstruction and Development, "Transition Report 1998: The Financial Sector in Transition" The Economic Bank for European Reconstruction and Development., 1999. 14.

⁶⁴ Robinson, 2000.

⁶⁵ Juliet Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (Ithaca, NY: Cornell University Press, 2000).

⁶⁶ Daniel Treisman, "'Loans for Shares' Revisited," *Post-Soviet Affairs* 26, 3. (2010): 207 - 27.

⁶⁷ Robinson, 2000.

⁶⁸ Ibid.

\$310 million.⁶⁹ Even more shocking was Boris Berezovsky's ability to purchase Sibneft, worth an estimated \$110 billion, for only \$1 billion.⁷⁰ The FIGs profited from loans-for-shares far more than the state: the state only pocketed \$779 million from the entire scheme, while the FIGs gained the controlling shares of the state's most lucrative firms.⁷¹

In the end, while it did provide some liquidity, loans-for-shares failed to generate enough revenue to compensate for poor tax collection mechanisms. Importantly, GKO sales, the other sources of budgetary funding, depended on the government earning a certain level of revenue to retain investor confidence.⁷² However, because the loans-for-shares programme shorted the government, it became more and more difficult to reach that threshold. Thus, the breakdown of privatisation not only resulted in the failure to create stable foundations upon which market institutions could develop, but also upheld those practices that continued to undermine attempts to do so. By favouring members of social networks over formal practices, the state undermined the rule of law and reinforced the need for the social economy. This was not only detrimental to the economy, but also to the state itself. The failure to focus on developing market institutions resulted in revenue shortages: by not hardening budget constraints, the government continued to subsidise enterprises when it could not afford to do so; by undermining privatisation, it failed to encourage enterprises to generate revenue the state could tax; and by not focusing on the institutional problems regarding tax collection, it was unable to collect vital revenue. These issues were unsustainable, and made the government vulnerable to economic trouble.

The financial crisis of 1998

The 1998 financial crisis was a devastating blow to the government, as it undermined both its domestic and international credibility. The economy imploded as inflation skyrocketed overnight and the government could no longer meet its financial obligations. The importance of this crisis cannot be understated because it was the result of partial reform equilibriums inability to stabilise economic institutions. The upside of the crisis is that it forced the state to implement some hard budget constraints, particularly regarding spending. The institutional impact of the crisis is also important, as it required the state to address institutional weaknesses such as tax evasion and barter trading. However, these new hard-line policies softened once

⁶⁹ Marshall Goldman, "Putin and the Oligarchs," *Foreign Affairs* 83, 6. (2004): 33 - 44. 35.

⁷⁰ *Ibid.* 35.

⁷¹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).188.

⁷² Robinson, 2000.

gas and oil prices increased shortly after the crisis, which compromised those reforms that should have encouraged institutional development. As a result, the crisis was a critical juncture that created new – and perpetuated old – practices that enabled weak institutions to continue replicating themselves. This section will examine Western conditionality and the inability to collect taxes and cut spending, and contagion from the East Asian crisis of the same year. The role banks and fiscal policy played in causing the crisis is the subject of chapter five.

After years of failing to harden budget constraints and develop tax collection mechanisms, the government found itself unable to control its fiscal spending. To cover these costs, the government printed money, which resulted in inflationary pressure. At the same time, the CBR had pegged the exchange rate to favour the ruble and they refused to float it, thus hiding said inflation. Additionally, the government had received loans from various organisations such as The World Bank, The IMF, and The European Bank for Reconstruction and Development (EBRD). In an attempt to ensure that Russia would undertake democratic and market economy reforms, the loans came with conditions. Many of these conditions required changes to economic and political institutions within the country, which the government genuinely implemented. However, by no fault of the Yeltsin administration, these changes had little effect.⁷³ As such, in the months preceding the financial crash, Russia found itself close to defaulting on its loan obligations as disbursements were withheld.

The largest contributing factor to the 1998 financial crisis was Russia's inability to adopt hard budget constraints. As a result, many firms continued operating at a loss at the expense of the government and the firms' creditors, as they continued to avoid taxation and debt repayment. In 1997, 49 percent of companies in Russia were operating at a loss, but neither the state nor creditors took steps to liquidate them.⁷⁴ This is due to the primitive bankruptcy laws that favoured enterprises.⁷⁵ These firms did not pay taxes and consistently had their outstanding tax arrears forgiven, undermining the credibility of state revenue collectors and the practice and expectation of paying taxes. As such, many firms realised that the more tax arrears mounted, the more difficult it would be for the state to collect them, and the more likely it was the arrears would be forgiven.⁷⁶ Consequently, profitable enterprises claimed to be operating at a loss to avoid paying taxes or wages and pocketed the difference. These enterprises had

⁷³ This will be further discussed in chapter five.

⁷⁴ The European Bank for Reconstruction and Development, 1999. 16.

⁷⁵ Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 980 – 982.

⁷⁶ Perotti, E. (2001). 382.

₹4.2 billion in wage arrears in 1998 and ₹1,126 billion, or 40 percent of GDP, of overdue payments.⁷⁷ Additionally, one third of the ₹129 billion tax deficit belonged to only 250 companies.⁷⁸

The government was no better than the enterprises. In addition to its inability to collect taxes, it was also unable to control its spending. As of January 1997, just over a year and a half before the crisis, the government had payment arrears of ₹67 billion, or three percent of its GDP.⁷⁹ It was \$242 billion in debt by the time of the crisis in 1998, with \$16 billion being accrued between June and August of that year alone.⁸⁰ It should be noted, that this estimate includes both foreign and domestic debt. With little to no taxes being paid at the time, tax arrears to the federal government stood at ₹129 billion.⁸¹ To find alternative means of financing its deficit, the Russian government entered the global financial market by allowing the Central Bank to issue treasury bonds. Yet, Russia entered did so on shaky ground: its fiscal and monetary policies were not sound, its financial institutions were weak, and the global financial market only amplified these weaknesses and vulnerabilities.⁸²

In seeking to improve its economic outlook by attracting foreign investors instead of addressing the serious structural problems the economy was facing, the government created a massive and fragile financial bubble. It was the steady foreign investment in treasury bonds that encouraged the government and Central Bank to maintain artificially low inflation by pegging the exchange rate. Thus, although it appeared that the Central Bank had achieved single digit inflation, it was masking the true interest rate, which had appreciated by at least 55 percent as of July 1997 and only continued to increase over the course of the year.⁸³ In the months leading up to the crash, the government needed to sell \$1 billion worth of treasury bonds investments if it wanted to keep using them to finance its debt. By 17 August 1998, this was no longer possible. The government defaulted on its international and domestic debt, and floated the ruble, which sparked a run on the banks.

The 1998 economic crisis demonstrated that Russia's economy was unstable and the

⁷⁷ The European Bank for Reconstruction and Development, 1999. 15, 16

⁷⁸ Ibid. 15, 16

⁷⁹ Ibid. 14.

⁸⁰ Brian; Ulatov Pinto, Sergei "Russia 1998 Revisited: Lessons for Financial Globalization" The World bank, 2010. 2.

⁸¹ The European Bank for Reconstruction and Development, "Structural and Macroeconomic Impact of the Crisis: An Overview" Internet. The European Bank for Reconstruction and Development, 2009. Annex 1.1 p. 16

⁸² Pinto, 2010.

⁸³ Ibid.

partial reforms it had relied on were unsustainable. The crisis led to a sharp devaluation in the price of Russian exports, which led to import substitution. Additionally, it forced the government to cut spending and improve the tax code. It is for these reasons that many see the 1998 crisis as a critical juncture in Russian institutional development: it is after this crisis that 'true' reform and modernisation takes place. Yet, none of the changes that occurred as a result of the 1998 crisis broke partial reform equilibrium or strengthened institutions. This argument will be further explored in chapter five. To better understand the illusion of reform, we must first analyse how Vladimir Putin changed Russian politics to have more control over the economy. In doing so, he inadvertently ensured the replication of weak, partially reformed institutions.

3.3 The Putin era: illusions and delusions

Gorbachev set out to make the command economy more productive and accidentally brought the system crashing down. In introducing market mechanisms, Gorbachev stalled the Soviet economy. He wanted to find a way to make the command economy more profitable and demand, but ended up with a dysfunctional, hybrid system that was neither communist nor capitalist. Similarly, the Yeltsin era was one of traumatic changes that were neither comprehensive nor consistent enough to break the partially reformed economy it inherited from the Soviet Union. Maintaining these practices allowed inefficient, non-performing enterprises to continue operating, which generated negative economic growth and led to a major economic crisis. Both Gorbachev and Yeltsin undertook economic modernization programmes, but because of the lack of institutional mechanisms to implement them, they failed.

Many see the 1998 economic crisis as a turning point for Russia's modernisation. It appeared that the crisis forced the state to finally implement hard budget constraints: the state cut spending, businesses began to fold, and unemployment levels rose. Then, as Kornai's transformational recession theory holds, unemployment and inflation eventually fell, and GDP and GDP per capita started to rise.⁸⁴ This coincided with Vladimir Putin coming to power. It appeared that he removed subsidies, cut spending, and allowed the market to flourish unfettered. Yet, while Putin undertook more reforms than his predecessor, many of these reforms only strengthened *sistema*, or the social economy, instead of formal economic institutions. He did this through the re-nationalisation of some of Russia's most lucrative enterprises, and installing members of his *blat*, or social network, as the managers and CEOs.

⁸⁴ Kornai, 1994.

Thus, where many see the emergence of a strong economy, instead it is the solidification of informal practices. The problem is that none of these practices are codified, and thus continue to defy formal laws and weaken economic institutions. This section will look at how Putin maintained partial reform equilibrium through renationalisation and replacing the Yeltsin era elites with loyal members of his own social network.

Vertikal: renationalisation and centralisation

Shortly after winning the 2000 presidential election, Vladimir Putin made it quite clear that he intended to make Russia a rule of law state. Having studied law, Putin understands the importance of law and strong institutions. In many of his early speeches, he propounded on the importance of the universality of law and its proper enforcement.⁸⁵ However, most of his presidencies have undermined these principles. One reason for this is that Putin's economic vision requires him to centralise power as much as possible, which is antithetical to the rule of law.⁸⁶ As noted by Vladimir Gel'man, a weak state may not be able to enforce the rule of law, but a centralised, strong state will use its power over the law as a vehicle to achieve its own ends and protect its own interests.⁸⁷ Putin did just this to achieve his economic objectives: a state that can profit from large conglomerates by exploiting the country's natural resources.⁸⁸ As such Putin set out to renationalise many of Russia's natural resource industries that had been privatised in the 1990s through the privatisation and loans for shares programmes.

To set the stage for renationalisation, Putin first had to rein in the oligarchs who manned the enterprises he sought to control. Their untrammelled influence exploited structural economic problems, bankrupted the state, and led to the 1998 financial crisis. Thus, it was imperative to Putin that the oligarchs cooperate or have their power curtailed. When he won the election in 2000, Putin strongly hinted that the oligarchs should work with him to achieve economic stability in Russia.⁸⁹ However, this meant a drastic reduction in economic autonomy for the oligarchs. Putin was effectively asking the oligarchs to give up both the political power that allowed them to rent-see, and the economic autonomy over the industries they managed. By curbing oligarchs' power or bringing them into line with his economic plan, Putin could

⁸⁵ Richard Sakwa, *Putin: Russia's Choice*, Second ed. (New York: Routledge, 2008). 254

⁸⁶ Shevtsova, (2007). 36 – 46.

⁸⁷ Gelman, 2004. 1025.

⁸⁸ Vladimir Putin, "Mineral Natural Resources in the Strategy for Development of the Russian Economy" (St Petersburg Mining Institute, 1996).

⁸⁹ Pauline Jones Luong and Erika Weinthal, "Contra Coercion: Russian Tax Reform, Exogenous Shocks, and Negotiated Institutional Change," *The American Political Science Review* 98, 1. (2004): 139 - 52. 149.

form policies to protect and promote the state's interest rather than the oligarchs'.

In 2002, Putin held a not-so-secret, behind-the-scenes meeting with the oligarchs in which he told them to cooperate with him, leave their positions, or face the consequences.⁹⁰ If they toed the line, Putin would allow them to remain in their management positions and keep their wealth.⁹¹ Those who did not would be prosecuted for economic crimes they committed in the 1990s, such as tax evasion, asset stripping, and money laundering.⁹² Although it could be argued that Putin lied to the oligarchs and always intended to strip them of power and reacquire their companies, the relationship is far more complicated. Putin wanted to recentralise state power in order to neutralise any opposition, and more effectively implement economic and political reforms.⁹³ Some of the oligarchs followed Putin, notably Potanin and Chubias. Others did for a time and left before business got ugly, like Abramovich.⁹⁴ Others tried to fight back and lost, including: Gusinsky, Berezovsky, and infamously, Khodorkovsky.

Under Putin, the oligarchs and elites of the 1990s were replaced with members of Putin's *blat*: the *siloviki* and the St. Petersburg Mafia. By filling these oligarchs' empty posts with trusted associates, Putin ensured that there was little resistance to his economic plans. The *siloviki* are Putin's former colleagues and contacts in the security and intelligence services, both the KGB and FSB. The St. Petersburg mafia refers to those colleagues that Putin worked with while working for Anatoly Sobchak, the Mayor of St. Petersburg in the early 1990s. For example, Anatoly Chubias is a member of the St. Petersburg Mafia as he and Putin worked for Sobchak until Chubias left to direct the privatisation programme. Members of Putin's *blat* were appointed to the highest positions in the most lucrative companies, and sprinkled in important positions in the government. Often, one person filled both those positions simultaneously.⁹⁵ The result was that Putin had near total control over the government and many natural resource companies.

Putin wanted to use the renationalisation of the natural resource industries as a means of strengthening economic institutions.⁹⁶ The idea was that by renationalising the state's largest and most profitable enterprises, the state would be able to enforce and assert company policies that would respect international norms for property rights, accounting standards, corporate

⁹⁰ Goldman, 2004. 36.

⁹¹ Freeland, (2000). 326.; Luong and Weinthal, 2004.

⁹² Goldman, 2004.

⁹³ Shevtsova, (2007).

⁹⁴ Sakwa, *Putin: Russia's Choice* (2008). 148.

⁹⁵ Paul Chaisty, *Legislative Politics and Economic Power in Russia* (Basingstoke: Palgrave-Macmillan, 2006).; also, see study below.

⁹⁶ Sakwa, *Putin: Russia's Choice* (2008). 254.

governance, and general rule of law. Additionally, it was hypothesised that this would create a trickle-down effect and spur changes in behaviour and expectation among the rest of the economy. Thus, Putin could kill two proverbial economic birds with one stone: the renationalisation would allow him to increase the state's earning potential, and use his central control over the corporations' corporate governance structures as a vehicle for institutional development and economic modernisation. There is no argument that the standard of living for most Russians increased under Putin. The number of people living under the poverty line shrank from 65 million in 1998 to less than 17 million in 2006; economic growth averaged 6.8 percent per year, translating in to an increase in real wages; and unemployment fell to 7.5 percent.⁹⁷ However, as evidence shows, Putin's renationalisation has done little to improve Russia's economy or strength of rule of law.

The problem is that development and modernisation via renationalisation presents a paradox: modernisation and institutional development requires a strong leader, yet it also requires him to restrain his power.⁹⁸ To renationalise, Putin selectively used law as a weapon to achieve his objective. The most famous example being the Khodorkovsky affair, in which Putin imprisoned the oligarch for tax arrears, among other violations. Therefore, Putin gained more control over the state's economic resources, but he was unable to use those resources to usher in modernisation, or stronger economic and legal institutions. The more the state's economy was centralised through renationalisation, the more it undermined the rule of law

Putin appointed loyal members of his social network to influential and strategic posts in the government or large and lucrative enterprises. In doing so, Putin centralised his power into a strict *vertikal* or hierarchy. This gave him large degree of control over both politics and economics: he could renationalise the nation's largest enterprises and undertake ambitious legislative projects with little resistance. For example, for many years, Igor Sechin, one of Putin's deputy prime ministers, was also on Rosneft's board of directors. This gave Putin indirect control over the company. Additionally, the line between government and economy blurred as the state used Gazprom to achieve domestic and foreign policy goals. For example, the state maintained subsidised gas prices at home, but shut off gas pipelines to other countries as a means of diplomacy.⁹⁹ As such, Putin's centralisation of power allowed him to use as an

⁹⁷ Ibid. 247.

⁹⁸ Huntington, "Political Development and Political Decay," 1965.; Hedlund, *Russian Path Dependence* (2012). 389. Carothers, "The "Sequencing" Fallacy," 2007.

⁹⁹ Robert Price, "Energy Reform in Russia and the Implications for European Energy Security," *Demokratizatsiya* 15, 4. (2007): 391 - 407.; Marshall Goldman, *Petrostate: Putin, Power and the New Russia* (Oxford: Oxford University Press, 2010).

efficient and effective tool of state power.

Yet, Putin's centralisation of power is another paradox of his presidency — for each measure that centralised his power, the more the bureaucracy expanded.¹⁰⁰ In theory, increasing his power would give him direct control over the economic and political reforms necessary to stabilise and expand the economy, and strengthen rule of law. However, the larger the bureaucracy, the more inefficient the government. Ironically, this further necessitates the fluidity of institutional constraints for the sake of expediency, and reinforces informal practices; it incentivises corruption to cut out the 'middle man.' For example, as federal agencies grew from 3 to 32 between 2003 and 2006, intermediary agencies multiplied rapidly from 59 to 85.¹⁰¹ Therefore, the more Putin expanded the bureaucracy in order to centralise control, the more power he lost. This reduced his ability to strengthen institutions and break partial reform equilibrium.

3.4 In whose interest is it anyway? A study of state and private interests in maintaining partial reform equilibrium.¹⁰²

This section is a micro-study illuminating the interests of individual agents in maintaining partial reform equilibrium. The results provide additional evidence of how the political and economic landscape changed under Vladimir Putin. Specifically, the study demonstrates the increasing direct and indirect state control over the economy. It compares the increasing vested interests in the gas and oil industry that are furthered and protected by *blat* and *sistema*, which do not necessarily uphold command practices, but still weaken market institutions. As such, this study has its own methodology, distinct from that enumerated in the previous chapter. The results of this study frame and support the argument set out in chapter one and the analyses of the formal case studies in chapters five and six.

The infiltration of select interests in an economy helps maintain partial reform equilibrium. These interests, or the those representing them, must have enough power to tailor policies and laws, or their selective application to suit various rent-seeking needs. This results in a variety of social, political, and economic problems; one of which is Russia's corruption that stems from, and upholds weak institutions and lack of rule of law. This study argues that,

¹⁰⁰ Sakwa, *Putin: Russia's Choice* (2008). 155.

¹⁰¹ Ledeneva, (2013). Loc. 1526., Loc. 1508. Table 2.1.

¹⁰² The initial results in this section come from a previous study. Given the what the results illustrated about government control in the gas and oil industry in 2010, I decided to run the study again and compare the two to better understand how state control in the gas and oil industry, and in the economy more generally, has evolved.

above all other economic interests that maintain partial reform equilibrium, none is more powerful or more successful than the gas and oil industry. This study classifies the degree of interest the elites and state have in maintaining partial reform equilibrium by analysing the presence of each in Russia's hydrocarbon industry. It examines the largest gas and oil companies to determine who uses it as a vehicle to seek rents or other benefits, thereby replicating weak institutions. Furthermore, it sheds light on who has an interest in maintaining partially reformed institutions, the state or the elites. This is an important distinction since institutional development and breaking partial reform requires government that is strong, but not too strong. Thus, too much elite interest in the gas and oil industry would signify that the government is not strong enough to regulate elite rent-seeking, whereas too much state interest would suggest the state is too strong.

Tracing the increasing number of gas and oil company executives that belong to certain social networking groups and / or their previous or current positions in the government, creates a clear picture of the degree of vested interest between the state and the gas and oil industry. To illustrate how and why the gas and oil industry in Russia has this degree of influence in politics and why, above all other industries, its influence is the most sought after, three crucial factors will be briefly explored. First, the gas and oil industry and its central and strategic role within Russia will be examined. Second, the different social networks and their importance will be explained. Finally, the study will be presented. Beginning with a synthesis of the previously explained background information, the hypothesis and objectives will be stated and clarified. Then, the scope and limitations of the case will be outlined and their reasoning and importance explained. Finally, the research methodology will be explained and the results presented.

* * *

Russia is the world's largest producer and exporter of natural gas and the world's second largest producer and exporter of crude oil, and their gas and oil revenues comprise about 65 percent of their exports.¹⁰³ While Russia has historically held the world's largest natural gas reserves and the world's top crude oil reserves, it was not until after the fall of the Soviet Union that these natural assets were exploited to their present capacity. Vladimir Putin realised long before he was president the importance of these natural resources and the wealth that could be derived from them. In his 1997 doctoral thesis, Putin stated, 'When effectively utilized, the natural

¹⁰³ The International Energy Agency, "Key World Energy Statistics" 2009. International Energy Agency. 2009. *Key World Energy Statistics*. Publication. <http://www.iea.org> 27 February 2010.; Goldman, *Petrostate: Putin, Power and the New Russia* (2010).13.

resource potential becomes one of the most important preconditions for the sustainable entry of Russia in to the world economy.¹⁰⁴ In his quest to assert Russia as a powerful nation, Putin understood the conditional security that comes from natural resource exploitation. He also understood the wealth that could be exploited from natural resource rents and furthermore argued that, ‘In the future it will be necessary to consider reducing the number of taxes and to shift primarily to rental payments, to raise the effectiveness of state management of resources exploitation...’¹⁰⁵ As previously discussed, when Vladimir Putin became President, he renationalised several industries and obtained a sizable share in others, a majority of these were gas and oil industries.

It is clear that because of the percentage of exports that come from the gas and oil market, the Russian state is at the mercy of its oil and gas revenues. Thus, whoever receives these revenues also receives a disproportionate amount of power. As Joel Hellman states, ‘...the most common obstacles to the progress of economic reform in post-communist transitions have come from very different sources ... these actors can hardly be classified as short-term net losers...they were its earliest and biggest winners.’¹⁰⁶ The gas and oil industry and those who run it in Russia, can certainly be classified as winners. During the liberalisation scheme mentioned previously, one of the industries that maintained state subsidies, but could sell its product at a market price, was gas and oil. Further, in the previously mentioned instances of voucher privatisation and the loans-for-shares program, the interests and the involvement in state politics of those who ran the gas and oil companies were legitimised, and their ability to exploit the industry’s wealth increased exponentially.

Furthermore, it has been shown that the more political power firms have correlates to higher growth and revenues in Russia.¹⁰⁷ From the Soviet era to the present, gas and oil interests have enjoyed immense political power via state capture, and played a large role in the government by influencing the shape of various policies to extract maximum rents. The oil barons who represent these interests (in addition to their own personal interests) hail from, and are in their positions thanks to, various social networks. To better understand political interest representation, the social networks must also be explored. These social groups are essential as they highlight the connections that certain individuals have, or have had, with the government.

¹⁰⁴ Putin. 50.

¹⁰⁵ Ibid. 54.

¹⁰⁶ Hellman, 1998. 204.

¹⁰⁷ Irina Slinko, Evgeny Yakovlev, and Ekaterina Zhurasskaya, "Laws for Sale: Evidence from Russia," *American Law and Economics Review* 7, 1. (2005): 284 - 318. 287.

There are several different social circles, but only five will be discussed in this study: the *Nomenklatura*, the Russian Union for Industrialists and Entrepreneurs (also known as ‘the oligarch’s union’), the Bankers, the *siloviki*, and the St. Petersburg Mafia.¹⁰⁸

The first network is the *Nomenklatura*, defined as an individual who was previously a high-ranking official in the Communist Party of the Soviet Union (CPSU) or a member of the Supreme Soviet. The *Nomenklatura* have had a distinct advantage in the Russian government as they understand how politics work and many of them helped lay the initial foundations of partial reform equilibrium before the collapse of the Soviet Union.¹⁰⁹ The *Nomenklatura* were Russia’s earliest winners of partial reform, and some of them (if not most) are also ‘Red Baron’s’ who institutionalised partial reform through the voucher privatisation process, as previously described, in which they cheaply bought the factories or companies they had managed in the Soviet Era.

Second, a particularly important group is the Russian Union for Industrialists and Entrepreneurs (RUIE). A form of *Nomenklatura* itself, this Union began in Soviet times as the Scientific Industrialists Union and was carried over into the Russian government by Arkady Volski. The RUIE has been nicknamed ‘the oligarch’s union,’ as many of its members are bankers and other wealthy individuals who have an interest in stalling reform, and whose interests are represented in political form. The best-known example of this is their opposition to Gaidar’s liberalisation reforms of the early 1990’s, which, as already mentioned, maintained partial reform, as the prices of Russia’s strategic industries remained subsidised while all other prices were liberalised. Many of the bankers who belong to the RUIE have or had connections to the gas and oil industry.¹¹⁰

Third is the social group made up of bankers. This group is essential to partial reform equilibrium, especially in the gas and oil industry, as it is the banks that process revenues and therefore, the rents. For example, most oil and gas companies have their own bank and these banks hold around 60 percent of the Russian cash flow.¹¹¹ Consequently, these banks hold immense power.

The government thus could not challenge the interests of a handful of powerful banks without a risk of undermining the system as a whole. At critical junctures,

¹⁰⁸ Chaisty, (2006). 126.

¹⁰⁹ Brown, *Seven Years That Changed the World* (2007).

¹¹⁰ Sakwa, *Russian Politics and Society* (2008). 294.

¹¹¹ Anastasia Gnezditskaia, "Unidentified Shareholders: The Impact of Oil Companies on the Banking Sector in Russia," *Europe-Asia Studies* 57, 3. (2005): 457 - 80. 459.

such as a decision to default, the interests of oligarchic banks tend to be particularly strongly intertwined with the fate of the entire sector.¹¹²

This illustrates that these banks have a high degree of power over the government, and thus the bankers within a company could play several key roles in maintaining partial reform.

The next two social groups, the *siloviki* and the St. Petersburg Mafia, fall into a patronage type network in which high paying and lucrative positions in the government and / or gas and oil industries are awarded to them because they know the ‘right’ people — not because they are necessarily qualified. They are also specific to the Putin presidency because these social networks lead directly to him. It must be clarified that many of these people sought employment in the private sector before the Putin era. However, it is necessary to stress that while some governmental officers were strategically placed in the certain industries, most ties with members already in these industries were simply convenient and not deliberately constructed.¹¹³ Rather, these individuals were called upon to help the government protect its interests if the need arose.

The first group is the *siloviki*. A *silovik* is defined as a politician who has a background in the military or security services industries. The *siloviki* network is significant considering Putin’s days as a KGB officer and the head of the FSB. The second group will be referred to as ‘the St. Petersburg Mafia,’ and denotes a person who is involved in the St. Petersburg (Leningrad) University Law or Economics faculty, where Putin completed his higher education or, more importantly, someone who worked in the St. Petersburg Mayor’s office where Putin was the Mayor’s assistant in the 1990s.¹¹⁴ These two groups are particularly dangerous in the context of partial reform equilibrium. Often, they have little or no experience in the field they are appointed to or choose to work in, and they are simply in the position to protect and further the interests of the state (in addition to their own personal enrichment interests). They are also protected from prosecution by the nature of their position in the government as Putin himself protects them.

Regardless of whether the gas and oil interests are represented in politics via state-capture as observed in the Yeltsin period, or renationalisation and bureaucratic recourse that characterised the Putin period, the industry has continuously presented one key incentive — to maximise rents. This harms progression of reform as it impedes development of rule of law, which in turn discourages investment, destabilises society, and in the end, perpetuates partial

¹¹² Ibid. 462.

¹¹³ White, 2003. 302.

¹¹⁴ Phrase first encountered in Goldman, *Petrostate: Putin, Power and the New Russia* (2010).

reform. To measure the degree to which the interests of certain gas or oil companies are represented in politics, a study of seven different gas and oil companies was performed. The hypothesis states that through vested interests in state politics, the political and economic elites of the oil and gas industry have played a significant role in stalling Russia's economic transition, thereby maintaining partial reform equilibrium. The objective is to determine the role of the gas and oil industry in maintaining partial reform equilibrium by measuring the degree of vested interest between the industry and political and economic elites, and the government. Of course, the null hypothesis says that any link made between the number of connections in a gas or oil firm and the government is a coincidence.

While the hypothesis is proven correct within this study, there are limitations to the results, which are presented through the challenges of the study itself. The most important challenge faced was language. While most information was available in English, there are other sources that could not fairly or adequately be understood or utilised that were in Russian. The second limitation was that of transparency. Being at the mercy of information that was publically available rendered the study vulnerable to the honesty of the information provided. Much information was not available, including: unidentifiable shareholders, various executives and managers that were not members of either the Board of Directors or Management Committee, lack of transparent corporate governance laws, and so on. The study successfully compensated for this through the literature review. For example, it was not clear from Igor Sechin's biography on the Rosneft website that he had experience in the KGB and worked in the St. Petersburg Mayor's office with Vladimir Putin, but this was highlighted and expanded upon in several books and articles.

Methodology

To properly illustrate partial reform equilibrium in Russia, the study analysed the composition of the board of directors and management committees of seven gas and oil firms in 2010 and in 2017.¹¹⁵ It singles out those members that were appointed during or after Vladimir Putin's second presidential term in 2004. This timeframe is chosen considering Putin's attempts to further centralise his power during his second term, specifically referring to the ending of the elections for Federation Council representatives and regional governors.¹¹⁶ Furthermore,

¹¹⁵ This study was first undertaken between 2009 and 2010, and made use of all resources available at that time.

¹¹⁶ Technically the elections for governors were terminated during Putin's first presidency, but with the addition of the termination of elections for Federation Council representatives this takes on significance

Post-Soviet Russia's identity crisis caused Moscow's foreign policy to shift and vacillate until President Putin's second term when Russian policy congealed into a coherent 'Doctrine', aimed at rebuilding Russian greatness atop objective pillars of energy fuelled strength.¹¹⁷

It was also chosen because, since this point in time, gas and oil interests in maintaining partial reform are intensified and represented in two different forms.

The first form is the traditional, independent, personal interest of the state captor: the oligarch or *Nomenklatura* who knows how to play by Putin's rules and does so to avoid the fate of previous oligarchs Khodorkovsky, Gusinsky, and Berezovsky. This measures the vested interest of the elite by looking at his or her connections via social networks and any previous political experience. The second form is that of the government. It measures the state's interest in maintaining partial reform equilibrium through Vladimir Putin's renationalising of key strategic industries. Therefore, it considers the overlapping roles of those who are simultaneously an appointed minister or representative and an executive in the gas and oil industry. Since Putin was still involved in the government as Prime Minister between his first two and current presidential terms, and because partial reform equilibrium is still present in Russia, the timeframe cannot simply be constrained to his second presidential term from 2004 – 2008. Furthermore, examining the composition of the committees at two different periods, 2010 and 2017, illustrates how the state has increased its direct and indirect control over the gas and oil industry and further entrenched partial reform equilibrium.

There are several gas and oil companies in Russia, but they were narrowed down to seven and split into two groups for the initial analysis in 2010: four natural gas companies and three oil companies. In each group, there is at least one company that is controlled by the state (meaning the state owns the controlling share), one company that has significant state investment (but not a majority share), and one company that is almost entirely privatised (the state's shares are too small to be significant), with attention paid to those companies that are almost entirely privatised. The four natural gas companies are: Gazprom, Surgutneftegaz, Novatek, and ITERA. The three oil companies are: Rosneft, LUKoil, and Tyumen (TNK-BP).

The research itself case study involved two steps: internet research and careful literature analysis. The internet research had a limited scope, but was an essential tool. The websites of

in that the governor is appointed by the president, and the governor in turn appoints his representatives to the Federation Council.

¹¹⁷ Julie Newton and William Tompson, *Institutions, Ideas, and Leadership in Post-Soviet Russia* (Basingstoke: Palgrave Macmillan, 2010). 190.

the seven companies were analysed to find out who the companies' executives are. While each website had various amounts of information, all, except for Surgutneftegaz, included the names of the members of the Board of Directors and / or the Management Committee, as well as their biographies. These were examined for A) their dates of employment with the company to determine if they correspond with B) any relevant past political experience and / or links to social networks and C) if the correlation of positions with the company and the government was after 2004. It was not possible to find all the company executives as only those who are current members of the Board of Directors and the Management Committees were listed, and the majority shareholders either coincided with the executives listed or were unidentified.

The second part of the methodology was a thorough analysis of various primary and secondary sources for the roles of the executives and / or other pieces of information to provide a more rounded picture. This was done by noting in each article or book, every time one of the executives' names was mentioned, the name of the person and what the author was using them to reference: a political post, a company, a social network, and so on. This greatly helped complete the picture because it often directly related a person to the government and Vladimir Putin, or indirectly did so by naming them in a particular social network or political post that was not included in the website biography. Through this, a more comprehensive biography of most of the companies' executives emerged. The exception to this was the natural gas company Surgutneftegaz, whose website was the only one that did not include biographies of its Board of Directors (it did not list a management team). Literature analysis did not turn up any further information on members of the Board of Directors other than CEO Vladimir Bogdanov. Thus, due to lack of information on company executives, other than Bogdanov, Surgutneftegaz was withdrawn from the study.

The applicable executives are further divided into two groups.¹¹⁸ The first, and most important group are individuals referred to as 'political executives': those that were simultaneously gas or oil industry executives and government ministers at some point from 2004 on. This group represents the state's interest in maintaining partial reform equilibrium via its direct influence on gas and oil companies. The second group is composed of individuals referred to as the 'political socialites': gas and oil executives who belong to one of the aforementioned social networks. If any of the individuals in the political executive group also belong to a social network (which is the case, more often than not) it will be noted, but they

¹¹⁸ Please see Appendix II for a complete list of members of the companies' Board of Directors and Management Committees, as well as a description, where provided, of the roles each are supposed to fulfil.

will not be counted twice in the ‘political socialite’ group.

To determine the power of a company’s interest in maintaining partial reform equilibrium, the results are divided into four degrees of interest, determined by the number of ‘political executives’ and ‘political socialites’ in each company. If at least one ‘political executive’ in a company exists, it is safe to assume that they are there to exploit and maintain partial reform equilibrium regardless of whether they are representing the company’s interest in politics, or the state representing its own interest in the company. Thus, the degree of representation a company has is largely, but not wholly, determined by the number of political executives. Because the total number of individuals is so small, they do not constitute a robust enough dataset to run any statistical analysis. As such, the degree of interest ranking was devised to measure the strength of each company’s power in the government — for each degree of interest a company has, the larger the stake they hold and the more bargaining power they have in politics, or vice versa.

Zero degree signifies that a company’s interest in maintaining partial reform is weak as there are no ‘political executives’ in the company and there are less than four ‘political socialites’ — their stake in partial reform is undetermined as there is not a specific link that can be drawn. Further, four ‘political socialites’ and no ‘political executives’ qualify a company as having first-degree representation since one or two ‘political socialites’ can be ignored as a coincidence; whereas three ‘political socialites,’ especially if they come from a powerful group, have past political experience, and / or come from or belong to the same network cannot be ignored.

First degree determines that the company has a mild interest in that there are no more than two ‘political executives’ or has at least four ‘political socialites.’ This interest is mild in that there is indeed a direct link, but it may not be very strong. It could either be a company executive who has a ministerial role to protect the company’s interest, or a minister sent to serve as an executive in the company and ensure it follows state directives. The fewer political executives there are, the more difficult this is to disentangle, thus the weak degree of interest in maintaining partial reform. Furthermore, if there are less than four ‘political socialites’ in a company, particularly if they are not from the same social network, their combined political capital is very weak, whereas if there are more than four, the chances of each of them not being from the same network is low, combined with their combined political capital is viable, even if only mildly so.

Second degree means that the company’s interest is strong in that it has between three and five ‘political executives’ and has up to five ‘political socialites’. These companies are,

most likely, not overlooked by the state and indeed the ‘political executives’ are representing the state’s interest in the company as well as the company asserting its own interest in the state. Consequently, we can assume that by having three to five individuals from the same company in the government, that interest representation is strong.

Finally, *third degree* signifies that a company’s interest in partial reform is critical in that it has more than five ‘political executives’ and has more than five ‘political socialites.’ In having more than five ‘political executives,’ third-degree companies have significant power in politics and the state conversely has a strong interest in these companies. Because the state has a high interest in third-degree companies, it is not likely to prosecute the company or its strategically placed employees since doing so would risk destabilisation. Thus, considering the state’s interest in these companies, if they play by the state’s rules they will enjoy the state’s protection because of the state’s ability to rule by law.

Results

Both analyses were undertaken as Russia’s economy exited economic crises, in 2010, after the 2008 crisis, and in 2017, after the 2014 crisis. The 2010 analysis was a case study that explored the increase in state control over the economy since 2004, and the 2017 analysis shows how this trajectory has continued. Generally, many of the political executives and socialites that were in the 2010 results have either changed companies or left the gas and oil industry completely. For example, Gazprom political executive Elvira Nabiullina was appointed the Governor of the Central Bank of Russia in July 2013.¹¹⁹ Since the initial 2010 study, the landscape of the gas and oil industry changed drastically as the economy responded to economic shocks and the government increased its control. Significantly, in 2014, Russia was sanctioned by the West after it annexed Crimea, which catalysed an economic crisis. While the degree of interest each company has in upholding partial reform equilibrium remains, much of the sector has been consolidated. The companies ITERA and TNK-BP no longer exist as they were both bought by Rosneft in 2013.¹²⁰ As such, the gas and oil industry has become one of many industries in which the state further expands its control in the aftermath of the 2008 economic crisis.

Gazprom has a third degree interest in upholding partial reform equilibrium in both

¹¹⁹ The Central Bank of the Russian Federation, "Elvira Nabiullina," The Central Bank of Russia, http://www.cbr.ru/eng/today/print.aspx?file=directors_board/new/nabiullina.htm.

¹²⁰ Courtney Weaver, "Rosneft Gains Control of Itera," *Financial Times*, 02 July.; Rupert Neate, "Rosneft Takes over Tnk-Bp in \$55 Bn Deal," *The Guardian*, 21 March.

2010 and 2017. In 2010, of the eleven members on the Board of Directors, five of them were labelled ‘political executives’ and four of them were labelled political socialites. Of the seventeen-member Management Committee, one member was labelled as a political executive and six of them were political socialites (see Table 1). In 2017, the Board of Directors had three ‘political executives’ and four ‘political socialites,’ whereas the management committee had two ‘political executives’ and four ‘political socialites’ (see Table 2).

Table 1: Gazprom 2010¹²¹

Gazprom ‘Political Executives’		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
Viktor Zubkov	Board of Directors	Head of Financial Monitoring Committee (2004 – 2007); Prime Minister (2007 – 2008).
Farit Gazizullin	Board of Directors	Minister of Property Relations (2004).
Elvira Nabiullina	Board of Directors	Economic Development Minister (2007 – present). ¹²²
Igor Yusufov	Board of Directors	Minister of Energy (2004)
Sergei Shmatko	Board of Directors	Minister of Energy (2009).
Alexander Koslov	Management Committee	Head of the Main Division for Procurement and Transportation with the Administrative Board of the President. (2004 – 2005)
Gazprom ‘Political Socialites’		
<u>Name</u>	<u>Position</u>	<u>Social Networks</u>
**Alexey Miller	Board of Directors	<i>Nomenklatura</i> ; St. Petersburg Mafia ¹²³

¹²¹ All executives listed were found at Gazprom, "Board of Directors," www.gazprom.com ; Gazprom, "Management Committee," www.gazprom.com

¹²² Institute for Contemporary Development, "Board of Directors," <http://www.riocenter.ru/en>.

¹²³ Andrew Barnes, "Russia's New Business Group and State Power," *Post-Soviet Affairs* 19, 2. (2003): 154 - 86. Table 1.; Goldman, *Petrostate: Putin, Power and the New Russia* (2010). 104.

**Elena Karpel	Board of Directors	<i>Nomenklatura</i>
Mikhail Sereda	Board of Directors	St. Petersburg Mafia; Banker (Sberbank)
Valery Musin	Board of Directors	St. Petersburg Mafia
**Valery Golubev	Management Committee	<i>Siloviki</i> ; St. Petersburg Mafia ¹²⁴
**Igor Fyodorov	Management Committee	St. Petersburg Mafia
**Viktor Illyushin	Management Committee	<i>Nomenklatura</i> ¹²⁵
**Olga Pavlova	Management Committee	St. Petersburg Mafia
**Andrey Kruglov	Management Committee	Banker (BNP – Drezdner)
Vlada Rusakova	Management Committee	<i>Nomenklatura</i>

** Denotes an executive who has a political experience prior to 2004.

Table 2: Gazprom 2017¹²⁶

Gazprom ‘Political Executives’		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
**Viktor Zubkov	Board of Directors	Head of Financial Monitoring Committee (2004 – 2007); Prime Minister (2007 – 2008).
Denis Manturov	Board of Directors	Minister of industry and trade (2007 – 2008); Deputy minister of industry and energy (2008 – 2012); Deputy minister of industry and trade (from 2012).
**Alexander Novak	Board of Directors	Deputy governor Krasnoyarsk (2002 – 2007); Deputy minister of finance (2008 – 2012); Minister of

¹²⁴ White, 2003. 299.

¹²⁵ Gnezditskaia, 2005. 466.

¹²⁶ Gazprom, "Board of Directors," <http://www.gazprom.com/about/management/directors/>.; Gazprom, "Management Committee," <http://www.gazprom.com/about/management/board/>.

		Energy (from 2012).
**Vladimir Markov	Management Committee	Member of State Duma, committee for energy (2007 – 2011); Head of Gazprom – State relations (Present).
Alexander Koslov	Management Committee	Head of the Main Division for Procurement and Transportation with the Administrative Board of the President. (2004 – 2005)
Gazprom ‘Political Socialites’		
<u>Name</u>	<u>Position</u>	<u>Social Networks</u>
**Alexey Miller	Board of Directors	<i>Nomenklatura</i> ; St. Petersburg Mafia
Andrey Akhimov	Board of Directors	Banker (Chairman VTB until 2002, Chairman Gazprombank until 2006).
Mikhail Sereda	Board of Directors	St. Petersburg Mafia; Banker (Sberbank)
Dimitry Patrushev	Board of Directors	Banker (Rosselkhozbank)
Timur Kulibaev	Board of Directors	<i>Nomenklatura</i>
**Valery Golubev	Management Committee	<i>Siloviki</i> ; St. Petersburg Mafia
**Igor Fyodorov	Management Committee	St. Petersburg Mafia
**Andrey Kruglov	Management Committee	Banker (BNP – Drezdner)

** Denotes an executive who has a political experience prior to 2004.

Gazprom’s third-degree ranking is not at all surprising as it is a strategic, state-owned company. The company is technically private and its shares can be bought and sold, but it is the state that owns the majority share. In 2009, Gazprom was ranked the 22nd largest corporation in the world and one of the world’s largest energy corporations.¹²⁷ Its performance over the timeframe has varied, with revenues decreasing in 2014 when sanctions were

¹²⁷ Fortune Magazine, "Fortune's Global 500 World's Largest Companies," <http://money.cnn.com/magazines/fortune/global500/2009/>

introduced as a response to Russia’s annexation of Crimea. Earning top revenues of \$141 billion 2009 and \$153 billion in 2013, profits fell from \$144 billion in 2015 to only \$91 billion in 2017.¹²⁸ Gazprom is strategically and economically important to Russia.¹²⁹ It makes sense that the state would want to place as many ministers in executive positions as possible to assure that the company runs as it should and continues to secure Russia’s place on the world stage, especially given the rapidly changing geopolitical climate. Therefore, in the case of Gazprom, partial reform equilibrium is a win-win situation since, as long as the company plays by the government’s rules, all rent-seeking parties can continue to exploit the system. Due to the state’s tactical interest in the company, the winners are assured that the state will use ‘rule by law’ to prevent prosecution of the company or its CEO’s — unless of course it is to their own benefit to do so. Thus, for Gazprom, both the state and individual executives are concerned with maintaining partial reform to protect their wealth and to continue to seek rents.

The gas production company ITERA, has first-degree representation, largely as a result of its shady dealings with Gazprom in the 1990’s. Of the seven-member Board of Directors, none of them were ‘political executives’; however, five of them were ‘political socialites’ (Table 3). ITERA is an abnormality because it meets the criteria for first-degree representation by having more than four ‘political socialites,’ but has no ‘political executives,’ and a Management Committee was not listed.

Table 3: Itera 2010¹³⁰

ITERA Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Igor Makarov	Board of Directors	<i>Nomenklatura; Siloviki</i>
**Vladimir Makeev	Board of Directors	<i>Nomenklatura</i>
**Valery Otchertsov	Board of Directors	<i>Nomenklatura</i>
Gennady Skidankov	Board of Directors	<i>Nomenklatura;</i> Banker (Sibneftbank)
Yuri Pianuk	Board of Directors	<i>Nomenklatura</i>

** Denotes an executive who has a political experience prior to 2004.

¹²⁸ Ibid.; Fortune Magazine, "Fortune Global 500," <http://fortune.com/global500/2013/> ; Fortune Magazine, "Fortune Global 500: Gazprom," <http://fortune.com/global500/2015/gazprom-26/> ; Fortune Magazine, "Fortune Global 500: Gazprom," <http://fortune.com/global500/gazprom/>

¹²⁹ Fortune Magazine, "Fortune's Global 500 World's Largest Companies".

¹³⁰ All executives listed were found at ITERA Group, "Board of Directors."; ITERA Group, "Management Committee."

To a certain extent, ITERA's first-degree representation was both expected and unexpected. It was expected because it was often accused of, and used for, asset stripping for Gazprom in the 1990s (easy to do as company's headquarters are in Jacksonville, FL, USA).

One of the most brazen examples of this asset stripping was the way Gazprom executives aided and abetted the formation of ITERA. This company soon became the second largest producer of natural gas in Russia ... no one in Jacksonville seemed particularly upset that ITERA's assets had been stripped from Gazprom.¹³¹

It was unexpected because when Putin renationalised Gazprom and replaced Viktor Chernomyrdin and Rem Vyakhirev with Dimitri Medvedev and Alexei Miller, ITERA lost the royalties and contracts that it received from Gazprom and simultaneously lost its place as Russia's second largest natural gas producer to Novatek.¹³² ITERA barely makes the first-degree qualification, but because two of its executives had past political experience and they all belong to the *Nomenklatura* group, it could be assumed that they had at least a mild degree of interest in maintaining partial reform. However, as ITERA was purchased by Rosneft for \$2.9 billion in 2013, there is no comparison for 2017. Additionally, Rosneft's purchase of ITERA is evidence of the state's increasing monopoly of the gas and oil industry, which maintains partially reformed economic institutions. This will be further discussed in chapters six and seven.

The independent gas company, Novatek, is quite interesting. It had first-degree representation in 2010, but second-degree representation in 2017, indicating its interest in partial reform equilibrium has increased. In 2010, of the nine-member Board of Directors, four of them were 'political socialites.' Out of the fifteen-member Management Committee, one of them was a 'political executive' and two of them were 'political socialites' (see Table 4). In 2017, two of the nine members of the Board of Directors were 'political executives', and three of them were 'political socialites'. The management committee shrank to eleven members, two of whom were 'political executives', and one was a 'political socialite' (see Table 5).

¹³¹ Goldman, *Petrostate: Putin, Power and the New Russia* (2010). 104.

¹³² *Ibid.* 103.

Table 4: Novatek 2010¹³³

Novatek 'Political Executives'		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
Lev Feodosiev	Management Committee	Deputy Director in the Ministry of Economic Development and Trade (2003 – 2007)
Novatek Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Andrei Akimov	Board of Directors	<i>Nomenklatura</i> ; Banker (Gazprombank)
**Vladimir Dimitriev	Board of Directors	<i>Nomenklatura</i> ; Banker (Vnesheconombank)
**Ruben Vardanian	Board of Directors	Banker (Novatek and Standard Bank); RUIE
Gennady Timchenko	Board of Directors	<i>Nomenklatura</i> ; Banker
**Iosif Levinzon	Management Committee	<i>Nomenklatura</i>
Evgeny Kot	Management Committee	St. Petersburg Mafia; Banker (Gazprombank)

** Denotes an executive who has a political experience prior to 2004.

Table 5: Novatek 2017¹³⁴

Novatek 'Political Executives'		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
**Viktor Orlov	Board of Directors	Federation Council, Committee for natural resources (2001 – 2012).
**Andrei Sharonov	Board of Directors	Minister of industry and trade (2007 – 2008); Deputy minister of industry and

¹³³ Novatek, "Board of Directors," [www.novatek.com.](http://www.novatek.com/); Novatek, "Management Committee," [www.novatek.com.](http://www.novatek.com/)

¹³⁴ Novatek, "Board of Directors," [http://www.novatek.ru/en/about/management/BOD/.](http://www.novatek.ru/en/about/management/BOD/); Novatek, "Management," [http://www.novatek.ru/en/about/management/administration/.](http://www.novatek.ru/en/about/management/administration/)

		energy (2008 – 2012); Deputy minister of industry and trade (from 2012).
**Lev Feodosiev	Management Committee	Deputy Director in the Ministry of Economic Development and Trade (2003 – 2007)
Denis Khramov	Management Committee	Deputy head Ministry of Economic Development and Trade (2008 – 2014); Deputy minister of natural resources and environment (from 2014).
Novatek ‘Political Socialites’		
<u>Name</u>	<u>Position</u>	<u>Social Networks</u>
**Andrei Akimov	Board of Directors	<i>Nomenklatura</i> ; Banker (Gazprombank)
Gennady Timchenko	Board of Directors	<i>Nomenklatura</i> ; Banker ¹³⁵
Leonid Mikhelson	Board of Directors	Banker (Russian Regional Development Bank)
Vladimir Baskov	Management Committee	<i>Siloviki</i>

Novatek is Russia’s second largest gas production company and is theoretically a private company. In 2010, the state, via Gazprom, owned about 19 percent of its shares (not enough to control it, but too much to say the company is truly independent) so the first-degree representation status was expected.¹³⁶ However, in after the initial study in 2010, Gennady Timchenko, on the board of directors, increased his share in the company to 20.77 percent.¹³⁷ Just after this, in late 2010, Gazprom sold 9.4 percent of its shares to Gazprombank.¹³⁸ While this may seem like the state reducing its shares in the company, it is not the case. Gazprombank

¹³⁵ Steven Lee Myers, Jo Becker, and Jim Yardley, "It Pays to Be Putin's Friend: Private Bank Fuels Fortunes of Putin's Inner Circle," *The New York Times*.

¹³⁶ Goldman, *Petrostate: Putin, Power and the New Russia* (2010). 167.

¹³⁷ Reuters Staff, "Timchenko's Fund Becomes Largest Novatek Owner," *Reuters*, 05 March.

¹³⁸ Reuters Staff, "Russia's Gazprom Sells 9.4 Pct Stake in Novatek," *Reuters*, 20 December.

is wholly owned by Gazprom. Thus, while Gazprom itself may be divesting itself of its Novatek shares, its political presence remains. In fact, what we begin to see is less of an interest of the company's elites in maintaining partial reform, but an increase in the government's interest in indirectly controlling the company, thereby maintaining partial reform equilibrium.

The presence of even one political executive is evidence of indirect state control. What gave Novatek an impressive and surprising amount of power in 2010, was the company's 'political socialites' who belonged to the social network of bankers. Four of the 'political socialites' were bankers, two of whom came from Gazprombank, which suggested that they might have had quite a bit of power over the state despite their first-degree status. Yet, state interest in this company has always been present, as it still owns a significant share of the company's stocks, and thus also gets its' share of rents. For example, 'political socialite' Iosif Levinson who is on the Management Committee, was the Deputy Governor of the Yamalo-Nenets region where Novatek holds its production and exploration licences.¹³⁹ As such, it can be inferred that the state has a strong desire to maintain indirect control over Novatek. The drastic increase in political executives confirms this. Accordingly, it appears that interests represented in Novatek are concerned with partial reform equilibrium to increase revenue through company rents.

TNK-BP, was unique in that it was the only Russian oil company, Tyumen (TNK), to be partially owned by a foreign company, BP. TNK-BP had first-degree representation in 2010. Of its twelve-member Board of Directors (only four of whom represent TNK), three of them (one of which is an independent director) were 'political socialites.' Of its fourteen-member management committee, one of them was a 'political executive,' and one of them was a 'political socialite' (see Table 6).

Table 6: TNK-BP 2010¹⁴⁰

TNK – BP 'Political Executives'		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
Anatoli Tyomkin	Management Committee	Deputy Minister of Natural Resources (2004 – 2008)
TNK – BP Political Socialites		

¹³⁹ Novatek, "Business: Production," www.novatek.ru/eng. Dates of Governorship do not coincide with dates of case study limitation.

¹⁴⁰ TNK-BP, "Board of Directors," www.tnk-bp.com ; TNK-BP, "Management Committee," www.tnk-bp.com

<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Mikhail Fridman	Board of Directors	RUIE; Banker (Alfa Group)
Viktor Vekselberg	Board of Directors	RUIE; Banker (Renova Group)
**Aleksandr Shokhin	Board of Directors (Independent)	RUIE; Banker (Renaissance Group); <i>Nomenklatura</i> ¹⁴¹
German Khan	Management Committee	Banker (Alfa Group)

** Denotes an executive who has a political experience prior to 2004.

TNK-BP's political connections gave it a degree of interest in maintaining partial reform for its own purposes. TNK-BP stood out because of its partnership with British Petroleum, which was, and still is, unusual given Russia's hostile foreign investment climate. The networks to which the 'political socialites' belonged gave TNK-BP most of its power in interest representation. All four 'political socialites' were bankers, who were in executive positions both at TNK-BP and at very powerful investment companies. Additionally, three of them are members of RUIE. Furthermore, all the 'political socialites,' minus Viktor Vekselberg, were notorious in the Yeltsin era and the heyday of the oligarchs for blocking and stalling reform, notably liberalisation and privatisation mentioned earlier in the chapter. Thus, because of the capital wealth controlled by the political socialites of TNK-BP, it is logical that they had a stake in the partial reform game to maintain that wealth, which in turn afforded them political power. While it was tempting to think that TNK-BP had more power than met the eye, it was bought by Rosneft in 2013.¹⁴² Importantly, this purchase was not hostile and many members of TNK-BP's board now work for Rosneft. However, this merger is further evidence of the state increasing its monopoly in the gas and oil industry.

The state oil company Rosneft has second-degree representation. In 2010, of the company's nine-member Board of Directors, five of them were 'political executives' and one was a 'political socialite.' Of the company's eight-member Management Committee, three of them were 'political socialites' (see Table 7). An exception needs to be made here. The head of the company and member of the Board of Directors, Sergei Bodanchikov, did not hold a political position during the Putin Presidency. Rather, he was appointed to his position by presidential decree in the Yeltsin era.¹⁴³ He remained in that position throughout the Putin era,

¹⁴¹ Chaisty, (2006).

¹⁴² Neate, 2013.

¹⁴³ Rosneft, "About Rosneft: Board of Directors," www.rosneft.com.

so it can safely be assumed that Putin approved of his placement and he can thus be considered a ‘political executive.’ In 2017, three of the nine-member Board of Directors were ‘political executives’, and one of them was a ‘political socialite’. The eleven-member Management Committee had two ‘political executives’ and two ‘political socialites’ (see Table 8).

Table 7: Rosneft 2010¹⁴⁴

Rosneft ‘Political Executives’		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
Sergey Bodanchikov	Board of Directors	Appointed president of Rosneft by Boris Yeltsin.
Sergei Naryshkin	Board of Directors	Deputy Prime Minister (2007 – 2008). ¹⁴⁵
Igor Sechin	Board of Directors	Deputy Head of the Executive Office of the President of the Russian Federation (2000 – 2008); Deputy Prime Minister (2008 – Present)
Andrei Reus	Board of Directors	Deputy Minister of Industry and Energy (2004 – 2008)
Yury Petrov	Board of Directors	Head of the Federal Agency for State Property Management (2008 – present)
Rosneft Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Andrey Kostin	Board of Directors	Banker (VTB Bank)
Sergey Makarov	Management Committee	Banker (Vneshtorgbank)

¹⁴⁴ Ibid.; Rosneft, "Managment Board," www.rosneft.com.

¹⁴⁵ Sergei Naryshkin is not listed on Rosneft’s website as the Vice-Chairman of Rosneft, however, he is listed as such by Marshall Goldman. Additionally, also lists him as Deputy Prime Minister. No records of Naryshkin’s company employment can be found on Rosneft’s website after 2008, but as his involvement still falls within the case study time frame, he was included in the case results. Goldman, *Petrostate: Putin, Power and the New Russia* (2010). Table 7.3.

Sergey Tregub	Management Committee	<i>Siloviki</i>
Viktor Ploskina	Management Committee	<i>Siloviki</i>

Table 8: Rosneft 2017¹⁴⁶

Rosneft ‘Political Executives’		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
Andrey Belousov	Board of Directors	Minister of economic development (2012 – 2013).
Oleg Viyugin	Board of Directors	Director Federal Financial Market Service 2004 – 2007). Banker.
Igor Sechin	Board of Directors	Deputy Head of the Executive Office of the President of the Russian Federation (2000 – 2008); Deputy Prime Minister (2008 – Present)
Yuri Kalinin	Management Committee	Director of the Federal Corrections Service (2004 - 2009); Deputy justice minister (2009 - 2010); Federation Council (2010 - 2012)
Andrei Shishkin	Management Committee	Deputy minister of energy (2010 – 2012)
Rosneft Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Matthias Warnig	Board of Directors	Banker (Dreznner Bank)
Peter Lazarev	Management Committee	<i>Nomenklatura</i>
Vlada Rusakova	Management Committee	<i>Nomenklatura</i>

¹⁴⁶ Rosneft, "Board of Directors," <https://www.rosneft.com/governance/board/>; Rosneft, "Management Board," <https://www.rosneft.com/governance/management/>.

Rosneft narrowly misses third-degree representation in both 2010 and 2017. Considering Rosneft's equal importance to Russia in the global economy as Gazprom, it was expected that Rosneft would also have as equal an interest-representation as Gazprom. Rosneft was ranked the 211th on the Fortune Global 500 ranking in 2010, and has increased its position since then, rising to 99th in 2013, and 51st in 2015, before falling to 158th in 2017.¹⁴⁷ However, Rosneft presents a very unusual case, the study of which is beyond the scope of this one. In sum, Rosneft appears to be used as a vehicle to increase the state's monopoly in the oil industry. As mentioned, it bought ITERA and TNK-BP in 2013, purchased Yukos after it was seized from Khodorkovsky, and in 2016, it obtained Bashneft from Sistema CEO Yevtushenkov in a similar manner.¹⁴⁸ Frustratingly, the state classifies and uses Rosneft as an example of a private company, but its controlling share is owned by Rosneftgaz, which is 100 percent state owned.¹⁴⁹ This is particularly important as Rosneftgaz seemingly privatised 20 percent of its Rosneft shares in 2017, yet the entire sale is unaccounted for and Rosneftgaz still controls the majority share. Thus, the degree of interest in Rosneft is important, both because of its role in monopolising the oil industry, and the state's endeavours to make the company look like a private enterprise. This will be further discussed in chapter seven.

Therefore, in light of their second-degree representation, Rosneft is unique, because there are clear examples of state interest being represented in the company. In 2010, this was manifest through the presence of 'political executives' Sergei Bodanchikov and Deputy Prime Minister Igor Sechin. As previously illustrated, Bodanchikov was appointed President of Rosneft by presidential decree of Boris Yeltsin. Deputy Prime Minister Igor Sechin is a noted Putin loyalist, both as part of the *siloviki* and the St. Petersburg mafia.¹⁵⁰ He joined Rosneft after being appointed Deputy Head of the president's office, and remained in that post while serving as Deputy Prime Minister from 2008 – 2012. Thus, it is safely assumed that he maintains direct ties to the highest levels of Kremlin power and is in that position to represent the state's interest while potentially serving his own. Furthermore, Sechin was appointed CEO

¹⁴⁷ Fortune Magazine, "Fortune's Global 500 World's Largest Companies".; Fortune Magazine, "Fortune Global 500".; Fortune Magazine, "Fortune Global 500: Rosneft," <http://fortune.com/global500/2015/rosneft-oil-51/>; Fortune Magazine, "Fortune Global 500: Rosneft," <http://fortune.com/global500/rosneft-oil/>

¹⁴⁸ Stephen Bierman, Elena Mazneva, and Evgenia Pismennaya, "Sechin Wins and Russia Approves \$5.3 Billion Rosneft Oil Deal," *Bloomberg*, 07 October 2016.

¹⁴⁹ Rosneft, "Shareholder Structure," Rosneft, https://www.rosneft.com/Investors/Equity/Shareholder_structure/

¹⁵⁰ Goldman, *Petrostate: Putin, Power and the New Russia* (2010). 193.

of Rosneft after Bogdanchikov resigned in 2010.¹⁵¹ This direct link bolsters Rosneft's nominal second-degree representation to third-degree levels. It is thus safe to say that the state's interest in seeking a share of Rosneft's rents helps maintain partial reform equilibrium.

Finally, the private oil company LUKoil has first-degree representation. Of the eleven-member board of directors, two are 'political executives,' and five are 'political socialites' (see table 2.5). There are no members of the management committee belonging to either group.

Table 9: LUKoil 2010¹⁵²

LUKoil 'Political Executives'		
<u>Name</u>	<u>Position</u>	<u>Government Post</u>
**Herman Gref	Board of Directors	Minister of Economic Development and Trade (2000 – 2007); Banker (Sberbank 2007 – present)
**Igor Ivanov	Board of Directors	Secretary of the Security Council (2004 – 2007)
LUKoil Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Valery Grayfer	Board of Directors	<i>Nomenklatura</i>
Vagit Alekperov	Board of Directors	<i>Nomenklatura</i> ; RUIE ¹⁵³
Sergei Mikhailov	Board of Directors	<i>Siloviki</i>
Nikolai Tsvetkov	Board of Directors	<i>Siloviki</i>
**Alexander Shokhin	Board of Directors	<i>Nomenklatura</i> ; RUIE; Banker (Renaissance Group)

** Denotes an executive who has a political experience prior to 2004.

Table 10: LUKoil 2017¹⁵⁴

LUKoil 'Political Executives'

¹⁵¹ Anders Aslund, "How Rosneft Is Turning into Another Gazprom," *The Moscow Times*, 20 June.

¹⁵² LUKoil, "Board of Directors," www.lukoil.com; LUKoil, "Management Committee," www.lukoil.com.

¹⁵³ Hanson and Teague, 2005. 661.

¹⁵⁴ LUKoil, "Board of Directors," <http://www.lukoil.com/Company/CorporateGovernance/BoardofDirectors>; LUKoil, "Management Committee," <http://www.lukoil.com/Company/CorporateGovernance/ManagementCommittee>.

<u>Name</u>	<u>Position</u>	<u>Government Post</u>
**Igor Ivanov	Board of Directors	Minister of Foreign Affairs (1998 - 2004); Secretary of Security Council (2004 - 2007)
LUKoil Political Socialites		
<u>Name</u>	<u>Position</u>	<u>Social Network</u>
Valery Grayfer	Board of Directors	<i>Nomenklatura</i>
Vagit Alekperov	Board of Directors	<i>Nomenklatura</i> ; RUIE
Roger Munnings	Board of Directors	RUIE
Vadim Vorobyev	Management Committee	<i>Nomenklatura</i>
Anatoly Moskalenko	Management Committee	<i>Siloviki</i>
Stanislav Nikitin	Management Committee	Banker (various banks)
Oleg Pashaev	Management Committee	<i>Siloviki</i>

** Denotes an executive who has a political experience prior to 2004.

The private company LUKoil has first-degree representation. LUKoil is probably the most unique company in the study, as it is one of Russia's few truly private companies.¹⁵⁵ Its success has increased over the years, rising from 93rd in the Fortune Global 500 in 2010, to 46th in 2013, and 43rd in 2015, before falling to 102nd in 2017.¹⁵⁶ Notably, it out ranks and out earns Rosneft. Yet, 2010 political executive Herman Gref was the Minister for Economic Development and Trade and has a strong interest in maintaining the state's interest in partial reform. "Liberal German [Herman] Gref ...work[s] no less actively to ensure the survival of bureaucratic capitalism."¹⁵⁷ It can be assumed that Gref was in his position to oversee and ensure the company complied with and did not hinder the government's interests. Gref has since left LUKoil, and it is assumed that his successor, Ivanov has carried on fulfilling this role. Thus, if LUKoil continues to play by the government's rules, then they are likely saved from further state control. Consequently, while LUKoil stands out as a private company, it is clear from their first-degree status that they do have some influence in state politics and that both parties, company and state, seek to protect their rents via maintaining partial reform.

¹⁵⁵ Goldman, *Petrostate: Putin, Power and the New Russia* (2010).

¹⁵⁶ Fortune Magazine, "Fortune Global 500".; Fortune Magazine, "Fortune Global 500: Lukoil," <http://fortune.com/global500/2015/lukoil-43/> ; Fortune Magazine, "Fortune Global 500: Lukoil," <http://fortune.com/global500/lukoil/>

¹⁵⁷ Shevtsova, (2007). 99.

The interest representation in this study goes two ways, but it is not always easy to tell in which direction it flows. The first direction flows from the company toward the state: the company asserts its rents-seeking interests vis-a-vis the government. This is, often, the case with companies that have first-degree representation as they have little or no direct relation with the state. The second direction of interest representation is the inverse: the state asserts its own rent-seeking interests through the company. This is most likely the case with second and third-degree representation companies, as there is a concrete relationship between the company and the state. Regardless of where the interests are coming from and where they are being directed, the interest that is being represented is that of maintaining the status quo of partial reform equilibrium.

The results show that there has been an increasing degree of state interest in maintaining partial reform equilibrium. In 2010, all the gas and oil companies selected have at least a mild degree of interest in maintaining partial reform equilibrium, with some possessing a strong interest. In 2017, only four of the original six companies remain, as Rosneft bought TNK-BP and ITERA. Additionally, Novatek's degree of interest increased, and while LUKoil's degree of interest remains unchanged, it has more political socialites in 2017 than it did in 2010. This suggests that state is exerting more indirect control to protect its interest. As such, because the state now controls most of the industry, it has de facto also increased its interest in maintaining partial reform equilibrium. What is most interesting about the results is that the initial analysis in 2010 suggested a healthy, symbiotic relationship between elites' vested interest and the state's vested interest in maintaining partial reform. However, the results from 2017 demonstrate that there has been a significant shift in furthering and protecting the state's interest in the gas and oil industry. Thus, what the results show is not only the role the gas and oil industry has played in maintaining partial reform, but also the state's increasing control in the industry. This reinforces and maintains partial reform equilibrium by placing the interests of the state over market competition, and the development of market institutions.

* * *

The above study demonstrates both the result of partially reformed institutions, as well as how they are maintained. It shows the blurred line between the state and the economy, and how the former can use its power to protect its own interests. This weakens market institutions and strengthens command practices as the government uses its power to control the country's most powerful industry. Even in those companies in which the state does not have a controlling stake or its own representatives, it protects its social networks. In turn, the social networks comply with state directives. By using members of his personal network in the hydrocarbon companies

and in the government, Putin ensured that the state would be the main recipient of gas and oil revenues. As a result, from the early 2000s, it appears that the Russian economy is booming: the state had budget surpluses, which Putin used to create a \$100 billion stability fund; GDP and GDP per capita expanded by 5.5 percent on average each year; and unemployment fell.¹⁵⁸ However, it created an incentive to replicate weak institutions and perpetuate partial reform equilibrium so Putin could continue seeking gas and oil rents to support the economy in the absence of a market.

3.5 Conclusion

This chapter has examined where partial reform equilibrium began: Gorbachev's *perestroika* reforms. While it was never his intention to freeze economic development, Gorbachev's attempts to fix the system brought it crashing down. This led to the critical juncture for Russia: in the aftermath of the collapse of the Soviet Union, it decided to focus on economic modernisation rather than institutional development. This set the state on a path that continues to reaffirm the incentives that maintain weak economic institutions that are neither command nor market. It was specifically affirmed by illustrating how, despite evidence to the contrary, Vladimir Putin did not break partial reform equilibrium. In fact, he further reinforced command over market practices, further entrenching the problem.

It is important to remember that the incentives to undermine attempts to strengthen institutions have not stemmed from corrupt officials, although they do profit from exploiting partial reform. Instead, it is because the institutions had no way of implementing the reforms the government attempted – they lacked the enforcement mechanisms to do so. As a result, corrupt practices, some necessary, others predatory, evolved to compensate for these shortcomings. This chapter has analysed how this has happened over time, and how informal institutions have proven more adaptable than formal ones. The following chapter will dive more specifically into the challenges and shortcomings of one institution: the Central Bank of Russia. Analysing its trajectory allows us to understand how no matter the intentions of the reformers, there was no way the objectives of many reforms could be met. It allows us to highlight how the state, society, and the institution itself copes with this riddle by resorting to informal rather than formal institutions.

¹⁵⁸ Appel, 2004.; The World Bank. "Russian GDP Per Capita 1991 - 2012." 2012.

CHAPTER 4

THE CENTRAL BANK OF RUSSIA

This chapter will discuss the history of the Central Bank of Russia (CBR), the role it has played in the transition, and the role it has played in the maintenance of partial reform equilibrium. As such, it is divided into three sections. The first examines the autonomy of the CBR as a means of understanding the how its status as an independent institution did not help the transition to a market economy, although many argued its autonomy was an essential first step. The second section provides a brief historical overview of the CBR to provide a historical framework for examining the roots of many social economic practices from the banking perspective. The final section is an analysis of CBR policies in the reform era and how these policies maintained partial reform by undermining market practices. This chapter will provide insight into the paradox of the CBR's development as a key economic institution.

4.1 Central bank independence and the Russian Federation

Central bank independence (CBI) is a sensitive issue because while central bankers are more concerned with inflation and price stability, politicians are more concerned with economic growth and employment.¹ While the end goals of both the central bank and the ruling party are economic stability and growth, how they are achieved and the sacrifices each are willing to make often conflict. The degree of independence a central bank has determines how the conflict between the two is resolved.² There are many debates surrounding central bank independence, but they can be separated into two categories. First, that central banks should be as independent and autonomous as possible in order to prevent long-term monetary goals from being undermined by short-term political pressures.³ There have been numerous studies that show a negative correlation between CBI and inflation.⁴ The argument is that this provides long-term

¹ J. B. Goodman, "The Politics of Central Bank Independence," *Comparative politics* 23, 3. (1991): 329-49. 329.

² Sylvester C. W. Eijffinger and Jakob De Haan, *The Political Economy of Central-Bank Independence* (International Finance Section, Department of Economics, Princeton University, 1996). 16 -17.

³ Bilin Neyapti, "Central Bank Independence and Economic Performance in Eastern Europe," *Economic Systems* 25, (2001): 381 - 99. 382 – 383.

⁴ Vittorio Grilli, Donato Masciandaro, and Guido Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy* 6, 13. (1991): 341 - 92.; Alberto Alesina and Lawrence Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit and Banking* 25, 2. (1993): 151 - 62.; Alex Cukierman, Geoffry Miller, and Bilin Neyapti, "Central Bank Reform, Liberalisation, and Inflation in Transition Economies — an International Perspective," *Journal of Monetary Economics* 49, (2002): 237 - 64.

price stability, which is important for the stability of a capital market where governments and enterprises can borrow cheaply and make long-term investments.⁵ The second argument is that central banks should be subordinated to an elected government or should be composed of elected officials.⁶ This is because an institutional agency that exists independently of electoral pressures undermines the democratic process, and cannot accurately reflect the will of the people.⁷ Those that argue against CBI, argue that the links between CBI and price stability are spurious and can be explained by other factors, such as political stability and accountability.⁸ However, the clear downside to compromised central bank independence is that it is much more susceptible to political pressure during times of economic hardship when there are calls for expansionist monetary policy to alleviate social burdens.

There are three main roles that a central bank is supposed to fulfil: setting monetary policy, regulating the banking industry and financial markets, and overseeing the payments system.⁹ As such, most measures of CBI try to evaluate how free central banks are to make policies regarding these issues. For example, the seminal work on contemporary CBI by Cukierman, Webb, and Neyapti examine two main criteria: legal independence, or how much autonomy is granted in the bank's mandate or the state's constitution; and personnel independence, or who appoints central bank managers and how easily can that person be removed and replaced.¹⁰ Both criteria examine the degree to which a government can pressure or sway central bankers to abandon their long-term focus for short-term gains. These criteria are measured on a scale of 0 – 1, with 0 being least independent and 1 being most independent. A recent study using these criteria by Cukierman, Miller, and Neyapti found that the Central Bank of Russia's autonomy scores .49 for its authority over monetary policy and problem solving with the government, placing it in the same category as the USA and Canada; it scores .47 for its limits on lending to the government, placing it in the same category as France.¹¹ This demonstrates that on paper and in practice, the CBR is autonomous.

The debate around CBI is very contentious, but little of it is applicable to Russia and other states in the Former Soviet Union. Thus, a full analysis of the merits and disadvantages

⁵ Alex Cukierman, Steven Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *The World Bank economic review* 6, 3. (1992): 353-98. 354

⁶ Joseph Stiglitz, "Central Banking in a Democratic Society," *De Economist* 146, 2. (1998): 199 - 226.

⁷ Ibid.

⁸ Eijffinger and De Haan, (1996).

⁹ Joachim Bald and Jim Nielsen, "Developing Efficient Financial Institutions in Russia," *Communist Economies and Economic Transformation* 10, 1. (1998): 81 - 93. 81.

¹⁰ Cukierman, Webb, and Neyapti, 1992.

¹¹ Average of two scores by two measures collated in Cukierman, Miller, and Neyapti, 2002. Table 2.

of CBI is beyond the scope of this study. However, it is necessary to understand the basis of the debate to rule out CBI, or the lack thereof, as a cause of partial reform equilibrium. It was expected that if Russia could construct an independent central bank, as international observers recommended, then its transition to a market economy would be swifter and easier. If we accept that Russia has not yet completed its transition and it is indeed trapped in partial reform equilibrium, then we can infer that either Russia's central bank is not autonomous or that CBI has little to no effect on the efficiency of its economic transition. While CBR independence is probably for the best, for reasons that will be explained, this has not made it any less susceptible to reinforcing command economy practices and maintaining partial reform equilibrium.

The degree to which CBI is a useful macroeconomic tool for developing countries and countries in transition is also up for debate. There are some studies that demonstrate that CBI is essential in developing economies, and has a stronger negative correlation to interest rates and price stability than in developed economies.¹² Regarding Russia and other FSU and formally socialist economies more generally, the results are mixed. Because of the challenges that many central banks in this region faced in the early transition period, it is difficult to untangle the causality between inflation and CBI. These countries sustained periods of high inflation during price liberalisation, which skews the data against CBI. Studies have found that if price liberalisation was sustained and fully completed, then CBI has the same effect on inflation as it does in developed economies.¹³ Additionally, CBI reinforces financial market development through hard budget constraints, which has a negative correlation to budget deficits, inflation, and a positive correlation to economic growth.¹⁴ The hypotheses for these relationships vary. It is likely that CBI, especially legal CBI, is an indicator of strong rule of law, which is conducive to long-term economic investment and overall political stability. The other common observation and hypothesis is that of contagion or coercion. Most of the countries that follow this pattern are geographically closer to, and / or members of the European Union.¹⁵

However, Russia does not fit this pattern. It has a high degree of CBI, but its control of

¹² Jeroen Klomp and Jakob De Haan, "Central Bank Independence and Financial Instability," *Journal of Financial Stability* 5, (2009): 321 - 38.

¹³ Cukierman, Miller, and Neyapti, 2002. 248 – 251.

¹⁴ Neyapti, 2001. 383.

¹⁵ Cukierman, Miller, and Neyapti, 2002.; Steven Levitsky and Lucan Way, "Linkage, Leverage, and the Post-Communist Divide," *East European Politics and Societies* 20, 1. (2007): 48 - 66.

monetary policy is questionable.¹⁶ In fact, especially in the 1990s, the CBRs inability to rein in inflation caused hyperinflation and widespread economic turmoil. As for any link to economic growth, this is a spurious correlation as numerous studies have demonstrated that it is far more likely that the rise in gas and oil prices in the 2000s to be responsible than other factors such as sound political, economic, or monetary policies. In fact, as will be discussed in further detail in the next section, CBI in Russia caused a lot of macroeconomic chaos as the CBR and the government pursued diverging reforms and policies in the first part of the 1990s. Since the 2000s, Johnson has argued, CBI has been slightly eroded by the Putin presidency, and the commercial banking industry and financial markets have not supported CBI, an important endorsement if it is to succeed.¹⁷ However, both Johnson and Tompson have demonstrated the increase in investments that occurred after Putin took power and began to bring the CBR more under executive control.¹⁸ 'If the desire for stability has caused financial institutions to back CBI in Western Countries, then the pain of stabilisation has had the opposite effect in Russia.'¹⁹ CBI has not had the expected effects on Russia's transition to a market economy as it has not been able to implement sound monetary policy and has often undermined the development of a market economy.

The institutional legacy that the CBR inherited set it up to fail regardless of its level of autonomy. CBI is a tool of market economies, but Russia was not a market economy so this tool could not have the same effect.²⁰ The CBR's autonomy was constructed with the help and advice of international observers and devoid of any economic legacy.²¹ As such, even when it wants to implement anti-inflationary monetary policy, or regulate banks more closely, it has no mechanisms to undertake these actions. In fact, Johnson makes a compelling argument that had the CBR had less autonomy in the 1990s, the liberalisation policies could have been much better coordinated and shock therapy would have been more effective. For example, although CBI had drastic anti-inflationary effects on those states that sustained rigorous liberalisation policies, Russia did not do this. As demonstrated in the previous chapter, the government undermined much of its shock therapy plan by maintaining many price subsidies. As will be

¹⁶ Juliet Ellen Johnson, "Postcommunist Central Banks: A Democratic Deficit?," *Journal of democracy* 17, 1. (2006): 90-103. 98.

¹⁷ *Ibid.* 100.

¹⁸ Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000.; Johnson, 2006.

¹⁹ Tompson, 1998. 1174.

²⁰ *Ibid.* 1157.

²¹ Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 973.

illustrated in the following sections, the CBR contributed to the failure of liberalisation by maintaining soft budget constraints and printing rubles to soften the blow of inflation, which led to hyperinflation. Much of this is not because the CBR was actively trying to sabotage the transition. Conversely, because the monetary tools it had on paper proved to be ineffective, it resorted to those it knew would give them some leverage.

One of the benefits of CBI is that it allows a central bank to act more decisively and effectively during an economic crisis.²² This means that central banks can raise or lower interest rates as necessary to control for inflation or provide emergency liquidity for banks or other entities that may need assistance. However, a measure of both CBI and, more crucially, credibility, is how easily a central bank reacts to pressures to aid banks or lower interest rates. Central banks with tighter limits on public lending tend to have more independence because it signals that they both are not subject to political pressure, and that they are committed to long-term price stability.²³ For example, during a crisis, if a central bank rescues problem banks to avoid crisis contagion, this signals that it is placing short-term pressures before long-term interests.²⁴ The more often it does this, the more it undermines its own credibility, and the more its actual autonomy is questioned. The CBR indeed has a high degree of autonomy and can, and does, respond rapidly to economic crises to prevent crises from crippling the economy. Yet these measures often go too far, do not allow for crises to foster ‘creative destruction,’ and echo the Soviet protectionist practices. Thus, providing relief, the CBR maintains command economy practices and soft budget constraints alongside those of a market economy.

It is tempting to think that if the CBR had enough independence, then it would have been able to take control of the economy and steer it toward a market. However, this ignores the fact that CBI did not make the anti-inflationary or other tools the CBR had any more effective. Furthermore, there is no evidence that subordinating the CBR to the government would have resulted in a different outcome. The problem of partial reform is that there are contradictory economic signals at play, each undermining the other. The CBR resorts to SBCs and other command economy practices, which undermine the market reforms both it and the government are trying to implement. This also undermines the rule of law and institutional practices: if the CBR does not adhere to its own policies, what good are they? If institutions, and by extension the rule of law, are weak, then the degree of central bank independence the CBR has will have no effect on partial reform equilibrium.

²² Klomp and De Haan, 2009. 322.

²³ Cukierman, Webb, and Neyapti, 1992. 357.

²⁴ Neyapti, 2001. 386.

4.2 History of the central banks of the Russian Empire and the Soviet Union

To better understand the role that the Central Bank of Russia plays in reinforcing partial reform equilibrium, we must first understand and analyse the economic role it has historically played historically. If indeed the economy is trapped between command and market systems, we must understand the role it played in the former versus the role it is supposed to play in the latter. This will highlight both the practices of the CBR that reinforce partial reform, as well as the limitations of the CBR to foster genuine economic reform. As such, this section will briefly describe the history of the CBR: from the State Bank of the Russian Empire through the collapse of the Soviet Union. Then, we will examine how the perestroika reforms affected the banking sector and thus the role the CBR inherited when the Soviet Union collapsed, and the tools it had to fulfil those roles.

State Bank of the Russian Empire and Gosbank

The State Bank of the Russian Empire was developed in 1860 as an auxiliary institution to the Ministry of Finance to facilitate the numerous economic development projects the empire was undertaking at the time.²⁵ The Bank would not begin to assume the regular responsibilities of a central bank until the 1880s, when it began regulating the empire's banks, lending to new commercial banks, taking bankrupt banks into receivership, and so on.²⁶ It was not until 1895 that the bank began issuing currency and taking control of monetary policy.²⁷ In the 1900s, the bank again evolved by amassing gold and currency reserves in line with the state's fiscal policy. Until the First World War, the State Bank of the Russian Empire maintained the empire's gold ratio at nearly 100 percent — the bank kept its currency value equal to the amount of gold reserves the state owned.²⁸ When WWI broke out, the Bank financed the Empire's involvement in the war via treasury bills and loans, but spent just over 500 million rubles of gold reserves on the war over a three-year period.²⁹ While this made a dent in the Bank's reserves, the bank could have spent much more on the war effort. This is important to note given that Russia's poor performance in the war was one of the contentions of the 1917 Revolution — it was one of the Bolsheviks' many rallying cries.³⁰ In December 1917, the Bank was seized as part of the

²⁵ The Central Bank of the Russian Federation, "The State Bank of the Russian Empire," <https://www.cbr.ru/Eng/today/?PrId=impbank>. Central Bank of Russia.

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ Service, (2009). 28 – 29.

revolution.³¹

From 1917 until 1920, it was the Bank of the Russian Soviet Federal Socialist Republic, after which it became the State Bank of the Soviet Union (Gosbank). It was during this time that the Bank would undergo the changes required for a command economy. It was a monobank, meaning it undertook banking activities for the state and the general population: it helped the state fund economic plans, but it also served as the state savings banks for individual depositors. Gosbank undertook these tasks by overseeing and directing the state's three specialised banks: Stroibank, the financing and investment bank; Sberbank, the state savings bank; and Vneshtorgbank, the foreign exchange bank.³² It stopped operating on a for-profit basis, and its main functions became financing the modernisation and industrialisation of the state by printing money, managing the redistribution process, and developing accounting practices that allowed the state to fulfil its economic plans.³³ The state set quotas of what was to be produced in each industry and Gosbank allocated the necessary funding to each industry according to these quotas.³⁴ It was not intended as a tool of macroeconomic management, and did not have tools to manage macroeconomic policies such as inflation and interest rates.³⁵ Instead, it had tools to soften the state's budget constraints. Gosbank was a part of the party machinery to ensure the command economy functioned smoothly. Its role was not to undertake any kind of fiscal or monetary policy, but to follow orders.

Since the main aim of the new state was to be working toward the formation of a moneyless society, the role of the bank would be to help the state finance its economic policies through creative accounting in the absence of hard, stable revenue.³⁶ To this end, Gosbank developed a non-cash system that allowed it to soften budget constraints. It developed two different forms of currency, liquidity and non-liquidity based, for different transactions: *nalichnye*, money or wages paid to workers, and *beznalichnye*, money used to conduct transactions between enterprises.³⁷ By the mid-1930s, the bank negotiated loans and

³¹ Ibid. 79.

³² Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 976.

³³ Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," 1997. 1160 – 1163.; Central Bank of Russia. <http://www.cbr.ru/Eng/today/?PrtId=nrbank>

³⁴ Ibid. 1160 – 1163.; Timothy Frye, "Governing the Banking Sector," in *The State after Communism: Governance in the New Russia*, ed. Timothy; Holmes Frye, Stephen (Rowman and Littlefield, 2005). 4.

³⁵ Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 976.

³⁶ Bald and Nielsen, 1998. Bald and Nielsen 1998. 81.

³⁷ Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 975.

outstanding payments in *beznalichnye*, non-cash settlements.³⁸ It is the *beznalichnye* that allowed for soft budget constraint (SBC) to be practiced, and was the most stubborn legacy Gosbank left to its predecessor. SBCs gave enterprises the financing necessary to acquire the raw materials or other goods needed for production (soft administrative pricing). Because *beznalichnye* was not a hard form of currency, the Bank was able to expand the currency as much as needed, thus allowing them to grant credit to enterprises (soft credit and soft subsidies). This further allowed them to settle debts and other arrears in non-cash payments, as the *beznalichnye* was not the currency in which the economy was valued — it was not used to purchase goods and services. Thus, by using an alternative currency on which the prices of goods were not based, Gosbank was able to grant and forgive loans, and expand credit seemingly without piling debt on the economy.

However, the issuing of two separate currencies to accommodate the needs of the command economy took a toll. The SBCs undermined the economy and perverted the notions of profit maximisation, leading to inefficiency. *Beznalichnye* worked well in theory, but it did not provide the state with the hard revenue it needed to stay afloat. It also contributed to the confusion of economic value — it was impossible to tell the actual cost or value of various goods and services. Gosbank had no experience in controlling inflation with interest rates, or undertaking and managing many of the policies on which market economies depend. The ability to maintain SBCs was the only tool that Gosbank had in its arsenal when it became clear that the economy was in trouble. To make matters worse, the tasks that were set during Gorbachev's *perestroika* reforms were mutually exclusive: to create a financial market that can help stimulate the economy and bring in much-needed revenue, but also protect the populace from the harsh realities of a market economy.³⁹ As *perestroika* proceeded, Gosbank could not meet these objectives. The agency, and the people who ran it, understood the theory behind the reforms, but that did not help them develop the necessary instruments to both implement the reforms and make them effective.⁴⁰ Reducing inflation and stimulating economic growth are straightforward concepts for a market economy with a sole currency. But in a dual monetary system in which the value of goods and services is unknown, these concepts become impossible to operationalise. Thus, as Gosbank began to take on the roles and responsibilities of a market central bank, it lost control over the command economy. The tools had to enact economic policy began to change, but had little to no effect, as the economy itself could not respond to

³⁸ The Central Bank of the Russian Federation, "The State Bank of the U.S.S.R."

³⁹ Brown, *The Gorbachev Factor* (1996). 116, 137 – 140.

⁴⁰ Johnson, 2006.

the bank's signals. Thus, Gosbank resorts to the tools it has and knows will work. The result is partial reform equilibrium, trying to make a market economy work with command economy tools.

Perestroika

The 1987 Law on State Enterprises' liberated Gosbank from the command economy, making it an autonomous agency. It was tasked with forming and implementing monetary policy, creating a financial market, and generally taking on the roles and responsibilities required of a central bank in a market economy.⁴¹ To this end, Sberbank and Vneshtorgbank were separated from Gosbank, but remained under its control. Three new specialised state banks (*spetsbanks*), Promstroibank, Agroprombank, and Zhilsotsbank, were created to undertake Gosbank's command economy responsibilities.⁴² Promstroibank managed the industrial sector; Agroprombank managed the agricultural sector; Zhilsotsbank managed housing and retail loans; Sberbank became the savings bank; and Vneshtorgbank managed foreign trade.⁴³ The law did not include clear mechanisms for supervising or regulating the *spetsbanks*, nor any guidelines for the banks on how to undertake banking.⁴⁴ This led to infighting between Gosbank and the *spetsbanks*.⁴⁵ Gosbank created as many barriers and obstacles to prevent the *spetsbanks* from having any meaningful role or power: they limited the amount of credit the banks could extend, and refused to give them flexible interest rates.⁴⁶ The idea was that if Gosbank did not have the power to properly regulate the *spetsbanks* it would do so by diminishing their role in the economy. The *spetsbanks* responded by hiring as many people as possible and not monitoring their loan portfolios, thereby creating bureaucratic mayhem for Gosbank to sort out.⁴⁷

The 1988 'Law on Cooperatives' commercialised banks in the Soviet Union.⁴⁸ In theory, this law allowed anyone meeting certain legal requirements to open a bank. In practice, the legal requirements of opening a bank created high barriers to entry for most budding

⁴¹ Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," 1997. 1161.

⁴² Bald and Nielsen, 1998. 86.

⁴³ Koen Schoors, "The Fate of Russia's Former State Banks: Chronicles of a Restructuring Postponed and a Crisis Foretold," *Europe-Asia Studies* 51, 1. (2003): 75 - 100.

⁴⁴ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 31.

⁴⁵ Schoors, 2003.

⁴⁶ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 31.

⁴⁷ *Ibid.* 31.

⁴⁸ *Ibid.* 32 - 33.

entrepreneurs. To get a banking license, one had to have the approval of the regional and head offices of Gosbank, the ministry of finance, and the local Soviet party. So, much like setting up a cooperative, only various party members, ministries, state enterprises, and those with personal connections to the party, could set up their own bank.⁴⁹ However, if one had the connections, setting up a cooperative bank was quite easy as the capital requirement was only ₺500,000.⁵⁰ For comparison, to set up a commercial bank in the Soviet Union under the same law, the capital requirement was ₺5 million.⁵¹ The objective of the policy was to make it easier for cooperatives and enterprises to undertake their own banking needs: they could have access to all the financial tools they needed to be sufficient from the state and command economy, make investments, and profit from them.⁵²

This led to an explosion of banks as enterprises set up pocket banks, or banks attached to and run by the enterprises themselves, and *spetsbanks* created several offshoots and subsidiaries, called zero-banks.⁵³ The banks would use their connections to borrow money at a favourable interest rate, transfer the money to a zero-bank or subsidiary, and then re-lend at the sum a higher interest rate and pocket the difference.⁵⁴ During this time, the dual-monetary system allowed the state to continue to use soft budget constraints to resolve enterprises' debt problems.⁵⁵ Moreover, enterprises and banks could not be held accountable for defaulting on their debt because due to the lack of bankruptcy laws. The first bankruptcy law was introduced in 1990 and heavily favoured the debtor.⁵⁶ This ended up being a de facto soft budget constraint.⁵⁷ Therefore, banks and enterprises rarely took their debt responsibilities seriously, expecting to be bailed out every time they defaulted. Second, in later years the CBR, and the state resort to SBCs in times of crisis to prevent economic hardship.

The 1987 'Law on State Enterprises' and the 1988 'Law on Cooperatives' attempted to create a market economy, or at least introduce profit driving incentives into the Soviet command economy.⁵⁸ Yet it completely undermined the end goals of increasing profits because

⁴⁹ Ibid. 35.

⁵⁰ Ibid. 35.

⁵¹ Ibid. 35.

⁵² Ibid. 33 – 34.

⁵³ OECD, "Banking Reform " in *OECD Economic Surveys: Russian Federation 2004* (Paris: OECD Publishing, 2004). 219 – 220.; Schoors, 2003.

⁵⁴ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 39.

⁵⁵ Ibid. 32.

⁵⁶ Perotti, 2002. 384.

⁵⁷ According to Perotti (2002), this law would eventually cover enterprises, but banks were basically exempted from bankruptcy proceedings until 1998.

⁵⁸ Brown, *The Gorbachev Factor* (1996).145 – 147.

it maintained soft budget constraints.⁵⁹ For example, central banks use interest rates for two purposes: to earn revenue (via interest as the cost of borrowing money), and to take money out of circulation (to combat inflation). However, the maintenance of soft budget constraints made Gosbank's new monetary tools useless. To begin, maintaining a dual monetary system makes trying to evaluate the cost of money or the rate of inflation impossible. Second, maintaining soft credit practices undermined the purposes of these mechanisms because they did not drive enterprises to innovate, maximise profits, and repay loans.

However, the use of soft budget constraints to undermine market institutions is complicated. Primarily, as Gorbachev expressly stated, the state wanted to prevent the imposition of HBCs because closure of enterprises might result in social dislocation.⁶⁰ Also, the state also has its own incentive not to implement HBCs because many of those enterprises are owned by the state — if they foreclose, that is the state's loss. Finally, because monetary tools are undermined by SBCs, Gosbank resorts to using them precisely because they are the only tools it possesses maintain some control over the economy.⁶¹ Therefore, partial reform equilibrium is borne not just out of a desire to maximise predatory rent-seeking and social protection, but it also becomes a tool for the state to protect itself. As will be seen, even still in times of crisis, the CBR's main goal when using HBCs is to protect the state.

4.3 The Central Bank of the Russian Federation: evolution from 1992 – 2014

After the collapse of the Soviet Union, Gosbank became The Central Bank of Russia. It was given complete autonomy and all the responsibility that came with it. Sberbank and Vneshtorgbank (renamed Vnesheconombank or VEB) became commercial banks, theoretically independent of the CBR.⁶² In practice, however, the CBR still owns the majority shares of both, and Sberbank remains largest bank in Russia. Shortly before the collapse of the USSR, Promstroibank, Agroprombank, and Zhilshotsbank privatised themselves and separated from the state banking system.⁶³ By 1992, when the Soviet Union collapsed, there were 1,360 banks in the Russian Federation alone.⁶⁴ The economy was in disarray after the collapse of the USSR, and the CBR was tasked with developing and implementing policies to sort everything

⁵⁹ Ibid. 147.

⁶⁰ See Chapter II for more details.

⁶¹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 77.

⁶² Schoors, 2003.; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).

⁶³ Schoors, 2003. 73.; Bald and Nielsen, 1998. 86.

⁶⁴ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 27.

out. This required the CBR to: reconcile the dual monetary system, implement HBCs, undertake financial market deepening, regulate the quickly multiplying banks, help the state collect taxes, and untangle and separate from the other former republics of the Soviet Union.⁶⁵

As argued above, it is the position of this study that the subordination of the CBR to the state would not have yielded drastically different results. Both the CBR's difference in vision from the government for how to proceed with economic reform, and its incapacity to enact its own policies, were the root causes of the economic upheaval of the early 1990s. It should be noted that there were three economic crises in Russia in the 1990s: in 1994, the ruble collapsed; 1995, banks began to fail due to a liquidity crisis; and 1998, when the state defaulted on its bonds and drastically devalued the ruble.⁶⁶ However, this chapter is not concerned with economic crises. It is more concerned with the role the CBR played in those reforms that were aimed at transitioning the economy from command to market, and how it helped to stall that transition.

1992: Liberalisation

The CBR undermined the efficacy of the shock-therapy liberalisation programme by maintaining soft budget constraints. It did so both because SBCs were the most effective economic tools it had to modernise the economy, and because it had no control over the money supply.⁶⁷ While the government was liberalising prices, trying to end inter-enterprise debt, and implementing hard budget constraints, the CBR undermined this by maintaining soft budget constraints and forgiving inter-enterprise debt.⁶⁸ Given the CBR's autonomy, there was very little the liberal reformers could do to stop the CBR and reconcile the two policies.⁶⁹ Indeed, the CBR printed ₺1.3 trillion to allow the enterprises to pay off their arrears, and gave them soft loans that were basically grants.⁷⁰ Additionally, it is estimated that federal subsidies amounted to 55 percent of GDP in 1992.⁷¹ The CBR would continue to extend soft subsidies,

⁶⁵ Hillman, 1993. 212.; Johannes Linn, "Economic (Dis)Integration Matters: The Soviet Collapse Revisited" Washington DC. Brookings Institution, mimeo, 2004.

⁶⁶ Abdur Chowdhury, "Banking Reform in Russia: Winds of Change?," *The Journal of Policy Reform* 6, 2. (2003): 89 - 103 91.

⁶⁷ Linn, 2004. ; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 87.

⁶⁸ Stone, (2002). 121.; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 86 - 87.; Tompson, 1998. 1171.

⁶⁹ Robinson, 2000. 1399.

⁷⁰ Perotti, 2002. 367.; Stone, (2002). 121.; Bald and Nielsen, 1998. 82.; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 87.

⁷¹ Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," 1997. 1170.

soft taxation, and soft credit to enterprises during the modernisation period. As a result, Daniel Treisman, says ‘...the banking system largely remained an instrument of centralised redistribution rather capital market allocation.’⁷² It is important to acknowledge here that the maintenance of SBCs was not only advocated by the elites. Thus, sustained partial reform equilibrium was not simply a consequence of vested personal interests looking for opportunities to enrich themselves. Rather, it was a by-product of trying to create a market economy through non-market means.

Instead of coordinating goals for restructuring the economy, the government and the CBR each used their own diverging means to foster a ‘market economy.’ In fact, many state-owned enterprises survived only because of these soft budget constraints.⁷³ The problem is that banking reform and macroeconomic and structural reforms cannot be pursued independent of each other.⁷⁴ Because it had not yet established control over the ruble, there was no way for the CBR to restrict cash emission and inflation skyrocketed. The result was a crippling inflation rate of 2000 percent and an economy in shambles.⁷⁵ While this had devastating effects on the economy, banks profited immensely, with banks accumulating wealth up to 9 percent of GDP.⁷⁶ This led to another explosion of banks, with an estimated 2,000 – 2,500 banks created by 1994.⁷⁷ Banks could borrow money from the CBR, but repay the loan at a lower interest rate than it was borrowed and pocket the difference.⁷⁸ The CBR also dispersed direct credits and subsidies to the thousands of pocket banks that managed their enterprises’ finances; little of this money was reinvested in the enterprise.⁷⁹ Additionally, banks profited from currency speculation by accumulating dollars as the ruble plunged.⁸⁰

Thus, there was no way that shock therapy could do for Russia what it did for other post-socialist states. To begin, many of the central banks in other post-socialist states (such as those in Central and Eastern Europe) were adept at using hard budget constraints and had the autonomy to do so.⁸¹ As such, in these states, both the government and the central banks were

⁷² Treisman, "The Politics of Soft Credit in Post-Soviet Russia," 1995. 949.

⁷³ Bald and Nielsen, 1998. 82.

⁷⁴ OECD, 2004. 226.

⁷⁵ Frye, "Governing the Banking Sector," 2005. 15.

⁷⁶ Ibid. 15.

⁷⁷ Estimates vary. Perotti, E. (2001) claims that there were more than 2500 banks; Schoors, K. (2003) and Laeven, L (2001) say that by 1994, there were over 2000 banks.

⁷⁸ Treisman, "The Politics of Soft Credit in Post-Soviet Russia," 1995. 950.

⁷⁹ Michael Dimitrieff et al., "The Banking Sector," in *Russia's Post- Communist Economy*, ed. Brigitte Granville and Peter Oppenheimer (Oxford: Oxford University Press, 2001). 213 – 239.

⁸⁰ William Easterly and Paulo Vieira da Cunha, "Financing the Storm: Macroeconomic Crisis in Russia," *Economics of Transition* 2, (1994): 443 - 65.

⁸¹ Neyapti, 2001. 2001.

of one mind about the means and objectives of liberalisation. Additionally, these states had far more concentrated and direct plans of action due to conditionality for joining the European Union, which was the immediate goal for most of them. More importantly, shock therapy could not be enacted in Russia because the liberal reformers and the CBR used mutually exclusive macroeconomic tools, each undermining the other. Shock therapy could not be properly implemented so long as this dual economic system existed. The state-owned enterprises gambled that the state would not actually hold them to their arrears, and the CBR's forgiveness of the arrears against the desires of the Yeltsin / Gaidar government confirmed and rewarded this risk.⁸² The result was the maintenance of partial reform equilibrium: soft budget constraints and command economic practices within the market economy that the government was attempting to create.

1992 – 1996: Privatisation and loans-for-shares

Regarding the banking industry, the privatisation programme failed in two ways. First, like the general economic privatisation, it failed to create an incentive for banks to maximise profits and restructure, contributing to the mass proliferation of banks that was taking place at the time. Second, it failed to address a key problem in the industry: the fact that the CBR owned the largest bank in the state, Sberbank. The CBR did not play a role in drafting privatisation programme designed by Anatoly Chubais. As a result, the privatisation programmes that Chubais designed were unattractive and unprofitable to the banks. The programmes were designed to officially convert the positions of the *nomenklatura* from managers to owners of their enterprises; not actually increase investment or bring in new management.⁸³ In fact, banks could use vouchers to purchase between 10 and 25 percent of company stock, providing both a barrier and disincentive for the banks to take part in the privatisation programme.⁸⁴ The absence of this contribution had far reaching consequences for the development of the financial market as it drove a wedge between banks and enterprises.

Additionally, the Duma passed a law that made banks responsible for the return of directed credits and the CBR did its best to enforce this law because not doing so undermined their tenuous grasp on monetary tools.⁸⁵ These credits were subsidies that enterprises were

⁸² Stone, (2002). 121.

⁸³ Hanson, 1999. 1143.; McFaul, 1999. 119.; Robinson, 2000. 1403.

⁸⁴ Luc Laeven, "Insider Lending and Bank Ownership: The Case of Russia," *Journal of Comparative Economics* 29, (2001): 207 - 29 209. See also: Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).; Freeland, (2000).

⁸⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 103 - 106

entitled to, but they had to be repaid — the enterprises had to earn enough to pay it back. However, because the enterprises had no incentive to restructure and earn profits, they were in no position to repay the directed credits and banks began refusing to issue them.⁸⁶ At first glance, this seems like progress as the state appears to be implementing a hard budget constraint. To get around this, enterprises opened their own pocket banks. This reversed the roles banks are supposed to play since they are owned by the enterprises.⁸⁷ This allowed for insider lending: poor lending practices when bank managers are unable to properly evaluate loans and take on more risk.⁸⁸ For example, enterprises held up to 90 percent of preferential loans at some banks.⁸⁹ The burden of responsibility for repaying loans should fall to the enterprises, not the banks. Yet, because of the way the Duma's law was enacted, it absolved the enterprises from repayment responsibility.⁹⁰ Thus, again, hard budget constraints are not implemented.

Critically, the privatisation programmes did not address privatising Sberbank and Vnesheconombank, which were still owned by the CBR. Sberbank and Vnesheconombank were turned into joint stock companies, but the CBR holds the majority share.⁹¹ Privatising these banks is important because it grants the CBR the independence necessary to deal with regulation or monetary policy, the main role of a central bank in a market economy.⁹² For example, Sberbank was not held to the same reserve requirements as other banks until January 1997.⁹³ When it cannot separate the two, the CBR's concern over its commercial enterprises can both distract from and taint its ability to undertake these roles successfully.⁹⁴ Further complicating matters is that Sberbank was the only bank that could insure deposits. This made the personal account market inaccessible to commercial banks since they could not offer the

⁸⁶ Alfred Steinherr, "Russian Banking since the Crisis of 1998," *Economic Change and Restructuring* 39, (2006): 235 - 59. 238.

⁸⁷ Laeven, 2001. 209.; Elena Belyanova and Ivan Rozinsky, "Evolution of Commercial Banking in Russia and Implication for Corporate Governance" Washington DC. The World Bank, 1994.

⁸⁸ Laeven, 2001. The preferential nature of the loans that enterprises could obtain is up for debate. Some argue that they didn't have more favourable repayment terms, they were just granted larger loans on fewer assets, but connections helped them avoid repayment all the same. (Laeven 2001; Perotti and Gelfer 1999.). Others argue that enterprises were not shown favour at all (Fan et al., 1996), but Laeven and Perotti and Gelfer provide more convincing arguments that undermine it.

⁸⁹ Ibid. 223 – 224; Steinherr, 2006. 238.

⁹⁰ Laeven, 2001.

⁹¹ Schoors, 2003. 80.

⁹² Bald and Nielsen, 1998. 81.

⁹³ William Tompson, "Russia's 'Ministry of Cash': Sberbank in Transition," *Communist Economies and Economic Transformation* 10, 12. (1998): 133 - 55 137.

⁹⁴ Cukierman, Webb, and Neyapti, 1992.

same protections.⁹⁵ Conversely, the CBR maintained control of Sberbank to prevent the government from exploiting it and using it to fund the state budget, which the CBR refused to do.⁹⁶ The CBR is then damned regardless of what it does: it remains largest vested interest in the financial market and its ability to objectively make monetary or regulatory policy is compromised, or it fails to prevent the government from overspending and makes inflation worse. Nevertheless, the CBR's continued control over Sberbank and VEB prevents the proper development of a market economy, and maintains partial reform equilibrium.

To further alienate enterprises from the CBR, the latter retained the power to extract taxes and arrears from enterprises' accounts through the old Soviet *kartoteka* system.⁹⁷ This system was used by Gosbank to ensure that enterprises were fulfilling the state's plan by only giving them the money they needed when they needed it and so on.⁹⁸ After the collapse of the Soviet Union the *kartoteka* system continued granting the CBR direct access to these accounts. Thus, if an enterprise had arrears, taxes or otherwise, the CBR could see if the enterprise had money in its account, and withdraw as necessary (or as much as possible if the available amount was insufficient to cover the entire arrear). Eventually, this encouraged enterprises to hide money from the CBR and enter a system of bartering with other enterprises.⁹⁹ As a result, both enterprises and banks were in a difficult position: banks could not do business without enterprise customers, and enterprises could not properly modernise and invest without banks. So many banks turned to the government for business.

Also seeking to avoid doing business with the Central Bank was the government. It did so by allowing certain banks, known as authorised banks, to manage its accounts; in fact, some banks were set up for this purpose alone.¹⁰⁰ It is estimated that these banks reaped more than \$1.3 billion profit from this set-up.¹⁰¹ While this provided commercial banks with the funds they needed and wanted to stay in business, it was a risk for the state. Authorised banks could not be held accountable for their own failures, meaning the state would lose whatever money they had entrusted to that bank.¹⁰² By alienating enterprises and the state, the CBR

⁹⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 108.

⁹⁶ Tompson, "Russia's 'Ministry of Cash': Sberbank in Transition," 1998. 138.

⁹⁷ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 103.

⁹⁸ Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," 1997. 1162.

⁹⁹ Hendley et al., 1997. 36.

¹⁰⁰ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 119 – 123.

¹⁰¹ Steinherr, 2006. 237.; Robinson, "The Global Economy, Reform and Crisis in Russia," 1999.

¹⁰² Tompson, "Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks," 1997. 1172.

unintentionally forced both to undertake business via the social economy, meeting much of the day-to-day business and banking needs through opaque connections and thereby undermining the efforts of all involved to create a market economy.

One of the main activities authorised banks undertook was selling GKO treasury bonds. The revenues from these bonds were used as a non-inflationary means of financing the state budget.¹⁰³ In other words, the bonds became a way for the state to raise the money it needed to finance its budget instead of printing more rubles to cover what tax revenue could not (which would lead to inflation). The problem is that the government and the banks began to speculate and rely too much on the GKO bonds. This became a problem as they relied on the bonds instead of cutting spending or fixing tax collection practices. The largest and more ambitious banks would go on to lobby for bank centred privatisation, as a means for both the banks and the state to raise much-needed funds. This would go on to form the basis of the loans-for-shares scheme, which would see bankers become inordinately wealthy, and the state continue to struggle to make ends meet.

Examining the loans-for-shares programme from the perspective of the banks sheds light on how it reinforced the partially reformed nature of the Russian economy. One of the reasons the scheme initially had support was not just that it was supposed to supply the state with funds, but also because it would finally restructure and re-orient the incentives in some of the state's most promising enterprises.¹⁰⁴ In theory, because the 1992 *nomenklatura* privatisation shut out the banks, allowing profit driven bankers to privatise large enterprises would surely transition from command to market incentives. However, this was not the case. Replacing the *nomenklatura* managers with bankers did not remarkably improve the efficiency, productivity, or profitability of the enterprises.¹⁰⁵ For example, Juliet Johnson shows that many of the enterprises privatised through loans-for-shares lost money: Noril'sk Nickel lost \$257 million in the first part of 1998 (pre-crisis), Sibneft lost \$28 million, and many other enterprises became heavily indebted.¹⁰⁶ While many would argue that these losses can be explained by venal corruption and rent seeking, I argue that these losses show how partial reform equilibrium has trapped the economy. Even these losses were due to corruption, the partially reformed nature of the economy skewed the incentives of the bankers to asset strip and rent seek instead of invest and restructure.

¹⁰³ Bald and Nielsen, 1998. 82.

¹⁰⁴ For more details, see chapter II.

¹⁰⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 197.

¹⁰⁶ *Ibid.* 196.

The actions of the government and CBR undermine the role that the banking industry is supposed to play. Financial market development should stimulate economic growth and diversification, but the state of the banking industry in Russia reinforced its economic problems. The banking and financial industry are essential to the construction of a diversified, accountable, and profit driven economy.¹⁰⁷ However, the explosion of banks in the early 1990s undermined this as many of the banks were unsound. Of the 2,000 plus banks that existed between 1994 and 1997, five of them held 40 percent of the sector's assets.¹⁰⁸ This is a strong indication that many of the remaining banks were undertaking little to no actual banking or investment, and that there were weak regulatory instruments. This lack of regulation undermined the development of a sound financial market.¹⁰⁹ Because of the lack of regulation, insider loans, and mistrust of the CBR, investment lending was deemed too risky. As such, banks were not undertaking long-term loans, which not only shaped their incentives for long-term investment, but hindered their ability to invest at all. More importantly, the weakness of banking regulation is directly tied to the protection of property rights. Without sound property rights, neither financial markets, nor economies more broadly can flourish. This perpetuates the need for a social economy because short-term thinking and planning persists. This is not conducive to the construction of a market economy and merely uses market means to obtain command ends.

The 1998 economic crisis

The instability of the banking sector, and the weakness of the CBR to regulate it, culminated in the 1998 economic crisis. Risky lending practices, liquidity problems, asset stripping, and reckless currency and treasury speculation caused the government to default on its international loan payments, and the CBR to devalue the ruble overnight. Many scholars have argued that exiting crisis necessitated institutional development, which resulted in a stronger economy that finally completed the transition from a command to market economy.¹¹⁰ However, upon closer inspection, this logic does not stand. Much of the economy and the banking sector remains partially reformed. An analysis of how economic crises can lead to institutional development, and a subsequent application of this to the 1998 and 2008 economic crises in Russia is the subject of the remaining chapters of this study.

¹⁰⁷ OECD, 2004.

¹⁰⁸ Martinez-Vazquez et al., 2001. 511.

¹⁰⁹ OECD, 2004.

¹¹⁰ Åslund, 2001.

3.4 Conclusion and outlook

Russia's banking industry has evolved since the mid-1990s. The Central Bank of Russia and the government eventually learned to cooperate, although the two still differ on how to tackle monetary problems from time to time. It has seen its share of trouble, including two major financial crises in 1998, 2008, and has been grappling with a protracted economic decline since 2012. These will be discussed in more detail in the proceeding chapters. There have been some successes: a deposit insurance scheme was created, capital requirements were increased and are better enforced, and regulation in general has improved. While these successes must be applauded, there are many underlying issues that undermine the industry and maintain partial reform equilibrium. The first problem is the continued involvement of the state at the expense of industry competitiveness and growth. The state has remained the majority shareholder in Sberbank and VEB, and has increased its influence. Second, there are still many regulatory issues that hamper industry transparency and growth. Each of these issues will be explored in turn.

At the end of 2010, there were 20 banks in which the state owned the majority share, and these banks controlled 46 percent of industry assets.¹¹¹ Moreover, the government increased its role in the financial sector by obtaining shares in over 400 banks (many of these shares are less than 25 percent), some of which are strategic banks.¹¹² While there have been some proposals to sell CBR or government shares and privatise the banks, only once has this happened: when the state privatised 10 percent of its stake in VTB in 2011.¹¹³ This creates a conflict of interest: the CBR largest creditor, holding 39 percent of outstanding credit to the non-financial private sector; it holds 79 percent of retail deposits; and is the sector regulator.¹¹⁴ Additionally, the role of the state distorts competition and maintains soft-budget constraints as a means of compensation. As state banks attract most deposits and assets, other banks are deprived of the capital and assets needed to build up their reserves, which is especially needed during economic crises.¹¹⁵ It was assumed that the creation of the deposit insurance scheme in 2003 would break the state monopoly, and create opportunities for banks to build their long-

¹¹¹ Johnathan Fiechter and Antonio Borges, "Russian Federation: Financial System Stability Assessment" Washington DC. The International Monetary Fund, 2011. Table 3. 16.

¹¹² Steinherr, 2006. 249.

¹¹³ This should not be confused with VEB (Vensheconombank); they are different banks with different functions. Both are owned by the state. Fiechter and Borges, 2011. 38.

¹¹⁴ OECD, 2004. 220.

¹¹⁵ Steinherr, 2006. 239.

term liabilities portfolios.¹¹⁶ This did not happen as state owned banks still control over three quarters of the deposit market.

Although controversial, there are several reasons why the state has maintained its participation in and control over the banking and financial market industry. To begin, the CBR maintains control of Sberbank because it can influence monetary and social policy more easily: it can restrict lending, increase or decrease interest rates, provide emergency liquidity and so on.¹¹⁷ Additionally, because of its present dominance and its historical role, it is the bank with the most physical presence throughout the country. This allows the state to reach vulnerable pensioners and provide banking services where there may otherwise be none.¹¹⁸ Thus, while there is no question that state owned banks need to be privatised if the sector is to be competitive and stimulate economic growth, it must be acknowledged the state maintains control in these banks for reasons beyond the promotion of personal interest.

Regarding the regulation of the industry, there has also been mixed progress. The CBR has struggled to revoke banking licenses from banks since the 1998 economic crisis, peaking in the early 2000s and again after 2013.¹¹⁹ In 1996, the Federal Commission for the Securities Market (FFMS) was created to regulate the non-financial banking sector.¹²⁰ It regulated bonds and securities and advocated for investors.¹²¹ This body was dissolved in 2013, and its responsibilities were allocated to the CBR.¹²² International accounting standards were adopted in 2004 and there has been greater shift to focus on transparency.¹²³ There has also been a change in focus on ensuring that banks are sound, rather than meeting bureaucratic requirements. For example, the April 2004 law 'On Banks Mandatory Norms' required CBR to evaluate the health and state of banks in addition to and sometimes above the bureaucratic

¹¹⁶ OECD, 2004. 227.; Frye, "Governing the Banking Sector," 2005. 35.; William Tompson, "What Kind of 'Financial Safety Net' for Russia? Russian Banking Reform in Comparative Context," *Post-Communist Economies* 16, 2. (2004): 115-35. 121.

¹¹⁷ Tompson, "What Kind of 'Financial Safety Net' for Russia? Russian Banking Reform in Comparative Context," 2004. 130.

¹¹⁸ Steinherr, 2006. 238.

¹¹⁹ The Central Bank of the Russian Federation, "Registration of Credit Institutions and Licensing of Banking Activities," <https://www.cbr.ru/Eng/statistics/?PrId=pdko>.

¹²⁰ The Federal Commission for the Securities Market (FSMS or FSMS depending on transliteration) would become the Federal Financial Market Service in 2004. For simplicity, this study will use the acronym FFMS.

¹²¹ Andrei Yakovlev, "Evolution of Corporate Governane in Russia: Government Policy Vs. Real Incentives of Economic Agents," *Post-Communist Economies* 16, 4. (2004): 387 - 403. 388, 393.

¹²² The Central Bank of the Russian Federation, "On the Abolition of Bank of Russia Financial Markets Service," news release, 2014, http://www.cbr.ru/eng/press/PR.aspx?file=11032014_124740eng_sfr.htm.

¹²³ Steinherr, 2006. 255.

regulations.¹²⁴

Yet, there are fundamental problems with banking regulation that prevent the transition to a market economy. Notably, the CBR's history of regulatory forbearance both before and after the 1998 crisis undermines its capacity and credibility to enforce regulations.¹²⁵ This has led to risky lending activities, as evidenced by the low diversification of loan portfolio risks.¹²⁶ As of 2010, the largest 30 borrowers in the country accounted for 56 percent of the loan portfolio.¹²⁷ The CBR has undermined its own credibility as a regulator by providing liquidity to banks that should otherwise be liquidated and by forestalling or delaying the implementation of regulatory requirements. To be fair, part of the reason for this is that CBR only gained power to force banks to increase their prudential requirements in 2015.¹²⁸ Thus demonstrating that even when the CBR has the tools necessary to perform its role properly, it doesn't always have the power to do so. There are many consequences of the failure to properly regulate the banking and financial sector. Fundamentally, it prevents the creation of an 'enabling environment': a combination of regulatory policies and legislation that encourages investment and profit maximisation, such as sound property rights and a strong rule of law.¹²⁹ The lack of these things requires most banks to have social / political connections to undertake most of its business, thus reinforcing the social economy maintaining partial reform equilibrium.

The CBR has a fundamental role to play in the transition to a market economy. It was unable and unwilling to aid the shock therapy liberalisation, which led to massive inflation and multiplying of small banks. It was left out of much of the privatisation programme, as it became alienated from the government and the banking sector. Overall, the CBR's struggles to undertake sound monetary and regulatory policies have resulted in skewed incentives for the industry. It is important to emphasise, again, that these incentives are shaped by a system over which there is little control. Thus, like the CBR and the government, economic actors undertake those activities that are in their best interest and help them get the most out of their environment. However, while there has been change there have also been opportunities for change that have been wasted. This will be the subject of the following case study chapters.

¹²⁴ OECD, 2004. 230.

¹²⁵ Ibid. 231.

¹²⁶ Steinherr, 2006. 242.

¹²⁷ Fiechter and Borges, 2011. (Table 3) 16.

¹²⁸ The International Monetary Fund, "Russian Federation: Financial Sector Assessment Program" Washington DC. The International Monetary Fund, 2016. IMF Banking Assessment 2016 (Sept). 29.

¹²⁹ Steinherr, 2006. 249.

CHAPTER 5

THE 1998 ECONOMIC CRISIS

The study's main argument is that Russia's banking institutions, as manifest in agencies like the Central Bank of Russia, are trapped in partial reform equilibrium. This chapter presents a case study in three parts, to examine how the 1998 economic crisis did not result in crisis modernisation. First, it analyses the causes of the crisis to highlight opportunities for crisis modernisation. Second, it enumerates and evaluates the crisis containment and crisis resolution measures implemented to stabilise the economy in the wake of the crisis. Finally, it synthesises these two components by testing the three hypotheses put forth in chapter two. These measures test whether the responses to the crisis were appropriate, if they were implemented efficiently and effectively, and thus, whether institutional development has taken place. The chapter concludes that while the measureable change that can be observed results from the 2001 tax reform, it does not amount to crisis modernisation and the CBR remains a partially reformed.

This study finds no evidence that crisis modernisation resulted from Russia's 1998 economic crisis. The crisis fulfils all the conditions under which crisis modernisation should occur, thus making it ideal for understanding why it failed to take place. Of course, there were other economic crises throughout the early 1990s that tested the government and Central Bank of Russia (CBR), yet these crises were brief and did not require the CBR to address institutional problems or systemic vulnerabilities. For example, in 1994, a sudden 27 percent ruble depreciation caused a currency crisis and led to the dismissal of then Central Bank Director Viktor Geraschenko.¹ It also ushered in a period of cooperation and policy coordination between the government and the CBR, resulting in a reduction of the fiscal deficit to 5.4 percent of GDP, an end to subsidies for certain enterprises, and thus a further reduction in rent-seeking to 8 percent of GDP.² Yet, these changes would not last and the government's debt to GDP ratio would rise again. While the government did learn to control its spending and the CBR more effectively managed the exchange rate after the crisis, these things happen independent of institutional development.

In theory, the 1998 crisis should have forced the government to address the structural problems within the economy that created instability, such as the existence of predatory banks,

¹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).

² Anders Åslund and Mikhail Dimitriev, "Economic Reform Versus Rent Seeking," in *Russia after Communism*, ed. Anders; Brill-Olcott Martha Åslund (Washington D.C.: The Carnegie Endowment for International Peace, 1999). 100.

inadequate liquidity ratios, risky lending practices, poor tax collection mechanisms, and so on. Yet, each of the proposed hypotheses that measure institutional development are false. One of the most effective reforms to result from the 1998 crisis was the improvement of tax collection mechanisms, which simplified the procedure and, according to some scholars, improved voluntary compliance by 70 percent.³ However, this did not strengthen the tax collection institutions, as the state undermines the fair and universal enforcement of the tax reform. This case study will first examine the causes and effects of the crisis, followed by an analysis of the crisis containment and crisis resolution reforms that were undertaken in response. Finally, it will test the three hypotheses to determine whether crisis modernisation indeed took place.

5.1 The 1998 economic crisis

Many, including the Central Bank of Russia, consider the crisis to have been primarily a currency crisis, caused by a debt crisis, that also affected banks.⁴ Yet, it was really a triple crisis, that was caused by poor macroeconomic policies and poor banking regulation. The CBR failed to ensure that banks met adequate reserve requirements and engaged in responsible lending and other financial market practices. Simultaneously, the government's need for revenue in the absence of a proper tax collection mechanism led it to work with banks and sell high yield treasury bonds (GKOs).⁵ However, because few banks had the capital to sell GKOs securely, this was a risky endeavour. To top it all off, the CBR was maintaining a pegged and overvalued ruble, while asset stripping, rent-seeking, and capital flight failed to generate the value needed to justify that exchange rate.⁶ Understanding the primary cause of the crisis is vital for determining what the most effective crisis resolution measures should be, and thus what needs to occur to result in crisis modernisation. If the crisis was primarily a banking crisis, then it is expected that crisis resolution mechanisms would focus on liquidating and restructuring insolvent banks, as well as improving sector regulation. Ideally, crisis resolution would address all the causes of a crisis, both primary and other. To best understand those factors that led to the 1998 crisis, each will be examined in turn.

After the collapse of the Soviet Union, the banking sector swelled, with the number of registered banks reaching an estimated 2,300 in 1996.⁷ Of these, only around 100 were

³ Åslund, 2001. 22.

⁴ Chiodo and Owyang, 2002.

⁵ Martinez-Vazquez et al., 2001. 502 – 503.

⁶ Perotti, 2002. 360.

⁷ Michael Ellman, "The Russian Economy under El'tsin," *Europe-Asia Studies* 52, 8. (2000): 1417 - 32. 1423.

commercially viable.⁸ Because of this, CBR was overstretched, and unable to effectively regulate the sector, particularly regarding reserve requirements.⁹ For example, most banks had less than 4 percent capitalization, which was the official requirement at the time.¹⁰ Banks exploited this through collective non-compliance, making it even harder for the CBR to enforce regulations.¹¹ As such, there was little financial discipline, which provided an incentive for banks to asset strip and evade taxes.¹² There were plenty of opportunities to undertake these predatory activities because there were few private bank accounts to service.¹³ As a result, a handful of banks acted as financial mediators and were insolvent long before the crisis.¹⁴ However, as the CBR spent much of its time funding and defending the ruble rather than going after predatory banks, it could be argued that its priority was not ensuring that banks adhered to regulations. As such, banks were not motivated to develop and strengthen the sector via regular profit maximising and commercial banking practices.

In the absence of undertaking normal commercial and financial services, most banks worked with government accounts. This led to a high degree of state capture as the banks and the government became closely intertwined, creating more connections to undermine CBR regulations.¹⁵ These Authorised Banks often stole money the government had given them to disperse, and funnelled CBR loans off-shore, along with state and private assets.¹⁶ Martinez-Vazquez et al., have described the 1990s banking industry like a casino, and government and banks like gamblers, because they sought revenue from high-risk government securities rather than normal banking practices.¹⁷ This was a dangerous combination, because the banking sector was severely undercapitalised given the high-risk activities it was undertaking, thus making it vulnerable to speculative attacks. Thus, there was no development of regulatory mechanisms prior to the 1998 crisis as the CBR either failed, or did not care to, ensure that banks did not expose the economy to shocks via liquidity shortage or currency devaluation.

Just as the CBR was unable to force banks to adhere to regulations, so too were banks unable to force enterprises and firms to repay their loans. The result is that enterprises remained

⁸ Fred Levy, "Russia: Bank Assistance for Financial Sector Development" Washington DC. The World Bank, 2002. 9.

⁹ Hanson, 1999. 1144.

¹⁰ Bald and Nielsen, 1998. 83.

¹¹ Perotti, 2002. 365.

¹² Ibid. 365

¹³ Ellman, 2000. 1419.

¹⁴ Perotti, 2002. 366.

¹⁵ Ibid. 384.

¹⁶ Hanson, 1999. 1144.; Ellman, 2000. 1423.

¹⁷ Martinez-Vazquez et al., 2001. 511.

unprofitable and inefficient, often generating negative output.¹⁸ To save these firms from failing, the state would provide indirect subsidies by allowing firms to accrue wage debts and by forgiving tax arrears.¹⁹ As a result, economic growth stagnated and the tax base began to shrink as firms avoided making profits to dodge taxes.²⁰ For example, there was an increase in barter transactions from 10 percent in 1992 to 45 percent in 1997.²¹ There was also no way to find firms insolvent, as bankruptcy laws would only force the firm to be reorganised rather than liquidated.²² As such, this formed a de facto soft-budget constraint that undermined the profit maximisation drive necessary for firms to repay loans.²³ This was a further incentive for banks to undertake predatory activities as they were unable to profit from normal lending. Because banks were unable to force firms to repay their loans, there was no incentive for firms to maximise their profits. As a result, parallel to the vulnerable banking sector was the failure to create solid economic growth as the establishment of market economy practices were undermined by the maintenance of command economy practices.

The lack of economic growth generated by maintenance of soft-budget constraints only exacerbated the state's weak tax collection practices. To make matters worse, the state could not agree on the best way to reform the tax code. Many assumed that there was no need to reform the code at all, as the development of a market economy would result in the growth of a private industry whose profits could be taxed, while the gas and oil profits would cover social spending.²⁴ The problem was that energy prices were declining and the gas and oil companies were evading taxes.²⁵ Gazprom and other state-owned enterprises owed ₺139 billion in tax arrears.²⁶ Rather than revising the tax code, the government turned to the banks. For example, the loans-for-shares programmes was the first of many schemes created to help the state compensate for its inability to collect revenue. However, this too failed to produce the revenue the state needed, so the government adopted two coping mechanisms to deal with the liquidity shortage: issuing IOUs and selling government bonds (GKOs).

As early as 1996, after Yeltsin's second election, the government started to lose money.

¹⁸ Clifford Gaddy and Barry Ickes, "To Restructure or Not to Restructure: Informal Activities and Enterprise Behavior in Transition" William Davidson Institute, 1998.

¹⁹ Hanson, 1999. 1156.

²⁰ Gerald Easter, "Revenue Imperatives: State over Market in Postcommunist Russia," in *The Political Economy of Russia*, ed. Neil Robinson (Maryland: Rowman & Littlefield Publishers, Inc., 2013). 56.

²¹ *Ibid.* 55.; Ellman, 2000. 1418.

²² Martinez-Vazquez et al., 2001. 512.

²³ Levy, 2002. 9 – 10.

²⁴ Easter, 2013. 53.

²⁵ Luong and Weinthal, 2004.

²⁶ Hanson, 1999. 1156.

In addition to the shrinking economy and poor tax collection practices enumerated above, the state began receiving less financial support from the international community once Yeltsin's victory was assured and the threat of a communist revival had been neutralised.²⁷ Additionally, the World Bank stopped disbursing its loans as many of its conditions, including development of banking sector regulations, had not been satisfactorily met.²⁸ To cope with the loss of income, the government began issuing IOUs to its employees, including those employed by state owned enterprises, and its suppliers.²⁹ By 1997, 50 percent of wage arrears were held by the state, and the state was only able to collect 50 percent of taxes due, resulting in tax arrears of \$13 billion.³⁰ The problem is that paying wages is an essential foundation of a market economy.³¹ Because, as wage arrears mounted, it began a vicious cycle of non-payment that led to the construction of a virtual economy, one 'based on an illusion of price, sales, wages, taxes, and budgets.'³² So when the government stopped paying workers or suppliers, they bartered, traded, or issue their own IOUs to obtain the goods, services, and materials they needed.

As arrears mounted, few could afford to pay taxes, thereby worsening the government's liquidity shortage.³³ The resulting deficit required enterprises and the government to borrow money from the banks, which significantly increased the interest rate. This made the use of barter transactions even more appealing because of the cost of currency.³⁴ Eventually, however, the government became so indebted that even the banks could not help as they had with loans-for-shares.³⁵ The government still received a little aid from the IMF, but once it met its debt obligations there was little left to use for budgetary purposes. For example, federal spending averaged 40 percent GDP in 1998, but revenue collection did not raise enough to cover these expenses.³⁶ The deficit was five percent GDP in 1998 — with internal debt payments comprising 2.5 percent and external debt payments totalling 1.5 percent, the government was

²⁷ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).

²⁸ Levy, 2002. 12.

²⁹ Brian Pinto, Vladimir Drebensov, and Alexander Morozov, "Give Macroeconomic Stability and Growth in Russia a Chance," *Economics of Transition* 8, 2. (2000): 297 - 324. 301.

³⁰ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 204.

³¹ Ellman, 2000. 1419.

³² Clifford Gaddy and Barry Ickes, "Russia's Virtual Economy," *Foreign Affairs* September / October, 1998. (1998).

³³ Homi Kharas, Brian Pinto, and Sergei Ulato, "An Analysis of Russia's 1998 Meltdown: Fundamentals and Market Signals," *Brookings Papers on Economic Activity* 2001, 1. (2001): 1 - 50. 2.

³⁴ Pinto, Drebensov, and Morozov, 2000. 304.

³⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000).

³⁶ Hanson, 1999. 1144.

spending a total of four percent GDP on its debt payments.³⁷ Thus, the government ended up indebted and overspending, and was unable to collect enough taxes to meet these obligations.

The government resorted to alternative means of earning liquidity by selling government bonds, or GKO's. The CBR processed and registered GKO's worth \$62 billion by September 1997, and was using these sales to pursue monetary policy.³⁸ Because investors bought up GKO's, the government used them to fund the budget and maintain soft-budget constraints.³⁹ The problem is that the GKO's had a rapid maturity date, so while they sold quickly, they also had to be repaid quickly. By the summer of 1998, the weekly turnover of the GKO's totalled \$32.7 billion, and the government could not sell enough bonds to honour previous holdings and fund the budget.⁴⁰ In June 1998, the international community bailed out the government, but this only delayed the crisis, although some would argue this is when the crisis began.⁴¹ Finally, on 17 August 1998, the ruble was devalued, the government announced a ninety-day moratorium on private international debt payments and the restructuring of all domestic debt due by the end of 1999. These problems were exacerbated when the CBR floated the ruble on 2 September 1998. The cost of the crisis was enormous: the CBR spent \$30 billion trying to defend the ruble, and foreign currency debt amounted to \$20.5 billion, of which \$16 billion was accumulated in the four months preceding the crisis.⁴² The failure to regulate the banking sector and implement hard budget constraints resulted in an overreliance on treasury bonds to fund the budget, which ended up being very costly both for Russia and its international investors.

Many economists and analysts working with Russia just before the crisis claim that it could have been avoided as late as the beginning of August 1998, mere weeks before the ruble collapsed and the government defaulted on its debt.⁴³ However, the government's refusal to address the structural weaknesses in the economy and financial sector demonstrate the potential for crisis modernisation. For example, the government had been trying to pass several laws on tax collection in July 1998, the month before the crisis. One of these laws was the adoption of a VAT tax that would have allowed the government to tax the vast amount of bartering that took place.⁴⁴ Additionally, the Duma failed to impose additional taxes prescribed by the IMF

³⁷ Martinez-Vazquez et al., 2001. 505.

³⁸ Bald and Nielsen, 1998. 82.; Frye, "Governing the Banking Sector," 2005. 22.

³⁹ Stone, (2002). 150.

⁴⁰ Kharas, Pinto, and Ulatov, 2001. 2.

⁴¹ Ibid. 3.

⁴² Ibid. 2.

⁴³ Stone, (2002). 155.

⁴⁴ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009. 105.

anti-crisis programme in the summer of 1998, in order to protect natural monopolies.⁴⁵ The failure to do this resulted in a potential revenue of only ₺3 billion, instead of the potential ₺71 billion that would have come from the original IMF proposal.⁴⁶ Furthermore, the longer the reforms were debated and the more they were redrafted, the more they increased rent-seeking capabilities of the elites and the members of their social network, or *blat*.⁴⁷ It was not that the government was unable to work on institutional development before the crisis, but it did not realise it needed to.

The 1998 crisis took a massive toll on the Russian economy, resulting in a 4.9 percent decrease in real output and a 75 percent loss in market value during a year when growth was expected.⁴⁸ Within two years, however, Russia recovered spectacularly, seeing an average of 6.7 percent GDP growth per year until the 2008 financial crisis.⁴⁹ However, much of this growth and recovery can be attributed to the effects of import substitution and an increase in the price of, and demand for, oil.⁵⁰ When Putin became president in 2000 he passed a series of economic reforms aimed at strengthening the economy and providing the state with the resources it needed to survive future economic crises. One of the reforms that he passed was the long-awaited tax reform that simplified the tax code and closed several loopholes.⁵¹ While long-term financial stability increased, this study argues that this is less attributable to post-crisis tax reforms, and more because of the increase in oil and gas rents.⁵² The tax reforms indeed led to an increase in compliance from 2002, but gas and oil prices drastically increased from 2003, which also increased energy companies' ability and willingness to pay taxes. Thus, though the economy recovered quickly from the 1998 crisis, the extent to which this recovery is due to the government and CBR addressing and fixing the systemic vulnerabilities is analysed below.

The crisis was a triple one. A currency crisis occurs when a currency loses 30 percent of its value, at a depreciation rate of 10 percent faster than the previous year.⁵³ Additionally, a currency crisis occurs when a state's Central Bank cannot afford, or chooses not to spend, the

⁴⁵ Chiodo and Owyang, 2002. 14.

⁴⁶ *Ibid.* 14.

⁴⁷ Åslund and Dimitriev, 1999. 108.

⁴⁸ Chiodo and Owyang, 2002. 14.

⁴⁹ The World Bank. "Russian GDP Growth 1991 - 2012," 2012. ; McFaul and Stoner-Weiss, 2008.

⁵⁰ McFaul and Stoner-Weiss, 2008.

⁵¹ Stone, (2002). 161.; Appel, 2004.

⁵² Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009. 20.

⁵³ Laeven and Valencia, 2008. 6.; Frankel and Rose, 1996. 2.

foreign exchange reserves needed to defend the currency.⁵⁴ 1998 was a currency crisis because after the ruble was devalued on 17 August, it lost two thirds of its value.⁵⁵ When the devaluation initially happened, the CBR said it would defend the ruble at an exchange rate of 6 – 9.5 rubles to the dollar. However, the value dropped far below 9.5, and the CBR free-floated the ruble on 2 September 1998.⁵⁶ Until the crisis, the CBR had been defending the exchange rate as a means of controlling inflation, but this required it to spend most of its foreign exchange reserves.⁵⁷ As a result, in the aftermath of the crisis, inflation soared to 43 percent over three weeks.⁵⁸ Additionally, 25 percent of banks' capital losses were attributed to the collapse in the ruble's value, compared with 13 percent of losses due to GKO's.⁵⁹ The problem is that, while the currency devaluation resulted in inflation and other liquidity problems, it was a symptom of more serious problems rather than the cause of the crisis itself.

The government's budget and spending problems have been enumerated above. As such, the sovereign debt crisis was caused by a deficit in both expenditures and revenues. The problem was so bad that government revenues declined from 12 percent in December 1997, to 10 percent in June 1998.⁶⁰ The government had tried to compensate for this by selling treasury bonds, but this ended up adding to its problems. One of the reasons it is argued that 1998 was primarily a currency crisis rather than a debt crisis is because the defence of the ruble obscured how much trouble the government was in. Investors knew that a crisis was imminent, but they expected the CBR to devalue the ruble, not the government to default on its debt payments.⁶¹ Because of this, investors kept lending to Russia, expecting a bailout from the CBR or the international community in the worst case, which contributed to the \$16 billion increase in debt between 1 June and 17 August 1998.⁶² The government's sudden insolvency and its default qualifies the crisis as a sovereign debt crisis. However, while the government's debt undoubtedly resulted in the currency devaluation, and is a significant cause, the foundations of the crisis are rooted in problems in the banking sector. For example, had bankruptcy laws been

⁵⁴ Chiodo and Owyang, 2002. 7.

⁵⁵ Perotti, 2002. 360.

⁵⁶ Hanson, 1999. 1152.

⁵⁷ The European Bank for Reconstruction and Development, "Transition Report 1998" London. The European Bank for Reconstruction and Development, 1998. 12.

⁵⁸ Hanson, 1999. 1152.; The European Bank for Reconstruction and Development, "Transition Report 1998," 1998. 17.

⁵⁹ Perotti, 2002. 385.

⁶⁰ Padma Desai, "Why Did the Rouble Collapse in August 1998?," *The American Economic Review* 90, 2. (2000): 48 - 52. 48.

⁶¹ Perotti, 2002. 373.

⁶² Pinto, 2010. 1, 3.

more effective, and the CBR more capable of cracking down on predatory banks, the government's budget would have been more balanced.

The 1998 crisis was primarily a banking crisis, caused by poor sector regulation and a weak regulator, the CBR. The banking sector was insolvent months before the crisis hit, and the CBR was bailing out several large banks.⁶³ As early as 1996, the total issued GKO's exceeded the deposits in the entire banking system.⁶⁴ The stock market had lost 75 percent of its value between January and August 1998.⁶⁵ Most of the banking sector was insolvent in the aftermath of the crisis.⁶⁶ Yet, the banking sector was wreaking havoc on the economy long before 1998. As described above, banks were not normal financial mediators, were engaged in predatory practices, such as asset stripping, and few of them were sufficiently capitalised. The CBR struggled to revoke banking licenses and end these practices, because its authority to do this was not clear.⁶⁷ Additionally, there were no effective bankruptcy laws to dissolve bad banks or even bad enterprises. Before the crisis, courts had heard only 4,300 bankruptcy cases even though 65,000 firms and banks were in arrears. If the CBR had been able to effectively regulate the sector, there would have been fewer banks, which would have been better capitalised, and it would have been less likely that a default would have occurred. Additionally, if there had been more effective bankruptcy laws, the government and CBR would not have had to expend resources maintaining soft-budget constraints. Weaknesses in the banking sector exacerbated other economic problems that also contributed to the crisis. Therefore, the root cause of the crisis lies more with poor macroeconomic practices and poor banking regulation.

The 1998 crisis was a triple crisis: banking, sovereign debt, and currency. While the sovereign debt and currency problems need to be addressed, the weaknesses in the banking sector must be the primary focus of crisis resolution to successfully exit the crisis. Appropriate crisis resolution measures would include clarifying the CBR's role as a sector regulator, liquidating insolvent banks, implementing a more effective bankruptcy law, ending state subsidies and hardening budget constraints, and improving tax collection mechanisms. The problem is that the government considered the crisis to be primarily caused by poor tax collection, so that is where the primary resolution measures were undertaken. The positive change that came from these measures is indisputable, and will be analysed below. However,

⁶³ The European Bank for Reconstruction and Development, "Transition Report 1998," 1998. 14.

⁶⁴ *Ibid.* 13.

⁶⁵ Chiodo and Owyang, 2002. 14.

⁶⁶ Perotti, 2002. 385.

⁶⁷ *Ibid.* 384.

because the crisis was not primarily caused by poor revenue collection, the failure to address bank regulation meant that the CBR would remain weak and underdeveloped, and the banking sector would remain partially reformed.

Each of the reforms discussed will be classified as either crisis containment or crisis resolution. As discussed in chapter two, these two categories classify the reform measures undertaken during economic crises. Crisis containment reforms are those which are aimed at restoring or maintaining confidence in investors, and generally preventing the economy from completely collapsing and minimise the damage done by the crisis.⁶⁸ These measures are further categorised as liquidity assistance, such as bailouts and financial assistance; regulatory forbearance, which is a temporary suspension of regulations; and deposit freezes, which prevent people from withdrawing their money from the banks at the same time. On the other hand, crisis resolution reforms address the structural and operational weaknesses that may have caused or exacerbated the effects of the crisis, and often target financial institutions.⁶⁹ These measures are new laws and regulations that seek to reduce the economic vulnerabilities, and thereby the likelihood of causing a crisis, by changing the practices and expectations of economic actors. When successful, these reforms result in crisis modernisation. Yet, Russia's responses to the 1998 economic crisis did not result in crisis modernisation.

5.2 Crisis containment and resolution measures 1998

In chapter two, three hypotheses were stated to test the extent to which the Russian economy experienced crisis modernisation in the aftermath of the 1998 economic crisis. The hypotheses measure whether the right and necessary policies were enacted; how long it took to implement them; and whether they changed behaviours and expectations. The main agency under study is the Central Bank of Russia, how it undertook crisis containment and resolution, and if these measures resulted in institutional development. Because the CBR does not have power to unilaterally draft and implement legislation, the government's role in crisis resolution is also examined. Because crisis containment does not necessitate strong institution, the CBR is more successful in this area than crisis resolution. This is particularly important as too much crisis containment undermines attempts at crisis resolution. Because crisis containment seemingly solved the problems caused by the 1998 crisis, there is a failure to undertake serious crisis resolution. Therefore, all three hypotheses are false.

⁶⁸ Laeven and Valencia, 2008. 7.

⁶⁹ Ibid. 7.

First, those reforms that qualify as crisis containment will be enumerated and examined. These reforms are split into three categories: government liquidity assistance, regulatory forbearance, and deposit freezes. Additionally, the various problems that arose from the containment measures will be discussed. Second, crisis resolution attempts at asset management, bank restructuring, privatisation, and tax reform will be analysed. Specifically, this section analyses the scarcity of crisis resolution programmes, and the difficulties in drafting and implementing them. In doing so, it will rely primarily on qualitative sources, such as reports, statistics, and other accounts of how the CBR managed the crisis, and what resulted from the containment and resolution measures. This enables the hypotheses to be tested and demonstrate how the crisis responses did not result in any meaningful institutional change.

1998 Crisis containment

While the government did not default on its payments until 17 August 1998, it was in May 1998 that state and CBR implemented containment measures. The goal was to prevent the debt crisis from becoming a banking and currency crisis, but they failed to do this. The government and CBR were nearly insolvent, and options for how best to contain the crisis were limited. Nevertheless, the CBR enacted several programmes and schemes to give the banking sector even small amounts of liquidity and some time to replenish reserves. Crisis containment measures do not require strong institutions to be effective. However, the weakness of the CBR even in these measures is demonstrated as banks and enterprises found ways to stay solvent. It can indeed be argued that the CBR avoided exerting direct power on the sector so as not to appear overly harsh, but that it exerted a considerable amount of indirect power to get banks and enterprises to adopt harder budget constraints. The following section will examine the three main forms of crisis containment: liquidity assistance, deposit freezes, and regulatory forbearance, and how they were implemented in 1998.

i) Liquidity assistance. Prior to the 17 August default, The CBR used various forms of liquidity assistance to prevent the debt crisis from becoming a banking and currency crisis. Primarily, it undertook currency interventions to maintain the pegged value of the ruble and avoid rapid currency devaluation and inflation. The CBR spent \$800 million in May, \$2.4 billion in June, \$3.8 billion in July, and in the first half of August alone, \$3.2 billion trying to stabilise the

ruble.⁷⁰ The estimates of how much was spent on currency intervention range from the CBRs total of \$15.5 billion, to the \$27 billion total that is put forth by most scholars.⁷¹ In addition to currency interventions, the CBR converted short-term GKO into long-term Eurobonds in July 1998, with the help of various organisations such as the IMF, the World Bank, and Goldman Sachs.⁷² The plan was that by converting GKO bonds to Eurobonds, banks would not be liable to fulfil GKO obligations for seven to 20 years, based on the bond's duration.⁷³ This converted \$2.97 billion GKO to seven year Eurobonds at a 15.4 percent interest rate, and \$3.47 billion to a 20 year Eurobond at a 15.7 percent interest rate.⁷⁴ The problem is that this kind of fiscal debt restructuring is complicated and its effects on bank restructuring during crisis resolution measures are understudied.⁷⁵ These measures did little to prevent the banking and currency crises that would follow, and they only prolonged their eventuality from May 1998 to 17 August 1998.

While there was no official blanket guarantee that the CBR would bailout the banking sector, it managed to provide a significant amount of liquidity assistance.⁷⁶ One of the first bailouts came just before the default in August as the CBR lent SBS-Agro \$100 million.⁷⁷ The CBR would continue issuing stability loans to large banks to keep them solvent over the next few weeks.⁷⁸ Banks such as Avtobank and Promstroibank pledged 75 percent plus one of their shares to the CBR as collateral in exchange for loans.⁷⁹ Additionally, the CBR injected ₪46 billion immediately after the 17 August default, with ₪11 billion used for short-term stabilisation loans, ₪9 billion lent to Sberbank as a long-term loan, and 17 banks received long-term loans of various amounts.⁸⁰ It is estimated that the CBR spent anywhere between ₪46 billion and \$3.5 billion at the low end, and ₪105 to 120 at the high end on liquidity assistance.⁸¹ These programmes were funded by a combination of reserves, monetary expansion, and tax

⁷⁰ The Central Bank of the Russian Federation, "Bank of Russia Annual Report" Moscow. The Central Bank of Russia, 1998. 71.

⁷¹ Ibid. 72; Kharas, Pinto, and Ulatov, 2001. 2.

⁷² Steinherr, 2006. 241.; Freeland, (2000). 297.

⁷³ Kharas, Pinto, and Ulatov, 2001. 3.; Pinto, 2010. 2.

⁷⁴ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 173.

⁷⁵ Hoelscher and Quintyn, 2003. 36.

⁷⁶ Ibid. 4.

⁷⁷ Kharas, Pinto, and Ulatov, 2001. 49.

⁷⁸ Steinherr, 2006. 243.

⁷⁹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 218 - 219.

⁸⁰ Steinherr, 2006. 243.

⁸¹ Ibid. 243.; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 219.; Hoelscher and Quintyn, 2003. 12. This number varies based on when the author argues the crisis began, and the measures they count as liquidity assistance.

revenues.⁸² Because of the ways the CBR attempted to hide and maintain inflation, as well as other backdoor negotiations, the amount spent on liquidity assistance and the source of its funding is debatable. Liquidity assistance kept banks solvent, but it did not force them to restructure or adopt hard budget constraints.

The CBR also engaged in debt swapping to provide a de facto form of liquidity assistance so banks could continue serving commercial accounts.⁸³ Johnson claims that the CBR did this by swapping frozen GKO bonds for Lombard credits, and estimates that this alone cost ₺14.8 billion rubles in the first two months after the crisis hit.⁸⁴ CBR statistics show that it extended ₺11.4 billion to 62 banks in June 1998, ₺5.7 billion to 40 banks in July 1998, and ₺14.5 billion to 68 banks in August 1998.⁸⁵ Additionally, banks and enterprises undertook more creative debt swapping between themselves.⁸⁶ For example: Enterprise A is owed 100,000 rubles by X Bank, which is insolvent. Enterprise B owes X Bank 100,000 rubles. Enterprise A sells Enterprise B its ₺100,000 credit from X Bank for only 50,000 rubles. Enterprise B then uses this ₺100,000 credit to cancel its ₺100,000 debt. Enterprise A now has an ₺50,000 surplus, and Enterprise B and X Bank are debt free.⁸⁷ The problem, however, is that the banks did not use the extra liquidity to its advantage as many banks and enterprises still defaulted on their debts.⁸⁸ Debt swapping provided some banks with liquidity, but ultimately did not encourage banks to meet their financial obligations.

While each of these liquidity assistance measures appear innocuous and what would be expected of most central banks in a time of crisis, the results were not what many would expect to come of these measures. It is expected that liquidity assistance contains the crisis by preventing banks and enterprises from defaulting on their debts. This prevents further cascading events such as rising unemployment, rising interest rates, and even higher inflation rates. It also lowers the risk that the crisis could become contagious by defaulting on foreign debt obligations. This was not the case in Russia. In fact, while the government used the money

⁸² John van Shaik, "Russia: The Newly Wed and the Nearly Dead," *Euromoney*.

⁸³ OECD, "OECD Economic Surveys: Russian Federation" Paris. The Organisation for Economic Cooperation and Development, 2000.74 – 75.; Shaik, 1999.

⁸⁴ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 218.; Hoelscher and Quintyn, 2003. 36.

⁸⁵ The Central Bank of the Russian Federation, "Bank of Russia Lombard Credits in 1998," The Central Bank of Russia, http://www.cbr.ru/eng/statistics/credit_statistics/print.aspx?file=lombard_cred_98_e.htm.

⁸⁶ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 219.

⁸⁷ This example is a simplified example of the process explained in Johnson 2000. Ibid.

⁸⁸ Ibid. 219.

it borrowed from the CBR to meet its debt obligations, the same cannot be said of the private banks and enterprises as many of them would later become insolvent. In economies with weak institutions, this is not uncommon. Studies show that aiding banks during a crisis can be counter-productive because it does not improve the banks' financial decision making.⁸⁹ Many banks did not meet or even partially fulfil their debt obligations even after debt swaps and bailouts, nor did they replenish their reserves.⁹⁰ The CBR had the tools to provide the banks with liquidity when they needed it, but it could not make them responsible. However, few banks were brought under state administration and / or liquidated. More will be said on this in the section on Government Owned Asset Management.

ii) Regulatory forbearance. The aim of the CBR's regulatory forbearance measures allowed banks to recapitalise and become solvent, and they are credited with helping banks recover from the crisis.⁹¹ There are two forms of forbearance that concern this study. The first is the more traditional definition of forbearance, whereby the CBR does not enforce those regulations that would otherwise cause banks to close. The problem is that the CBR struggled to ensure banks were solvent in the first place, so this can hardly be a special dispensation.⁹² One of the first regulations to be relaxed was allowing banks to draw from their CBR reserves to pay down their debts, prior to the 17 August default.⁹³ After this, the reserve requirement ratio for bank accounts was halved from seven percent to 3.5 percent to enable banks to remain solvent and for the CBR to clear the payments system.⁹⁴ This is where it becomes difficult to disentangle regulatory forbearance from poor regulatory enforcement. Western auditing firms found banks had been hiding their insolvency, that their asset to liability ratio was much smaller than reported, and that they were much more exposed and unstable than they appeared.⁹⁵ Additionally, years after the crisis in 2001, studies found that banks were still undercapitalised with liabilities dangerously outweighing assets.⁹⁶ Therefore, traditional regulatory forbearance indeed prevented many banks from becoming insolvent, which contributed to future economic

⁸⁹ Calomiris, Klingebiel, and Laeven, 2003.

⁹⁰ Shaik, 1999.

⁹¹ Angana Banerji et al., "Russian Federation: Selected Issues and Statistical Appendix" Washington DC. The International Monetary Fund, 2002.; Hoelscher and Quintyn, 2003. 42.

⁹² Robinson, "The Global Economy, Reform and Crisis in Russia," 1999. 555.

⁹³ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 218.

⁹⁴ Steinherr, 2006. 248.; Banerji et al., 2002. 17.; The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 20.

⁹⁵ Perotti, 2002. 385.

⁹⁶ Banerji et al., 2002. 47 – 48.

growth. However, it did not eliminate risky lending practices or improve regulatory capacity.

The second form of regulatory forbearance was the exemption of the gas and oil sector from IMF proposed pre-crisis measures.⁹⁷ By extension, this included oil and gas pocket banks as these banks depend on their parent companies for assets and liabilities.⁹⁸ This took the pressure off natural resource industry, but it also cost the state ₪71 billion.⁹⁹ This delayed the reintroduction of export quotas and tariffs.¹⁰⁰ A significant contributing factor to the 1998 crisis was a drastic drop in oil prices.¹⁰¹ Given the revenues that come from this industry it is not surprising that the last thing the government would do is place anti-crisis measures on the one industry that brings in money. Furthermore, while the gas and oil industry was the largest exemption from the anti-crisis measures, it was far from the only one.¹⁰² By extension, all pocket banks continued to escape CBR regulation. It is argued that these exemptions had less to do with protecting the economy, and more to do with protecting the oligarchs.¹⁰³ Like the other forbearance measures, these practices may have shielded the industries from undue hardship during the crisis. Yet, they also hindered the proper restructuring of the industry by protecting the status of pocket banks that did not contribute to the banking sector. This further exposed the banking sector and the entire economy to continued risk.

While regulatory forbearance is a way to ease pressure on banks and enterprises in the face of a crisis, it ultimately failed to make much difference in Russia in 1998. The key difference between Russia and other established market economies where regulations are properly enforced is that in the latter, banks fulfil a specific role and relaxing the regulations allows them to continue performing that role at little extra cost to the economy and society. However, the role of banks in Russia's economy were not yet fully established, nor was the role of the banking regulator. Thus, while regulations existed in theory, they were rarely adhered to or enforced in practice. The relaxation of these regulations did little more than provide more loopholes for the bankers and managers to slip through.¹⁰⁴ The difficulty of reasserting the relaxed regulations would be one of the more serious long-term consequences

⁹⁷ Chiodo and Owyang, 2002. 14.; Sergei Vasiliev, Overview of Structural Reforms in Russia after the 1998 Financial Crisis. Investment Climate and Russia's Economic Strategy, Moscow. 2000

⁹⁸ Gnezditskaia, 2005.470.

⁹⁹ Chiodo and Owyang, 2002. 14.

¹⁰⁰ Vasiliev, 2000.

¹⁰¹ Luong and Weinthal, 2004.; Freeland, (2000).

¹⁰² Vasiliev, 2000.

¹⁰³ Gnezditskaia, 2005.

¹⁰⁴ The Organization for Economic Cooperation and Development, "Economic Survey of the Russian Federation 2004: The Sources of Russian Economic Growth" Internet. The Organization for Economic Cooperation and Development, 2004. 231.

of the crisis and would further complicate crisis resolution.

iii) Deposit freeze / bank holiday. Deposit freezes are enacted as a measure of last resort to prevent bank runs and ensure absolute monetary control.¹⁰⁵ The CBR did not implement an outright deposit freeze out of fear of further damaging confidence in the industry. However, it did forbid six commercial deposit banks (except for Sberbank and VTB) from servicing their accounts as a means of encouraging the banks to transfer these deposits to Sberbank.¹⁰⁶ This was to protect the accounts, because the banks did not have deposit insurance and Sberbank did.¹⁰⁷ Hoelscher and Quintyn argue that moving most of the commercial accounts to Sberbank prevented a bank run.¹⁰⁸ However, consumer confidence in the sector was weak prior to the crisis, with accounts only comprising seven percent GDP.¹⁰⁹ As such, there was a decline in the number of deposit accounts after the crisis.¹¹⁰ Additionally, while there was no official deposit freeze, some banks unilaterally implemented their own and discouraged large withdrawals.¹¹¹ The CBR managed to maintain monetary control without implementing an official bank holiday. However, its unofficial actions implied one nonetheless.

Additionally, the 90-day moratorium on foreign debt payments is considered a bank holiday as it destroyed investor confidence, and caused banks and the state to default on financial obligations. The moratorium was one of the first steps taken to ensure that the state would have the liquidity it needed and slow capital flight.¹¹² The CBR also implemented various forms of capital controls, such as: restricting foreign exchange trading among small and medium sized banks, and increasing required reserves on corporate ruble deposits.¹¹³ This cost investors and debtors to Russia dearly. It is estimated that overall losses amounted to 80 – 90 percent of the value of GKO, or around \$33 billion.¹¹⁴ The exact total of losses is hard to determine as the devaluation of the ruble and its subsequent fluctuations make it difficult to approximate how much could not be recovered. For example, in September 1998, the ruble's value increased just before the state had a large loan payment due, but then it decreased once

¹⁰⁵ Hoelscher and Quintyn, 2003. 7.

¹⁰⁶ OECD, 2000. 75.

¹⁰⁷ Steinherr, 2006. 241.; Chowdhury, 2003.

¹⁰⁸ Hoelscher and Quintyn, 2003. 42.

¹⁰⁹ Kharas, Pinto, and Ulatov, 2001. 34.

¹¹⁰ Chowdhury, 2003. 90.

¹¹¹ Hoelscher and Quintyn, 2003. 47.

¹¹² Hanson, 1999. 1152.; Stone, (2002). 157.; Chowdhury, 2003. 92.

¹¹³ Martinez-Vazquez et al., 2001. 513.

¹¹⁴ Hanson, 1999. 1152 – 1153.

the transaction was completed.¹¹⁵

While the CBR never implemented an actual deposit freeze, the controls it did implement served a de facto freeze. These measures had a similar effect in that it ruined investor confidence both domestically and internationally: consumers lost confidence in the banking system, the government defaulted on its debt and suffered a \$2 billion decline in foreign direct investment that year.¹¹⁶ However, these actions demonstrate the inability of the CBR to control the crisis. Numerous attempts were made since May of 1998 to prevent the debt crisis from spreading, but none of the containment measures taken succeeded in doing so. While the containment measures did indeed provide the banking and financial sector with some much-needed breathing space, they did little to impose hard budget constraints on the banks. In fact, many of these measures would provide loopholes for banks to exploit the crisis and undermine resolution measures.

1998 Crisis resolution

Russia undertook few crisis resolution measures, and many of the de facto measures were undertaken informally. When examining crisis resolution measures, it is important to analyse whether the policy objectives address those issues that caused or exacerbated the crisis. These often include the measures discussed in chapter two: government owned asset management, sale of government assets, and bank restructuring. Additionally, measures that address banking and larger systemic problems that do not fit neatly into these categories, but are important nonetheless. However, the consensus of scholars is that none of these measures were actively pursued, and that the sector was not reformed.¹¹⁷ Few banks were liquidated, few licenses were revoked, and little actual restructuring took place. The problem is that crisis resolution measures should attempt to fix structural weaknesses, yet this necessitates strong institutions. As the CBR lacked proper institutional development at the time, its ability to enact crisis resolution measures was compromised. The few measures that were enacted were messy and are difficult to categorise. This section will illustrate both official and unofficial measures, and attempt to untangle them to determine how the CBR responded to the larger systemic issues the crisis presented.

¹¹⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 219.

¹¹⁶ The World Bank. "Russian Foreign Direct Investment," Washington DC. 1991 - 2012.

¹¹⁷ Frye, "Governing the Banking Sector," 2005.; Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000.; Steinherr, 2006.; Chowdhury, 2003.

i) Government owned asset management. In theory, banks would become government owned assets as they were liquidated or found insolvent through bankruptcy proceedings. In practice, no official government asset management program was undertaken, but the government often merged state banks with failing banks, or took on the assets of other banks.¹¹⁸ There were two main problems that impeded a government owned asset management programme: the inability of the CBR to revoke banking licenses, and the inadequacy of bankruptcy laws. As the crisis wore on, the state would come to control most of the banking sector through one of its state-run affiliates, such as Gazprom, the CBR, or a regional or city administration.¹¹⁹ This was done to keep banks operational, since liquidation was not an option, and it benefitted both the bank and the government.

First, the CBR struggled to revoke banking licenses, and force bank closures in the few instances where licenses were withdrawn.¹²⁰ Its supervisory capacity was overwhelmed before the crisis, and it did not improve in the immediate aftermath.¹²¹ Furthermore, the CBR was unlikely to rescind the licenses of those banks in which it owned a majority or minority stake. As a result, fewer licenses were revoked after the crisis than in the year preceding it. According to the CBR, 229 licenses had been revoked by December 1998, including three of the top twenty banks, MOST-bank, SBS-Agro, and Inkombank.¹²² However, scholars point out that 334 licenses were revoked in 1997.¹²³ Where the Central Bank did revoke a license, it was unable to force the bank to cease operations, resulting in phantom banks. For example, only 75 percent of registered banks had licenses between 1997 and 2001.¹²⁴ The foundation of government owned asset management programmes is the ability of a central bank, or other authority, to force the closure of risky or insolvent banks by revoking their licenses and absorbing what remains of their assets. Thus, because the CBR unable to do this, the ability to carry out a government owned asset management programme was compromised.

Second, bankruptcy laws were weak and did little to facilitate bank liquidation.¹²⁵

¹¹⁸ Hoelscher and Quintyn, 2003. 7, 58.

¹¹⁹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 223 – 224.

¹²⁰ Perotti, 2002. 385.

¹²¹ Chowdhury, 2003. 89 - 90

¹²² The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 90 – 91.; Frye, "Governing the Banking Sector," 2005. 26.

¹²³ Steinherr, 2006. 243.; Perotti, 2002. 385.

¹²⁴ Chowdhury, 2003. 96.

¹²⁵ Saul Estrin and Alan Bevan, "Russia: Bank Assistance for Private Sector Development" 2002.

Rather, they required restructuring that protected owners at the expense of investors.¹²⁶ As a result, inefficient and insolvent banks remained operational.¹²⁷ Although the CBR knew it needed new bankruptcy legislation to facilitate liquidation, it delayed drafting it.¹²⁸ The Primakov government wanted to end bankruptcy proceedings altogether, and require state approval for bank liquidation.¹²⁹ As such, few bankruptcy cases were undertaken.¹³⁰ Combined with various regulatory freezes, this did not incentivise banks to recapitalise, and did little to mitigate moral hazard problems.¹³¹ Further complicating matters was the state's ownership of the country's largest banks, and its minority stakes in hundreds of smaller banks.¹³² This makes it hard to take insolvent banks into state administration, as the state already controls them. Thus, the state's concern was less with institutional development and structural reform than it was with recapitalising the banks to support the government's industrial policy.¹³³ Thus, there was little incentive to pursue a government owned asset management programme that actively sought to thin the banking industry, because doing so would threaten the government as well.

The only official government owned asset management programme was the transfer of household deposits from private commercial banks to Sberbank.¹³⁴ At the time of the 1998 crisis, Sberbank was the only bank to offer deposit insurance, which caused the CBR to fear a bank run on other commercial accounts. To this end, it coerced the six private banks that held 70 percent of the retail deposits outside of Sberbank (SBS-Agro, Menatap, Inkombank, Most Bank, Mosbiznesbank, Promstroibank, and Rossiiskii Credit), by offering them a 'choice': transfer their deposits to Sberbank, or lose access to the accounts for a year at a significantly reduced interest rate.¹³⁵ In the end 12 percent, or ₺7.1 billion of these deposits were transferred.¹³⁶ As a result, Sberbank once again monopolised the banking industry, controlling 88 percent of the deposit market by 2000.¹³⁷ The move is not entirely unjustified. With few regulatory alternatives, the transfer was vital to securing the deposits and retaining some

¹²⁶ Martinez-Vazquez et al., 2001. 514; Steinherr, 2006. 244.

¹²⁷ Martinez-Vazquez et al., 2001. 512.

¹²⁸ Frye, "Governing the Banking Sector," 2005. 25.

¹²⁹ Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000. 619.

¹³⁰ Levy, 2002. 18.; Perotti, 2002. 373.

¹³¹ Steinherr, 2006. 245.

¹³² Chowdhury, 2003.

¹³³ Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000. 618.

¹³⁴ Perotti, 2002. 385.

¹³⁵ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 220.

¹³⁶ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 88.

¹³⁷ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 224.

measure of confidence in the banking system.

As discussed in chapter two, government owned asset management is complicated as the state often lacks the knowledge to properly restructure banks. Furthermore, where the state has a vested interest or connection to the bank(s), it will find it difficult to objectively liquidate them.¹³⁸ This is what we see in Russia: the CBR owned controlling shares in the country's largest banks and minority shares in smaller banks. This provided the CBR and government with no incentive to strengthen bankruptcy laws, which would have been essential to undertaking an asset management program. Both because of the lack of incentive to reform bankruptcy proceedings, and the necessity to maintain control over the banking sector, no real government owned asset management program was enacted.

ii) Bank restructuring. The difference between government owned asset management and bank restructuring is that the former requires the state to seize the assets of liquidated banks, whereas the latter does not. Restructuring seeks to reorganize banks and their assets and make them more efficient and crisis resistant. Furthermore, restructuring does not have to be carried out by the state. While it most often takes place during the implementation of new regulations and requirements, it can also be part of a change in ownership or merger, or some combination of the two. Bank restructuring usually follows regulatory forbearance, and in the absence of a stronger bankruptcy law, bank restructuring was the only recourse the CBR had to try and manage insolvent banks. However, the CBR often found its attempts to introduce new prudential requirements blocked by the Duma, which undermined the former's ability to resolve the crisis.¹³⁹ While there were several mergers, very little restructuring took place. For example, non-performing loans were neither restructured, nor resold.¹⁴⁰ As such, little was done to strengthen systemic weaknesses or increase efficiency via restructuring.

To avoid falling under state administration, many banks attempted to restructure by merging by forming 'bridge banks'.¹⁴¹ Bridge banks are financial institutions built to absorb and manage the assets of one or more failed banks.¹⁴² Because the bankruptcy law protected the owners and shareholders over the creditors, bankruptcy cases did not seek to liquidate the

¹³⁸ Klingebiel, 2000.

¹³⁹ Chowdhury, 2003. 92 – 93.

¹⁴⁰ Hoelscher and Quintyn, 2003. 58.

¹⁴¹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 220.; The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 94.

¹⁴² Hoelscher and Quintyn, 2003. 2.

bank's assets in order to account for its liabilities.¹⁴³ The result was that bankers could keep their bank's assets and continue to undertake predatory practices as before.¹⁴⁴ Banks would move assets to a new bank, or merge them with another bank, without also transferring the liabilities.¹⁴⁵ For example, Oneximbank became Rosbank, and Menatap became Menatap-St Petersburg.¹⁴⁶ The old bank would fall under state administration or collapse, leaving all but the most lucrative customers without their deposits. Restructuring via bridge banks made the banks neither more efficient nor more profitable.

In order to resume receiving funding from international organisations, the state created an 'objective' organisation to restructure the banking sector, the Agency of the Reconstruction of Credit Organisations (ARCO).¹⁴⁷ The aim of ARCO was to evaluate each of the banks, determine how healthy they were, and decide which to leave alone, which needed to be restructured, and which needed to be closed.¹⁴⁸ The problem is that the CBR strongly opposed the creation of ARCO from the start, and did its best to ensure it remained weak and ineffective.¹⁴⁹ For example, it was supposed to be a completely objective organisation, yet it was subordinated to the CBR.¹⁵⁰ As such, ARCO was never granted the authority to revoke licenses, close banks, force restructuring, or even observe banking operations without a manager's permission, nor did it attempt to stop the rampant asset stripping.¹⁵¹ It was only given a budget of ₺10 billion, most of which it spent on buying frozen GKO bonds and lending Alfa Bank ₺1 billion.¹⁵² In sum, ARCO participated in a total of 21 projects, restructured fourteen banks, and liquidated only three.¹⁵³ Thus, ARCO was a largely ineffective organisation that undertook very little restructuring, and did not contribute to any institutional development.

Finally, banks restructure after a crisis through the changing of reserve and other requirements. The problem is that reserve and other prudential requirements were not properly

¹⁴³ Estrin and Bevan, 2002. 6 – 7.

¹⁴⁴ Steinherr, 2006. 244.; Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 221 – 222.

¹⁴⁵ Chowdhury, 2003. 92.

¹⁴⁶ Frye, "Governing the Banking Sector," 2005. 25.

¹⁴⁷ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 126.

¹⁴⁸ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 221 – 222.

¹⁴⁹ Frye, "Governing the Banking Sector," 2005. 25.

¹⁵⁰ Steinherr, 2006. 243.

¹⁵¹ Chowdhury, 2003. 93.

¹⁵² Steinherr, 2006. 243. It is unclear why ARCO gave Alfa Bank a loan as it was one of the few banks not struggling. While it is most likely that the loan was corrupt, further speculation is beyond the scope of this study.

¹⁵³ Ibid. 244.

re-introduced. Generally, the regulatory environment did not improve after the crisis as new banks had stringent capital requirements placed upon them, but older banks largely avoided these requirements.¹⁵⁴ For example, the CBR abandoned a regulation that would require banks with less than \$1 million to restructure as non-banking organisations.¹⁵⁵ Had this been enacted, it would have attempted to crack down on small shell banks used for asset stripping and money laundering. Instead, most of the regulation the CBR enacted post-crisis was regarding foreign exchange and government securities. These regulations included requirements on the level of capital needed to purchase securities, and ensuring that export earnings were transferred to accounts in a timely manner.¹⁵⁶ The problem is that none of these new requirements addressed the structural problems that led to the crisis in the first place: the inability of the CBR to regulate the sector and the proliferation of predatory, under capitalised banks.

Bank restructuring failed to take place after the 1998 crisis. Mergers between banks were not aimed at improving efficiency and increasing profit maximisation, and new prudential regulations did not address the industry's underlying structural problems. Instead, the CBR focused on the things it could immediately control: foreign exchange and GKO's. It is unclear to what extent the CBR tried to correct the fundamental issues with the banking system. On the one hand, it encountered resistance from the Duma and government when it tried to redraft the bankruptcy and insolvency law; on the other, it strongly opposed the creation of ARCO. As a result, the CBR's inconsistency perpetuated systemic problems and its own institutional weakness.

iii) Sale of government owned assets. In theory, the sale of government owned assets occurs as part of the government asset management programme, either after the assets have already been restructured, or for investors to restructure themselves. These measures would ensure the assets are productive, but also that the government recovers part of the crisis's cost.¹⁵⁷ As there was no official asset management programme, it follows that there would be no selling of assets. However, the concept of government asset management was complicated by the fact that the government already owned or had a stake in a large part of the banking industry. As such, if the government were to pursue this measure, it would be concerned with straight forward

¹⁵⁴ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 93.; Perotti, 2002. 385, 390.

¹⁵⁵ Banerji et al., 2002. 42

¹⁵⁶ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 21, 98 – 99, 134 – 135.

¹⁵⁷ Hoelscher and Quintyn, 2003. 2.

privatisation. However, the state was more interested in nationalisation rather than privatisation in the aftermath of the crisis. For example, it would not provide struggling banks with liquidity assistance, but it would provide a state-owned bank with the capital to buy struggling banks.¹⁵⁸ Observers noted that privatisation would be unlikely, and that the consequences of this would impact the stability of the sector more than the development of private banks because the state has an interest in favouring itself.¹⁵⁹ There were calls from international advisors and even some Russian bankers for privatisation, but none of them resulted in anything.

The most well-developed programme for sector development and privatisation was called the Mamut Plan, which sought to increase reserve requirements, privatise state banks, convert accounting practices to the International Accounting Standard, and introduce a three-tiered banking system.¹⁶⁰ The plan would require banks to have ₺1 billion (\$33 million) of capital to start a bank, which would have to increase to ₺3 billion (\$100 million) within two years.¹⁶¹ It also wanted to create two kinds of licenses based on reserve levels, with larger banks getting full licenses that would allow them to operate anywhere in the country, and smaller banks restricted to the services they provide and where they are located.¹⁶² Additionally, one of the compromises was to create deposit insurance that would cover all banks, thereby breaking up Sberbank's monopoly.¹⁶³ This would have allowed the state to maintain control over Sberbank, while giving depositors and investors confidence to do business with other banks. The plan was supported by the Russian Union of Industrialists and Entrepreneurs, and other banking oligarchs, but because it was opposed by the CBR and the Duma, it failed.¹⁶⁴ This plan was not implemented, although some of its suggestions, such as deposit insurance and the conversion to IAS, would later be adopted.

The CBR is no different from the government when it comes to privatisation. In the immediate aftermath of the crisis, there was a proposal to slowly decrease the CBR's role in Sberbank and other banks, but there was a general reluctance to do so, and it was perpetually postponed.¹⁶⁵ There was additional legislation to continue the privatisation of state-owned banks and enterprises that had begun in 1992, yet this proposal was highly contentious and while the state agreed to break-up some unitary enterprises, it again exempted strategic national

¹⁵⁸ Chowdhury, 2003. 248.; Frye, "Governing the Banking Sector," 2005. 41 – 42.

¹⁵⁹ Levy, 2002. 20.

¹⁶⁰ Frye, "Governing the Banking Sector," 2005. 30 - 31.

¹⁶¹ Ibid. 30 – 31.

¹⁶² Gnezditskaia, 2005. 468.

¹⁶³ Ibid. 468.

¹⁶⁴ Frye, "Governing the Banking Sector," 2005. 31.

¹⁶⁵ Ibid. 23.

enterprises and banks from the process.¹⁶⁶ In the end, the Duma did not approve the proposal and privatisation was again postponed. Therefore, there were no privatisation or other policies targeting state banking monopolies as a measure of crisis resolution. Because the CBR remains an active player in the banking industry instead of a regulator or mediator, it maintains its partially reformed nature. While this may be beneficial to the CBR, it undermines the development of a market economy.

iv) Tax reform. Most of the measures necessary to resolve the 1998 crisis neatly fall into the programmes discussed above, and the CBR and governments' failure to implement these measures will be discussed below. There is one important measure that does not fit into any of the categories above, yet was vital to preventing future crises: tax reform. At first glance, this may not seem like an apposite crisis resolution measure. However, the reliance on GKO's to provide revenue stemmed from the inability of the state to collect taxes. Thus, improving tax collection mechanisms was of the utmost importance in ensuring the government had access to the revenue it needed. While it is undisputed that the state also needed to cut down on spending, this section is more concerned with tax collection since it directly involves and affects the CBR. The CBR largely failed to implement the other crisis resolution reforms, but tax collection is the one that it seems to have done right.

The CBR's role in tax collection is important because of the *kartoteka* system.¹⁶⁷ Gaidar wanted to implement tax reform in the early 1990s, by taxing the private sector instead of the public sector, under the assumption that the later would replace the former.¹⁶⁸ However, as the state undermined and delayed privatization, this shift did not happen. Additionally, the incentives for avoiding taxation were strong. Tax collection mechanisms were unfair and complex, with each collector imposing a different set of regulations and criteria.¹⁶⁹ Thus, it is estimated that 90 percent of tax payers were involved in the shadow economy to avoid paying taxes, and there was no punishment for not doing so.¹⁷⁰ The government did not help this by forgiving enterprises' tax arrears, and creating special tax exemptions that would cost them upwards of \$6 billion in lost revenue.¹⁷¹ By 1996, tax arrears accounted for five percent of

¹⁶⁶ Vasiliev, 2000. 3.; Gnezditskaia, 2005. 469.

¹⁶⁷ Discussed in chapter four, the *kartoteka* system was the old Soviet system that allowed the state to access individual and enterprise accounts to withdraw taxes and other sums. It remained in practice in the 1990s, driving enterprises to keep their profits in offshore accounts to avoid taxation.

¹⁶⁸ Easter, 2013. 53.

¹⁶⁹ Ibid. 54; Martinez-Vazquez et al., 2001. 508 – 509.

¹⁷⁰ Easter, 2013. 54.; Luong and Weinthal, 2004. 141.

¹⁷¹ Easter, 2013. 58.

GDP, and by January 2001 it was eight percent.¹⁷² The government needed to improve both tax collection and compliance, and given its role in the existing system, the CBR was a vital part of this.

Tax reform was implemented in April 2001, which was nearly three years after the 1998 crash, and two years after growth resumed. The main parameters of the reform reduced profit tax from 32 percent to 24 percent, introduced a flat income tax of 13 percent, and a flat tax for small businesses of 15 percent.¹⁷³ There is, however, a debate surrounding the effectiveness of the reforms, with scholars pointing out that the revenue rate and welfare spending has not changed.¹⁷⁴ As Vladimir Pastukhov explains, the reform should have simplified social taxes by reducing them from four to one. While the tax payer receives a bill for one amount, it is broken down into four taxes, and it is up to the tax payer to ensure all four taxes have been paid.¹⁷⁵ However, when tax evasion was made a criminal offence, compliance increased by 9 – 12 percent, government revenues rise by 25 percent, and the economy grew by five percent.¹⁷⁶ Yet, there are also questions about causality. It could be possible that tax compliance increased as the economy strengthened and people could afford to pay taxes. Additionally, Putin's renationalisation of Russia's most lucrative enterprises may have increased compliance. Even so, except for nationalisation, the increase in tax collection cannot be ignored or denigrated as it is a tiny, promising step toward institutional predictability and strength.

The weakness of the CBR can be seen in the responses to the 1998 economic crisis. It effectively implemented crisis containment measures by preventing a systemic wide collapse, but this does not require strong institutions. It was directly within the CBR's purview to increase liquidity assistance and relax regulations; there was no need for it to seek approval from or cooperate with the government to enact these measures. However, the CBR struggled to implement in-depth and far reaching reforms that would restructure the industry and strengthen the institution. It lacked the ability to unilaterally withdraw banking licenses, and to force banks' closure. Thus, while the CBR could prevent the system from imploding, it was unable to implement resolution measures that would secure those vulnerabilities that caused

¹⁷² Ibid. 57.; Luong and Weinthal, 2004. 141.

¹⁷³ Easter, 2013. 64.; Luong and Weinthal, 2004.142.

¹⁷⁴ Yuriy Gorodnichenko, "Myth and Reality of Flat Tax Reform: Micro Estimates of Tax Evasion Response and Welfare Effects in Russia," *Journal of Political Economy* 117, 3. (2009): 504 - 56.505.

¹⁷⁵ Vladimir Pastukhov, "Law under Administrative Pressure in Post-Soviet Russia," *E. Eur. Const. Rev.* 11, (2002): 66. 71.

¹⁷⁶ Gorodnichenko, 2009.; Easter, 2013. 59.

the crisis in the first place.

5.3 Hypothesis testing

To determine whether crisis modernisation has occurred, the above analysis will be used to measure the hypotheses presented in chapter two. These hypotheses are testing for institutional development by measuring if A) the government and CBR's crisis management responses were appropriate and addressed the causes of the crisis; B) the government and CBR were able to implement crisis containment and resolution measures effectively and efficiently, and C) if the reforms strengthened institutions by changing the behaviours and expectations of economic actors. Each of the three hypotheses is measured against the null hypothesis, which states that economic crises have do not affect institutional development in Russia. Each hypothesis will evaluate the evidence presented above. As the hypotheses progress, any evidence that does not support one hypothesis is excluded from testing the ensuing hypothesis. This narrows the analysis to those measures most likely to result in crisis modernisation. The only measure that receives full consideration is tax reform. However, even where it does result in some change, there is not enough evidence to support the hypothesis that it has led to institutional development.

Hypothesis I: The government and Central Bank of Russia will undertake the appropriate policy responses to resolve the crisis at hand.

In the aftermath of the 1998 crisis, Russia needed to cut spending by 11 percent of its GDP, achieve a budget surplus of two percent GDP, reduce the deficit, improve bankruptcy procedures, reform the banking sector, and improve the exchange rate.¹⁷⁷ These are complex measures for any economy to undertake, much less one that is partially reformed. Thus, it is expected that the CBR and the government would have a difficult time resolving the crisis. Yet, these measures were essential for the CBR and government to exit the crisis and strengthen the economy in the process as each of them targets a specific weakness. For example, the directive to reform the bankruptcy law was to facilitate the dismantling of insolvent banks that increased the risk for the industry. Therefore, despite the difficulty in undertaking these measures, for the first hypothesis to be true, we examine whether attempts were made to undertake them.

On the face of it, the CBR implemented appropriate crisis containment measures by

¹⁷⁷ Martinez-Vazquez et al., 2001. 504.

providing some liquidity assistance to prevent banks from defaulting on loan obligations and worsening the crisis, relaxing regulations and giving banks time to replenish their reserves, and avoiding a deposit accounts freeze. The government did cut spending in the aftermath of the crisis, resulting in a 3.4 percent of GDP surplus by 2001, with the budget expecting a surplus from 2002 on.¹⁷⁸ The CBR continued to accumulate reserves, which appreciated the exchange rate by 30.7 percent from the end of 1999.¹⁷⁹ This also helped offset the increases in currency emission, which would otherwise lead to inflation as the monetary base rose by ₺110 billion in 2001, but reserves increased by the equivalent of ₺218 billion.¹⁸⁰ However, this is not particularly surprising as these measures are text book crisis containment, which do not necessitate strong institutions, or the creation of new ones, to be implemented.¹⁸¹ Thus, the basic fiscal and monetary issues that caused the crisis were addressed.

The CBR's handling of crisis resolution, on the other hand, is far more complex. The simple answer is that it failed to implement the appropriate crisis resolution measures, with the exception of tax reform. The lack of proper bankruptcy proceedings, the inability of the CBR to withdraw licenses, and the entanglement of the state in the banking sector all complicated the Central Bank's ability to correct and strengthen systemic flaws. Also, in the absence of official programmes, it's difficult to disentangle which programmes fit into each category. Yet, this is not for lack of trying. As such, it is necessary to evaluate the attempts that were made at crisis resolution.

Government owned asset management would have enabled the government to more efficiently liquidate insolvent banks. This could have strengthened the systemic vulnerability that parasitic banks posed by liquidating their assets and using them to pay off the banks' liabilities. However, the bankruptcy laws in place at the time made this impossible since it favoured owners and managers over shareholders. As such, where banks were forced to declare bankruptcy, they were not liquidated, but reorganised. This is why the IMF and other international advisors encouraged the CBR and the state to focus on redrafting a new bankruptcy law. While there was an attempt to amend the law to protect investors, it failed to pass a Duma vote in 1999 and was not implemented.¹⁸² It was not until 2000 that the law 'On the Insolvency of Credit Organisations' allowed a bank to be declared bankrupt.¹⁸³ Although,

¹⁷⁸ The World Bank, "The Russian Economic Report" Moscow. The World Bank, 2001. 5.

¹⁷⁹ Ibid. 4.

¹⁸⁰ Ibid. 4.

¹⁸¹ Laeven and Valencia, 2013.

¹⁸² Martinez-Vazquez et al., 2001. 512 – 513.

¹⁸³ Frye, "Governing the Banking Sector," 2005. 33.

by this time, the concern for liquidation had faded as new economic growth occurred. Overall, there was no government owned asset management programme to liquidate insolvent banks.

There are three best practices for bank restructuring programmes: they need to be comprehensive; they should be undertaken by the government and funded by the tax payer rather than a central bank to increase accountability and transparency; and they must begin immediately.¹⁸⁴ According to this and other measures, bank restructuring failed take place as banks moved their assets to bridge banks rather than restructure. This did not make them more efficient or increase their profits, and investors and depositors were often left empty handed. ARCO was created to facilitate restructuring, since that is what the bankruptcy law at the time provided, but it failed to do so. It had no power to even properly assess banks and lacked the authority to restructure them. The CBR itself was not very preoccupied with restructuring the banking sector in the aftermath of the crisis. Most of its efforts went into tackling requirements for foreign exchange and buying government securities. While this is not unimportant given how the lack of oversight on these issues contributed to the crisis, these did not force banks to increase their reserve requirements or otherwise become less vulnerable to crises, and less likely to cause them.

There was no selling of government owned assets; neither from the asset management programme that never occurred, nor privatisation of state owned banks. In fact, in the absence of an official programme to liquidate banks, the CBR lent capital to state owned banks so that they may buy and merge with insolvent banks, which is not the same thing as the latter banks' assets are not being used to offset their liabilities. Additionally, the World Bank reported in 2001 that much of the desire to accelerate market reforms in the years following the crisis would require the state to relinquish its control on the economy, yet there were never plans for this to take place.¹⁸⁵ While the 2001 report says there is no reason to doubt the state will remove itself as an economic player, the problem of nationalisation over privatisation only worsens from 2000 on.

Unlike the other crisis reform measures, tax reform was the only successful policy to be implemented after the 1998 crash. The revenue collection mechanisms were broken, which led to the government's reliance on selling GKO's to raise budgetary revenue. While the selling

¹⁸⁴ Steinherr, 2006. 244. The correlation between transparency, accountability, and restructuring using tax payer money is that tax payers will hold the state accountable to the results, thus demanding a more fair and transparent process from the outset. It also reduces the moral hazard of the government as it must ensure that restructuring will strengthen systemic weaknesses, or they risk losing power. For several reasons, this would not have been possible in Russia in 1998.

¹⁸⁵ The World Bank, "The Russian Economic Report," 2001. 6.

of securities was not the sole cause of the crisis, it was a symptom of a larger problem: the inability of the government to collect taxes and the failure of banks to generate profits independent of the government that did not involve asset stripping or other predatory practices. While tax reform does not address the larger systemic problems, increasing the ability of the government to collect taxes is no small feat and adequately addresses one of the causal factors of the crisis.

Overall, the CBR failed to implement the appropriate measures necessary to resolve the crisis. The crisis containment measures were adequate, but they did not resolve the crisis. Furthermore, they did not require strong institutional foundations to be enacted. So, while the CBR implemented these policies as needed, it failed to address larger systemic problems such as liquidating insolvent banks and encouraging banks to restructure in a manner that is beneficial to the sector. Therefore, the first hypothesis is mostly not true, and institutional development is not likely to result from the 1998 economic crisis. However, as tax reform was implemented, it is important to see if it led to institutional development. Furthermore, by examining how the other hypotheses are false will shed light on why institutional development failed to take place after the 1998 economic crisis.

Hypothesis II: The Central Bank of Russia is strong enough to implement crisis resolution measures effectively and efficiently. Reforms also seek to improve institutional efficiency.

Russia's economic institutions, such as the CBR, were not strong enough to implement crisis resolution reforms, and it is this weakness that led to the crisis in the first place. As such, if institutional weakness caused the crisis, then crisis resolution measures should focus on institutional development. As mentioned above, most of the reforms suggested by international advisors concerned procedural issues that would enhance the CBR's ability to manage the crisis's recovery more efficiently. Yet, by the time these issues were addressed, the crisis had passed, and the effect on institutional strength is debatable. Therefore, if reforms that sought to improve the CBR's efficiency were not implemented, and the CBR was subsequently too weak to undertake crisis resolution measures, then both parts of the hypothesis are false.

Government owned asset management programmes could not be undertaken because no credible bankruptcy law existed. As such, there was no means for the CBR or a government appointed organisation, to acquire the assets of insolvent banks. Additionally, the CBR's authority was not clearly defined as it struggled to dissolve problem banks since the withdrawal

of a license did not force banks to close.¹⁸⁶ The closest approximation of an asset management programme was ARCO, which was able to liquidate banks in theory, but in practice it aimed at restructuring banks since few provisions for liquidation existed. Bankruptcy legislation was not reconsidered until two years after the crisis. Not only was the bankruptcy procedure inadequate, but the government and CBR did not address the problem it posed until after the crisis had passed. Therefore, the second hypothesis is not true for government owned asset management.

Because the CBR largely considered 1998 to be a liquidity crisis, not a banking crisis or even a triple crisis, it sought to recapitalise banks rather than force them to restructure.¹⁸⁷ There were no measures that explicitly required banks to restructure in the aftermath of the crisis. As such, productive bank restructuring was not really possible. Even after the crisis passed, banking reform was not a priority.¹⁸⁸ Many laws that would consolidate the sector and increase its competitiveness were continually being debated, redrafted, and delayed.¹⁸⁹ In general, the CBR's institutional foundation prevents it from adequately regulating the industry, thus impairing its ability to restructure.¹⁹⁰ Few measures were taken to enhance the CBR's regulatory powers as a means of resolving the crisis. Thus, the CBR was neither strong enough to carry out every day banking regulation or bank restructuring, nor was there an attempt to address these weaknesses. As such, the second hypothesis is not true for bank restructuring.

Additionally, it is not so much that the CBR is not strong enough to undertake privatisation, rather, that it has no interest in doing so. As previously discussed, Sberbank's ubiquitous presence throughout the country provides access to banking services people might not get in a purely competitive market. Additionally, as Putin renationalises much of the country's most profitable sources, it follows that the state would want to maintain control of the financial apparatus as well. Of course, the inability to disentangle the CBR's roles as a regulator and economic actor poses several problems, the most important of which is the poor enforcement of property rights as the state encroaches on the assets and investments of private investors.¹⁹¹ This problem is not just in the financial sector: investing in or purchasing

¹⁸⁶ Steinherr, 2006. 245.

¹⁸⁷ Ibid. 244.

¹⁸⁸ Perotti, 2002. 377.

¹⁸⁹ The World Bank, "The Russian Economic Report," 2001. 6.

¹⁹⁰ Gnezditskaia, 2005. 472 – 473.

¹⁹¹ Olga Lazareva, Andrei Rachinsky, and Sergey Stepanov, "A Survey of Corporate Governance in Russia" 2007. 32 – 33.

government property has become more difficult since the 1998 crisis.¹⁹² Therefore, because no attempt was made at privatising government owned assets as a means of crisis resolution, the second hypothesis is not true for privatisation as a means of crisis resolution.

Tax reform is the only measure taken where the hypothesis has a degree of truth. This is because the measure itself appears to strengthen one of the systemic weaknesses that caused the crisis. Unfortunately, this reform was not a priority. It was debated after the crisis, but it was not implemented until 2001, well after the crisis had been resolved. This time lag raises questions about the nature of the reform as well as its effectiveness. On the one hand, Putin and others close to the reform have argued that the crisis had such devastating economic effects that implementing it before the economy had started to grow again would only have encouraged evasion.¹⁹³ And, there is evidence that the reform indeed increased the percentage of voluntary tax compliance and reduced the instances of evasion after it was implemented.¹⁹⁴ On the other hand, there are debates over how successfully tax reform was achieved. Some scholars argue that it is because Putin, the Central Bank, and the hydrocarbon leaders negotiated a deal, and thus tax compliance has been non-coercive.¹⁹⁵ Others point out that in renationalising many of the banks and extraction companies, there was little resistance to either the reform or its implementation.¹⁹⁶ The distinction between these two arguments is crucial to determining whether tax reform actually strengthened the CBR and tax collecting institutions. Thus, the second hypothesis is true for tax reform and its role in crisis modernisation is discussed below.

Hypothesis III: New regulations are fairly and universally enforced, leading to reliance on formal rules and organisations to resolve conflicts.

This hypothesis is false. It tests how much institutional development has resulted from crisis resolution reforms, and whether crisis modernisation has taken place. The stronger the institution is, the more formal rules are enforced above informal norms.¹⁹⁷ When this fails to take place, relations between actors remain erratic and insecure as the institutions can only

¹⁹² O. Shetin et al., "Monitoring the Administrative Barriers to Small Business Development in Russia: Fifth Round" 2005.

¹⁹³ Rudiger Ahrend and William Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia," *Europe-Asia Studies* 57, 6. (2005): 801-21. 12.

¹⁹⁴ Gorodnichenko, 2009. 546.

¹⁹⁵ Luong and Weinthal, 2004.

¹⁹⁶ Olga Kryshstanovskaya, "The Rise of the Russian Business Elite," *Communist and post-communist studies* 38, 3. (2005): 293-307. 303.; Easter, 2013. 57.

¹⁹⁷ Steinmo, 2008. 124.

meet the needs of the elite.¹⁹⁸ As such, societies with stronger institutions tend to have more economic opportunities as the implementation of rules is more stable and predictable.¹⁹⁹ Had crisis resolution measures resulted in institutional development, the CBR would have increased its authority and more consistently enforced regulations across the entire sector, resulting in restructuring. As demonstrated above, the CBR and state largely failed to restructure the banking sector in the wake of 1998. Apart from tax reform, there was little development of the CBR's enforcement mechanisms. Additionally, there is doubt that tax reform is as successful as it appears. Therefore, this hypothesis is false.

There was no sector wide restructuring in the aftermath of the crisis. The CBR attempted to regulate the banks in the aftermath of the crisis. However, of the 1,271 institutions the CBR identified as problems, only 229 banking licenses were revoked.²⁰⁰ Undercapitalised, non-viable banks continued functioning in Russia, able to avoid hard budget constraints even when their licenses had been revoked.²⁰¹ In some instances, bankers whose licenses had been revoked had the license returned.²⁰² As a result, there were several phantom banks that emerged out of the 1998 crisis: never more than 75 percent of licensed banks were operational between 1997 and 2001.²⁰³ Additionally, banks that remained open opted to engage in market speculation and treasury operations, rather than more traditional commercial banking.²⁰⁴ Thus, there was no increase in the CBR's regulatory powers as a result of the 1998 crisis, which did not lead to more predictability or stability.

Furthermore, the CBR's involvement in the banking sector skews incentives against strict regulation and the maintenance of partial reform. The CBR undertook no privatisation as either an act of crisis resolution, nor after the crisis had passed.²⁰⁵ On the one hand, the CBR stopped absorbing acquiring failing banks, but it refused to privatise state banks.²⁰⁶ This impedes the CBR's ability to fairly, objectively, and consistently regulate the sector and complete the transition to a market economy.²⁰⁷ This bias undermines the formal rules and the CBR, resulting in a lack of confidence that the institution can be used for conflict resolution or

¹⁹⁸ Andrei Kuznetsov and Olga Kuznetsova, "Institutions, Business and the State in Russia," *Europe-Asia Studies* 55, 6. (2003): 907 - 22.

¹⁹⁹ Hanson and Teague, 2005. 669.

²⁰⁰ The Central Bank of the Russian Federation, "Bank of Russia Annual Report," 1998. 99.

²⁰¹ Estrin and Bevan, 2002. 8.

²⁰² Perotti, 2002. 385.

²⁰³ Chowdhury, 2003. 95.

²⁰⁴ Gnezditskaia, 2005. 457.

²⁰⁵ Estrin and Bevan, 2002.

²⁰⁶ Frye, "Governing the Banking Sector," 2005. 23.

²⁰⁷ Barnes, 2003. 156.

to mediate transactions.

As a result, the social economy flourished in the absence of a market after the 1998 crisis. Many scholars note the need for social connections with the CBR to avoid regulatory infractions. For example, banks owned by gas and oil companies are the best capitalised in the state, so they seemingly adhere to CBR regulations.²⁰⁸ Yet, they flouted CBR regulations that require investors who purchase more than 20 percent to be identified.²⁰⁹ In response, 35 percent of Russia's top banks possessed no investors who own more than 20 percent of shares, yet the CBR was reluctant to force banks to disclose the identities of said shareholders.²¹⁰ This undermined the CBR's credibility as a fair and trustworthy regulator. Since the 1998 crisis, many businesses and investors found regulatory uncertainty is one of the primary investment constraints in Russia, with most lacking confidence that their property rights will be protected because well connected firms receive preferential treatment.²¹¹ Thus, the unpredictability of regulatory enforcement necessitates social connections to navigate the banking industry in the absence of a strong regulator.

Tax reform appears to be the one measure taken that has resulted in some institutional development, and it is important not to belittle the progress made. The number of taxes people must pay have been reduced, collection has been simplified, and exemptions and loopholes have been closed.²¹² Also, tax evasion was made a criminal offence.²¹³ Yet, there are still issues that question the enforcement and implementation of the reform. Notably, the CBR was not removed from the tax collection process. There was never an intention of outsourcing tax collection to an independent body as the government wanted to continue using the CBR as a means for tax collection and project financing.²¹⁴ Because the CBR oversees the payments system, it transfers taxes from the Ministry of Finance to the government budget, and it carries out orders to forcefully withdraw payments for violators.²¹⁵ However, there is little evidence that this power has been abused. Although there are several high-profile cases centred on tax

²⁰⁸ Gnezditskaia, 2005. 457.

²⁰⁹ Ibid. 470 – 471.

²¹⁰ Ibid. 471.

²¹¹ Raj M. Desai, "Improving the Investment Climate," in *Can Russia Compete?*, ed. Raj M. Desai and Itzhak Goldberg (Washington DC: Brookings Institution Press, 2008).7; *ibid.* 91, 97 – 98.

²¹² Clifford Gaddy and William Gale, "Demythologising the Russian Flat Tax" *Tax Notes International*, 2005. 986; Shetinin et al., 2005. 11.

²¹³ Pastukhov, 2002. 70.

²¹⁴ Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000. 618.

²¹⁵ The Central Bank of the Russian Federation, "Russian Payments System," The Central Bank of Russia, http://www.cbr.ru/eng/archive/archive/root_get_blob.aspx?doc_id=9092

arrears, the CBR has never been directly involved.

Tax evasion continues, although schemes have become more elaborate as it is difficult to undertake. Employers often collude with their employees to avoid paying taxes by underreporting wages in return for cash payments.²¹⁶ The larger the firm, the less likely it is to get away with tax evasion as they are subject to more scrutiny, but the state is often the worst offender.²¹⁷ Many businesses disagree with the reform's implementation, and surveys taken during the early 2000s show that Russian businesses spent more time dealing with tax authorities than other state in the region.²¹⁸ Additionally, the new tax system was not automatic; firms had to register for it, of which 38 percent have not.²¹⁹ While no tax collection system will ever be perfect, Russia's still has notable flaws.

Finally, tax reform is often hailed as an example of institutional development in Russia as the elites now pay their taxes, rather than use connections to evade them. Many scholars argue that this is because the elites and the state negotiated the reform together, a sign of conflict resolution. For example, the state promised to keep foreigners out of the gas and oil industry (or at least make it more difficult for them to invest) if the companies pay their taxes.²²⁰ However, as pointed out by Andrew Barnes, oligarchic support for passing new laws is not the same thing as the strengthening of the rule of law, or the submission of the state to law.²²¹ As such, it is no coincidence that this happened as the state began to renationalise the gas and oil industry. While the state lowered profit taxes on many industries, but the trade-off was increasing taxation on the hydrocarbon industry.²²² In fact, the new tax measures greatly enhanced the state's ability to rent-seek in the gas and oil industry.²²³ Thus, the state has often undermined the progress that has come from the reform measures so far.

The institutional development that resulted from tax reform crisis resolution measures is questionable. On the one hand, market economy development is seen in the reduction of loopholes, increasing compliance, and streamlining enforcement. On the other, command economy practices are also reinforced as the state used tax reform to increase its power and undermine the strength of the tax collecting institutions. If the laws are not fairly enforced because the state is the main violator of the law, and if the state is using the law as a tool to

²¹⁶ Gorodnichenko, 2009. 509.

²¹⁷ Ibid. 518 – 520.

²¹⁸ Desai, 2008. 99.

²¹⁹ Shetin et al., 2005. 11.

²²⁰ Luong and Weinthal, 2004. 143.

²²¹ Barnes, 2003. 155.

²²² Ahrend and Tompson, 2005. 13.

²²³ Appel, 2004. 311.

acquire more power, then the tax collection institutions cannot be relied upon to resolve conflict. Therefore, the CBR and the tax collection institutions remain partially reformed in the aftermath of the 1998 economic crisis as very little crisis modernisation has taken place.

5.4 Conclusion

While the Central Bank of Russia's ability to implement crisis containment measures certainly contributed to Russia's recovery, post-crisis growth resulted from a combination of the import substitution effect and an increase in oil prices. Furthermore, Russia's financial prudence that emerged from 1998 is not a positive change, but rather further evidence of partial reform equilibrium. The sudden ability of the government to pay its debts and create an emergency stabilisation fund did not come from its new ability to effectively and efficiently collect taxes or a concerted effort to control spending. Rather, it came from the sense to save oil profits when they came pouring in between 1999 and the early 2000s. While this indeed is a good change, it does not speak to or illustrate an improvement in the movement of the economy toward a market by improving its business culture, increasing the scale and scope of private enterprises, or increasing economic diversification.

To transition to a market economy, firms, including banks, must be subject to the laws of supply and demand, or hard budget constraints. This did not happen in Russia. For example, banks knew that the state would not force them to close or repay loans. Additionally, where the CBR refused to directly help banks, it used its position to take control of the bank, but then not reprivatize once the crisis had passed. As such, post-1998 Russia did not enter a new period of economic transition as the government and CBR's actions undermined one of the fundamental dynamics of a market economy: the state versus the private enterprise.²²⁴ While the tax reform is a good example of crisis modernisation because it resulted in tangible change, there are still problems with enforcement and expectation because government is part or majority owner of those enterprises that get away with tax evasion.²²⁵ Because the government owns the most profitable enterprises, thanks to Putin's national champion's plan, this means that the state's most profitable enterprises are not paying taxes.²²⁶ Most of these enterprises did not reinvest their tax breaks to update infrastructure or undertake exploration.²²⁷ Additionally, in the years after the crisis, the new tax reforms would be used as a tool to renationalise

²²⁴ Barnes, 2003. 156.

²²⁵ Appel, 2004.; Goldman, *Petrostate: Putin, Power and the New Russia* (2010).

²²⁶ Appel, 2004.

²²⁷ Goldman, *Petrostate: Putin, Power and the New Russia* (2010).; Price, 2007.

oligarchic enterprises. Therefore, while the tax reform did result in a more clear and efficient tax collection mechanism, this is undermined by the reform's selective enforcement.

During the 1998 crisis, the government passed both containment and resolution reforms, yet the former were far more effective than the latter. Furthermore, the crisis containment reforms, although successful, undermined the implementation of successful resolution measures.²²⁸ This is because they maintained soft-budget constraints and reinforced the social economy, when the necessary crisis resolution measures would have imposed hard budget constraints. While it is okay to suspend enforcing regulations temporarily, continually delaying their implementation makes it difficult to fix problems.²²⁹ As Michael Ellman observes, 'The failure to establish a healthy private banking system in the 1990s was one of the biggest failures of the Yeltsin period.'²³⁰ Furthermore, immediate growth post-crisis that weakened the urgency to undertake institutional development. Therefore, the CBR remained partially reformed in the aftermath of the 1998 economic crisis, because none of the reforms targeted weaknesses that caused the crises in the first place.

²²⁸ Laeven and Valencia, 2008. 7.

²²⁹ Steinherr, 2006. 245.

²³⁰ Ellman, 2000.

CHAPTER 6

THE 2008 ECONOMIC CRISIS

This chapter presents a case study that examines how the 2008 economic crisis did not result in crisis modernisation. It is split into three sections. The first analyses the causes of the crisis and highlights the opportunities for crisis modernisation. This section is particularly important, as it demonstrates that the underlying cause for both the 1998 and 2008 crises is poor development of the banking sector and its regulation. Second, it enumerates and evaluates the crisis containment and crisis resolution measures implemented to stabilise the economy in the wake of the crisis, and how they differ from the 1998 economic crises. Finally, it synthesises these two components by testing three hypotheses. These hypotheses measure whether the responses to the crisis were appropriate, if they were implemented efficiently and effectively, and thus, whether institutional development has taken place. The chapter concludes that while the most measurable change that can be observed is in the consolidation of the Central Bank of Russia and the Federal Financial Market Service's regulatory powers, it does not amount to crisis modernisation and the CBR remains limited by its partially reformed institutional capacities.

The 2008 economic crisis was like the 1998 crisis in that both were banking crises, yet in both cases the Central Bank of Russia (CBR) failed to enact proper crisis resolution measures by addressing the vulnerabilities within the banking sector. There were many differences between the 1998 and 2008 crises: there was no sovereign debt crisis as the government had exercised reasonable fiscal discipline during the oil boom; there was no currency crisis as the ruble was not artificially inflated (although it did depreciate considerably); the government had not been relying on bonds and securities to finance the budget; and both crises were caused by external factors. However, the exogenous shock of both the 1998 and 2008 crises highlight the fundamental vulnerability that makes the country not only susceptible to crises, but makes the effects worse than they need to be: poor development of the banking sector. As such, the failure to consistently address systemic weaknesses perpetuates partial reform and undermines critical junctures wherein the banking sector could be strengthened. This is particularly important as many scholars overlook the fact that both crises were exacerbated by exogenous shocks that expose systemic weaknesses.¹ In fact, Putin himself stated, 'We have had no liquidity crisis

¹ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009.; Richard E. Ericson, "The Russian Economy in 2008: Testing the "Market Economy"," *Post-Soviet Affairs* 25, 3. (2009): 209-31.

and no mortgage loan crisis of a kind that some European and American markets experience. We did not have it, we have avoided it.²

Before analysing the CBR and government's responses to the crisis, we will first examine how this crisis qualifies as a banking crisis, and the ways in which it differs from the 1998 crisis. This is important as different crises necessitate different responses, yet the fundamental causes of both crises and the response to them remains the same. This chapter will first examine the similarities and differences between the 1998 and 2008 crises. Next, we will analyse the crisis containment and crisis resolution responses that were undertaken. Finally, we will use this analysis to test the three hypotheses to demonstrate that the null hypothesis is true, and that the 2008 economic crisis did not result in crisis modernisation.

6.1 The 2008 economic crisis

The 2008 economic crisis was a banking crisis caused by Russia's corporate debt, and exacerbated by a rapid decline in oil prices. Reinhart and Rogoff define the characteristics of banking crises as: large-scale mergers or takeovers by the state, accompanied by large-scale government assistance to important institutions that sets off a similar pattern of assistance throughout the sector.³ Similarly, Laeven and Valencia define a banking crisis as an increase in financial and corporate sector defaults as banks and corporations struggle to meet debt obligations, and financial market capital is exhausted.⁴ This is an important distinction as these definitions fit Russia's experience of the 2008 economic crisis. The government and Central Bank of Russia largely ignored the role banks played in causing the crisis, instead blaming it on the USA and the decline in oil prices. Understanding this is fundamental to analysing the state and CBR's approach to crisis containment and crisis resolution, and how it failed to address the causes of the crisis.

Initially, the 2008 crisis did not hit Russia the same way it did other states because oil prices did not start to decline until late 2008. Furthermore, the crisis exposed just how much the state was reliant on gas and oil revenues to support economic growth. The largest contributing factor to Russia's GDP contraction in 2009 was the rapid decline in gross capital

² Vladimir Putin: Archive of the Official Site of the 2008 - 2012 Prime Minister of the Russian Federation, "Interview Granted by Prime Minister Vladimir Putin to the French Newspaper Le Figaro," Office of the Prime Minister of the Russian Federation, <http://archive.premier.gov.ru/eng/events/news/1903/>.

³ Reinhart and Rogoff, 2011. 1680.

⁴ Laeven and Valencia, 2008. 5. As discussed in chapter two.

investment, not a fall in domestic consumption.⁵ This signifies that the banking sector was not investing in long-term projects, which undermines economic dynamism and growth. Thus, if there were few long-term investments in the years preceding and during the crisis, then economic growth was driven by gas and oil rents. As such, without these revenues, the economy collapsed. The projected GDP contraction for 2009 was 4.5 percent, but the actual contraction was 7.9 percent after an average of 8.2 percent growth per year since 2000.⁶

Because of gas and oil rents, the state was unconcerned with actively attracting investment of any kind, but was especially hostile to foreign investors. This is because, as discussed in chapter three, the Putin administration embarked on renationalising the economy and using rents from these industries to develop and modernise the economy. Thus, foreign investors were crowded out as the government limited potential investment opportunities and expanded its own presence. For example, from 2004 to 2006 the state acquired the controlling stake of an additional 22 companies either by increasing a minority share it already held or securing the majority share in a private firm.⁷ Furthermore, the number of banks directly and indirectly controlled by the state increased from 35 to 47 between 2000 and 2009. In fact, from 2003 there was an increase in raiding, defined by Sakwa as ‘the hostile attack of one corporate entity against another, often accompanied by physical raids by armed state organs.’⁸ The Khodorkovsky affair was one of the earliest, and remains the most famous, of the raiding cases to date.⁹ As a direct consequence of raiding and other instances of renationalisation, the private sector’s share of GDP fell from 70 percent in 2004, to 65 percent in 2006.¹⁰

Additionally, raiding cases, as well as the general renationalisation of the economy, have undermined the security of property rights in Russia, which is a serious disincentive to long-term investment for domestic investors.¹¹ This was further reflected in the World Bank’s ‘Ease of Doing Business’ survey, which released its first official world ranking in 2007, ranked Russia as 97th out of 175 countries for 2006, and as 96th for 2007.¹² What is even more telling

⁵ Zeljko Bogetic, "Russian Economic Report No. 20" Washington DC. The World Bank Group, 2009. 2.

⁶ Zeljko Bogetic, "Russian Economic Report No. 17" Washington DC. The World Bank, 2008. 25.; The World Bank. "Percent Change in Russian Federation GDP Per Year 1991 - 2012." 2012.

⁷ Andrei Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," *Eurasian Geography and Economics* 53, 2. (2012): 250 - 66. 252.; Hanson, 2007. 873.

⁸ Sakwa, "Systemic Stalemate: Reiderstvo and the Dual State," 2013. 73.

⁹ Richard Sakwa, *Putin and the Oligarch: The Khodokovsky - Yukos Affair* (I.B. Tauris, 2014).

¹⁰ Saul Estrin et al., "The Effects of Privatisation and Ownership in Transition Economies," *Journal of Economic Literature* 47, 3. (2009): 699 - 728. 700.

¹¹ Hanson, 2007. 876.

¹² The World Bank, "Doing Business 2007: How to Reform" Washington DC. The World Bank, 2006. The ‘Ease of Doing Business’ report series began publication in 2003. However, it was not until 2006

about these rankings is that on individual measures, Russia ranked 159th for ease of getting credit, 163rd for ease of obtaining licenses, and 143rd on ease of trading across borders.¹³ Hanson illustrates that the lack of trust in Russia's economy in the mid-2000s is demonstrated by the amount of capital flight from Russia alongside an increase in foreign borrowing.¹⁴ This signifies that Russians do not trust the economy enough to invest long-term. Making matters worse, in April 2008, a few months before the crisis hit, 'The Law on Foreign Investment in Strategic Sectors' was passed.¹⁵ This law listed 42 industries that required state approval before any foreign investment could take place.¹⁶ This raised concerns of further national control over certain sectors of the economy, particularly in hydrocarbons and minerals.¹⁷ The result was a 39 percent decline in FDI between 2008 and 2009, which prompted the government to begin discussing relaxing the legislation.¹⁸ This became yet another motivation for the state to rely on external borrowing to compensate for the decline in FDI, as discussed above.

As a result, in the years immediately preceding the 2008 economic crisis, Russia's banks were heavily indebted both to domestic and foreign lenders borrowing an estimated \$115 billion annually.¹⁹ A higher refinancing rate a few months before the crisis hit drove banks to increase borrowing from abroad, increasing Russia's private foreign debt by 70 percent in the span of a few weeks.²⁰ By June 2008, total external borrowing had reached \$200 billion or 40 percent GDP.²¹ Importantly, the majority of this debt was short-term loans, or loans of one to three years.²² Furthermore, the average loan-to-deposit ratio in 2008 was 125 percent, signalling both a reliance on foreign banks and increasing sector wide vulnerability.²³ This creates a problem because although the Russian economy had been steadily growing since the 1998 crisis, this growth was driven by oil prices rather than demand or increased productivity

that it included a list ranking all countries in the study from best to worst, as opposed to the best and worst ten.

¹³ Ibid. 137.

¹⁴ Hanson, 2007. 873.

¹⁵ Bogetic, "Russian Economic Report No. 17," 2008. 12.

¹⁶ Silvana Malle, "The Policy Challenges of Russia's Post-Crisis Economy," *Post-Soviet affairs* 28, 1. (2012): 66-110. 94.

¹⁷ Bogetic, "Russian Economic Report No. 17," 2008. 12.

¹⁸ Malle, 2012.

¹⁹ Sergey Aleksashenko, "Russia's Economic Agenda to 2020," *International Affairs* 88, 1. (2012): 31-48. 36.

²⁰ Jacques Sapir, "What Should Russian Monetary Policy Be?," *Post-Soviet Affairs* 26, 4. (2010): 342-72. 354.

²¹ Richard Connolly, "Financial Constraints on the Modernisation of the Russian Economy," *Russian Economy, Eurasian Geography and Economics* 52, 3. (2011): 428 - 59. 446.

²² Bogetic, "Russian Economic Report No. 17," 2008. 3.

²³ Ibid. 35.

as Russia's economy remained underdeveloped.²⁴ In fact, the GDP contribution of those industries that were stimulated by the import substitution effect in the wake of the 1998 ruble devaluation (such as food production, metallurgy, chemical production, and so on) declined from 45 to 50 percent between 1998 and 2000, to about 15 percent between 2001 and 2002.²⁵ Even where domestic demand for consumption and investment is a driver of growth, it is fuelled by rising oil prices that increase personal incomes.²⁶ Thus, because the state becomes so reliant on oil and gas prices instead of more domestic, consumer demand based industries, when the price of oil drops, there are few resources for banks to meet their mounting debt obligations.

The oil boom of the early 2000s was used to boost Russia's credit rating as windfalls were saved in the Stability Fund and pay off sovereign debt, which helped demonstrate strong macroeconomic fundamentals. Banks then used this reputation to secure loans from foreign banks and investors.²⁷ If oil prices stayed high, banks would be able to retain investors and repay their loans.²⁸ Additionally, the strong credit rating, a low level of sovereign debt, significant international reserves, and the CBR's raising the interest rate when other states were lowering them, made Russia appear like a safe haven for investors.²⁹ However, this led to economic overheating as the output and production failed to match the rapidly rising value of the ruble, which was overvalued by nearly ₺20 to \$1.³⁰ As such, the Russian economy entered the 2008 economic crisis when the price of oil dropped from \$150 per barrel in July 2008 to \$65 per barrel in October 2008. Investors began to withdraw, and capital flight increased.³¹ To make matters worse, a nearly \$11 billion decline in foreign direct investment in 2008 was supplemented by external borrowing.³²

The way Russia's banking system is structured strongly encourages external borrowing, because there are few sources of domestic non-bank financing compared with a variety of foreign lending.³³ In fact, getting credit is one of the largest hurdles for current and would-be

²⁴ Connolly, 2011. 428.

²⁵ Aleksashenko, 2012. 35.

²⁶ Hanson, 2007. 871 – 872.

²⁷ Clifford G Gaddy and Barry W Ickes, "Russia after the Global Financial Crisis," *Eurasian Geography and Economics* 51, 3. (2010): 281-311. 289.

²⁸ *Ibid.*

²⁹ Bogetic, "Russian Economic Report No. 17," 2008. 2.; Sapir, 2010. 349 – 350.

³⁰ Sapir, 2010. 450, Figure 2.; Bogetic, "Russian Economic Report No. 17," 2008.1.

³¹ Robert Ortung, "Russian Political System Faces Significant Challenges Dealing with Economic Crisis," *Russian Analytical Digest* 40, (2008): 8 - 12. 8 – 9.

³² Bogetic, "Russian Economic Report No. 17," 2008. 11 – 12.

³³ Connolly, 2011. 450.

investors in Russia.³⁴ As such, banks borrowed too much short-term debt, creating a large roll-over risk that was magnified by the decline in oil prices.³⁵ Furthermore, the risk of default increased from zero to 20 percent in seven years as risk management deteriorated with the creation of the Deposit Insurance Agency.³⁶ Finally, Russia's overly large, fragmented, and poorly regulated banking sector remained a source of economic vulnerability. In 2008, there were 1,172 banks in Russia, but only 1,058 of these had a license to operate from the CBR.³⁷ Yet, Sberbank and 46 other state controlled banks held 57.4 percent of household deposits, and 46.4 percent of household loans.³⁸ Of the smaller banks, some were attached directly to corporations and undertook banking practices exclusively for their employees, such as issuing or cashing pay cheques. However, many others were shell banks used to abet capital flight and money laundering.³⁹ These banks had access to both domestic and international lines of credit. Yet, because these banks did not engage in regular banking activities, they did not have the necessary commercial deposits, reserve requirements, or collateral to support themselves.

As such, this highlighted the need for the CBR to address the plethora of banks and their practices, and its ability to effectively regulate the sector. Furthermore, although the 2008 crisis was a private debt crisis, that does not absolve the state of responsibility. As the state controlled the largest banks, as well as most of the banking sector, then a good portion of the debt that caused economic instability was borrowed by these banks, and by extension the state itself. Addressing these problems, then, would require the CBR to become a more effective regulator with clearly defined authority over both private and state controlled banks. It would need to assess the quality of banks' assets and ensure they meet reserve requirements; improve risk assessment to decrease moral hazard; and diversify sources of liquidity to discourage banks from borrowing abroad.⁴⁰ To tackle some of these issues, the CBR merged with the Federal Financial Market Service in 2013, to increase the former's regulatory authority. In theory, this appears to be a promising start of institutional development, even if it

³⁴ As per every Ease of Doing Business survey, which is discussed below.

³⁵ Zeljko Bogetic, "Russian Economic Report No. 19" Washington DC. The World Bank Group, 2009. 11.

³⁶ OECD, "Making the Banking Sector More Efficient and Resilient" OECD, 2009. 106.

³⁷ The Central Bank of the Russian Federation, "Information on Registering and Licensing of Credit Institutions " <https://www.cbr.ru/Eng/statistics/?PrtId=lic>.

³⁸ Vernikov, 2012. 257. Table 2.

³⁹ Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," 1994. 986.; OECD, "Making the Banking Sector More Efficient and Resilient," 2009.

⁴⁰ Sapir, 2010. 364.

is too late to be considered crisis resolution. However, there is little strong evidence to support this, which will be discussed below.

The Russian financial crises of 1998 and 2008 are largely incomparable as the country suffered different effects during both. Russia suffered more from the effects of the 2008 crisis than the 1998 crisis because of the lack of control that the government had over the crisis, the slowness of the economy to recover, and the uncertainty of future growth. While the rapidity of the 1998 crisis's 6.4 percent decline in GDP was more severe, it grew by six percent the following year.⁴¹ Conversely, the 2008 crisis did not immediately hit Russia, and it was two years before the economy experienced a low 3.5 percent growth. Furthermore, the sustainability of this growth was questionable as the government continued to depend exclusively on the energy sector despite the rhetoric of fostering economic diversification.⁴² On the one hand, Russia was a victim of the 2008 global financial crisis rather than an instigator, because it was not government insolvency that caused the crisis. Yet, the economy was vulnerable to the crisis because of irresponsible and unregulated borrowing on the part of private banks. As such, the 2008 crisis has more far-reaching implications for institutional development than the 1998 crisis.

In 1998, Russian debt was overwhelmingly the result of years of poor fiscal policies. This debt had accumulated for several reasons: economic stagnation, poor fiscal and monetary policies, relying on the sale of treasury bonds to compensate for monetary and fiscal shortcomings, mounting wage arrears, and a pegged exchange rate that was hiding inflation costs.⁴³ As a result, investor confidence eroded and the government was forced to devalue the ruble and suspend all loan payments. Second, while the 1997 Asian financial crisis certainly played a role in increasing investor sensitivity to the Russian financial market, it was the instability of the Russian government's fiscal and monetary policies, and an unregulated banking sector exposed by the crisis, that caused the most damage. Finally, oil prices rose drastically in 1999, leading to economic recovery, illustrated by rapid GDP growth, reaching 12 percent growth by the end of 1999.⁴⁴

In contrast, the debt that made Russia susceptible to the 2008 crisis was private rather than public. Because banks had borrowed money both domestically and abroad, the economy

⁴¹ Chiodo and Owyang, 2002..

⁴² Sergei Ulatov and Zeljkov Bogetic, "Growth with Moderation and Uncertainty" Washington DC. The World Bank Group, 2010. 17.; Aleksashenko, 2012.

⁴³ Chiodo and Owyang, 2002. 8, 15.

⁴⁴ Zeljko Bogetic, "Russian Economic Report No. 18" Washington DC. The World Bank Group, 2009. 8. Assuming this is representative of fourth quarter growth only.

was more susceptible to the effects of the global financial crisis.⁴⁵ As global and domestic demand decreased, businesses and enterprises could not earn the profits needed to meet their loan payments, sending them into default. Thus, the economic decline that Russia experienced in the 2008 crisis is just severe if not more so than that of 1998, it just did not manifest itself as violently.⁴⁶ Russia lost USD 1 trillion in 2008 and its GDP shrank by 7.9 percent in 2009 from an average of seven to eight growth per year since 2000. Whereas the GDP only shrank about 6 percent in 1998 and recovered a year later.

Thus, the challenges posed by the 2008 economic crisis were different from those in 1998 as the latter was a triple crisis, and the former is a straight-forward banking crisis. Banking crises are difficult to resolve, and this is made even harder when the state owns or controls most of the banking sector.⁴⁷ First, to resolve the crisis, the state needed to restructure the sector by selling its assets to private interests. This would make the sector more efficient and profitable by consolidating and liquidating inefficient and insolvent banks. Additionally, this would implement hard budget constraints where the state struggled to do so. Second, the CBR must increase its regulatory abilities. Privatisation would directly contribute to this because it would allow the CBR more effectively regulate the sector by removing its direct interest as an economic player. As such, for crisis modernisation to arise out of the 2008 economic crisis these two issues, privatisation and regulation, must be addressed through crisis resolution. However, because the state itself was not the immediate cause of the problem, which was reinforced by its ability to provide the necessary liquidity to keep the economy stable, the state undertook very little crisis resolution at all. Instead, it focused primarily on liquidity measures through crisis containment, which contributed to poor economic recovery as it allowed unprofitable banks and enterprises to remain operational. The following section will analyse the crisis containment and crisis resolution measures enacted to manage the 2008 economic crisis.

6.2 Crisis containment and resolution measures 2008

This section will analyse the crisis containment and crisis resolution measures undertaken by the Central Bank of Russia and the Medvedev government. This will provide the basis to determine whether the 2008 economic crisis resulted in crisis modernisation using the three hypotheses stated in chapter two: was the CBR and government able to undertake the necessary

⁴⁵ Ibid. Box 1.2, 8.

⁴⁶ Bogetic, "Russian Economic Report No. 19," 2009. Box 1.3, 11.

⁴⁷ Laeven and Valencia, 2008. 18. See chapter two for more details

and appropriate measures to resolve the crisis; were these measures undertaken in a timely and efficient manner; and did the implementation of these measures result in institutional development by changing behaviours and expectations. Overwhelmingly, little crisis modernisation resulted from 2008 crisis resolution, as few measures that could result in institutional development are undertaken. The Central Bank and government focused primarily on liquidity assistance, with most measures aiming to increase the ease with which the state could inject funds or create more liquidity. The Stabilisation Fund was used to help stabilise the banking sector from the moment the crisis began in mid-2008.⁴⁸ While all states undertook some form of liquidity assistance to cope with the 2008 crisis, Russia spent seven percent of its GDP on stimulus programmes, which was higher than the international recommendation of no more than two percent.⁴⁹ Yet, these measures both increased state control in the economy and undermined fundamental market principles, such as hard budget constraints. Thus, the following analysis provides little evidence to support the hypotheses.

In the first part of this section, we will analyse the following crisis containment measures and how they were implemented: liquidity assistance, regulatory forbearance, and bank holidays. Furthermore, the negative effects of these measures and how they undermined future economic growth will be discussed. Second, this section examines the crisis resolution measures government owned asset management, bank restructuring, privatisation, and increasing the CBR's regulatory powers. Specifically, this section demonstrates that the government did not actively undertake these measures, and that the failure to do this undermined the development of the banking sector as it became more reliant on the state. Whereas the CBR struggled to implement crisis resolution in 1998, there appears to be little evidence of active crisis resolution on the part of either the government or the Central Bank in 2008. To this, a qualitative analysis of the CBR and government's actions is derived from a combination of various economic reports, statistics, and other scholarly sources. This provides enough evidence to test the three hypotheses in the next section to determine that crisis modernisation does not occur.

2008 Crisis containment

As the CBR remained a relatively weak institution after the 1998 crisis, it is expected that it would rely on containment measures rather than resolution measures, as the latter are harder to

⁴⁸ Malle, 2012.; Gaddy and Ickes, 2010.; OECD, "Making the Banking Sector More Efficient and Resilient," 2009.

⁴⁹ Bogetic, "Russian Economic Report No. 18," 2009. 11.

implement. There were no bank holidays, deposit freezes, or strict capital controls. The crisis containment measures during the 2008 crisis primarily focused on liquidity assistance and regulatory forbearance, which was paid for by the government and CBR. In fact, Russia provided more liquidity assistance to banks and enterprises than any other G20 state, spending more than ₺29 trillion, or 6.7 percent of its GDP, well over the recommended two percent GDP by early 2009.⁵⁰ These policies primarily benefited those banks and enterprises that were directly and indirectly state-owned, by buying up their debt, and / or delaying tax deadlines and lowering tax rates.⁵¹ There was little to no assistance to households, and private industry also struggled with many banks, such as Globex and Sobin Bank, being bought by the state to avoid insolvency. Thus, rather than diversifying and safeguarding the private sector, or protecting households from the effects of the crisis, the containment measures were undertaken to protect the state's own interests and reinforcing the social economy in the process. In the end, these measures were soft budget constraints that afforded the state nothing but the ability to delay institutional development.

i) Liquidity assistance. Liquidity assistance was provided by the government, the Ministry of Finance, and the CBR. In total, over \$100 billion was spent on stabilising the ruble, reducing the rollover risk, offering low interest rate loans, and generally bailing the state out of the economic crisis.⁵² Most of this money came from the National Wealth Fund and the Stability Fund, totalling \$35.4 billion by March 2009, which was half of the 2009 crisis budget set in 2008.⁵³ The CBR flooded the market with ₺1.9 trillion worth of cheap, unsecured loans, draining one-third of the CBR's reserves.⁵⁴ Additionally, the Central Bank spent ₺300 billion on Lombard loans to strategically important firms, mortgage backed bonds, ₺2.4 trillion on further uncollateralised loans, and ₺220.2 billion in repo loans in 2009.⁵⁵ Currency swaps and

⁵⁰ Ibid.

⁵¹ Neil Robinson, "Russian Patrimonial Capitalism and the International Financial Crisis," *Journal of Communist Studies and Transition Politics* 27, 3-4. (2011): 434-55. 450.

⁵² Ericson, 2009. 221.; Gaddy and Ickes, 2010. 301.; Sakwa, *Putin Redux: Power and Contradiction in Contemporary Russia* (2014). 6.;

⁵³ Bogetic, "Russian Economic Report No. 19," 2009. 9.

⁵⁴ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113.; Sapir, 2010. 349.

⁵⁵ The Central Bank of the Russian Federation, "Banking Supervision Report 2009" Moscow. The Central Bank of Russia, 2009. 36.; The initial repo loan offerings in 2008, were as much as ₺430 billion, although it was unnecessary as the worst of the crisis had not yet hit. See Bogetic, "Russian Economic Report No. 17," 2008., for more.

cost the CBR a further ₺1.91 trillion in 2008, though this declined to ₺540 billion in 2009.⁵⁶ After spending \$100 billion trying to stabilise the ruble, it lost 20 percent of its value in two months.⁵⁷ The state and CBR also promised to compensate banks who suffered losses on interbank loans, and provided ₺700 billion to compensate banks for losses on corporate loans.⁵⁸ Finally, the CBR provided liquidity for banks by depositing budgetary funds in their accounts for up to three months, totalling ₺1.79 trillion in 2008, and ₺690 billion in 2009.⁵⁹ This figure would rise substantially as these deposits were converted to uncollateralised loans.⁶⁰

Half the cost of the crisis was spent on bailing out and merging with banks (discussed below), costing 3.3 percent of GDP by early 2009.⁶¹ The CBR began by increasing the interest paid to banks for maintaining their deposit accounts to both decrease the need for banks to use the funds in said accounts, but also as an incentive not to do so.⁶² Liquidity totalling ₺60 billion for Gazprombank, Sberbank and VTB was announced as early as September of 2008, and measures later that year would include ₺725 billion for Sberbank, VTB, and Rosselkhozbank.⁶³ For VEB alone, the CBR allocated most of a \$3 billion general liquidity injection, as well as a recapitalisation deposit of \$50 billion to reduce its loan roll-over risk.⁶⁴ VEB was given ₺450 billion to provide subordinated loans to banks other than Sberbank, which itself was given ₺500 billion for the same purpose.⁶⁵ For example, VEB used these funds to inject \$2.5 billion of liquidity into Svyaz Bank, and \$2 billion into Globex in late 2008.⁶⁶ In this capacity, we begin to see large state owned banks use CBR and government liquidity to merge with or invest in failing banks as a means of supporting them, which will be discussed in the crisis resolution section.

The sheer cost of liquidity assistance demonstrates that Russia's economic efficiency

⁵⁶ The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 36. It should be noted that this decrease in currency swaps is not due to ruble stabilisation, rather it is because the CBR gave up trying to stabilise the ruble. For more information, see Aleksashenko, 2012. 42.

⁵⁷ Ericson, 2009. 221.

⁵⁸ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113.; Bogetic, "Russian Economic Report No. 17," 2008. 31. The state's insuring of corporate loans only applied to state owned corporations, which comprised 70 percent of total outstanding loans.

⁵⁹ Bogetic, "Russian Economic Report No. 17," 2008. 30.; The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 36.

⁶⁰ Aleksashenko, 2012. 42.

⁶¹ Bogetic, "Russian Economic Report No. 18," 2009. 9.

⁶² OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113. Box 4.4.

⁶³ Bogetic, "Russian Economic Report No. 17," 2008. 29.

⁶⁴ *Ibid.* 19, 31, 32.

⁶⁵ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113.

⁶⁶ Bogetic, "Russian Economic Report No. 17," 2008. 30.

has not improved since 1998. The government and CBR spent ₺5 trillion bailing itself out of the economic crisis, more than most other countries, and it still suffered one of the worst GDP contractions, 7.9 percent. This was not only worse compared to more developed countries, but also compared to countries with similar economic profiles such as Brazil, China, and India, with the latter two experiencing economic growth from 2009.⁶⁷ Furthermore, capital flight increased significantly during the crisis, suggesting that not an insignificant portion of funding was funnelled out of the country.⁶⁸ Thus, that the government spend so much on aid that did not successfully protect the economy from the worst of the crisis indicates that the economy is still unable to maximise capital inputs, and undermines the idea that the elites are investing in the economy.

Finally, the government's various forms of liquidity assistance that intended to stabilise the economy were ineffective. On the one hand, Russia did not suffer the collapse or insolvency of high profile banks. On the other, very little economic stabilisation occurred. While all countries will use some form of liquidity assistance during a crisis, most of this funding is used to stimulate domestic demand by targeting households via personal income tax cuts and government investment in infrastructure projects, thereby keeping businesses afloat. Russia well outspent most countries, with revenue measures to the banking and financial sector accounting for one-third of the total spent.⁶⁹ The government increased some unemployment benefits, but the crisis containment measures largely ignored the need to increase demand. This was a fundamental oversight as the non-oil economic growth that did occur in the years preceding the crisis was demand driven.⁷⁰ The fall in investment accounted for 14 percent of the GDP contraction, whereas domestic consumption contributed by 4 percent.⁷¹ As such, where demand focused measures stimulated growth and recovery in other countries, Russia's consumer demand did not pick up. One could argue that the because crisis hit Russia so late, its economic growth might be the last to recover. However, as late as 2012, Russia's domestic demand had not recovered.⁷²

There are two main problems with the approach to liquidity assistance as a response to the 2008 crisis. First, liquidity assistance is an emergency measure, not a panacea. The

⁶⁷ Malle, 2012. 75.

⁶⁸ Karen Dawisha, "Is Russia's Foreign Policy That of a Corporatist-Kleptocratic Regime?," *Post-Soviet Affairs* 27, 4. (2011): 331-65. 341.

⁶⁹ Bogetic, "Russian Economic Report No. 18," 2009. 14.

⁷⁰ Bogetic, "Russian Economic Report No. 19," 2009.

⁷¹ Bogetic, "Russian Economic Report No. 20," 2009. 2.

⁷² Aleksashenko, 2012. 37.

government used these measures to stop the crisis from destroying the system, but at the cost of not fixing what made the system so vulnerable in the first place. Even where the CBR does address the weakness in the banking industry, it is as an afterthought and more of a response to how the banks used and abused the stimulus funds rather than an active attempt to strengthen the industry. Second, this massive assistance package did not actually result in proportional economic recovery. Russia still suffered the largest GDP contraction, and it has not recovered since as the 4.5 and 4.2 percent growth for 2010 and 2011 respectively was much lower than the nearly seven percent average leading up to the crisis.⁷³ Liquidity injections targeted strategic industries and banks, and favoured state-owned enterprises and the elites rather than stimulating domestic demand.⁷⁴ This shows not only a fundamental misunderstanding about the causes of the crisis itself, but also the continued reliance on gas and oil rents. Thus, because the government and CBR had the liquidity to bail out financial sector, and because they blamed the crisis on exogenous factors, they assumed that there was no need to undertake reform and that they could ‘pay their way’ out of the crisis.

ii) Regulatory forbearance. In addition to the liquidity assistance measures listed above, the regulatory forbearances allowed during the crisis was also costly for the government and CBR, but provided many banks with additional liquidity. To begin, in September 2008, just as Russia was beginning to feel the effects of the crisis, the CBR cut the reserve requirements for banks.⁷⁵ This provided banks with an extra ₺400 billion in liquidity, but at an estimated cost of ₺300 billion to the CBR.⁷⁶ Reserve requirements were cut again in October 2008, but this time the CBR extended the cut until early 2009, costing an additional ₺100 billion.⁷⁷ As the crisis deepened, the CBR allowed banks to average all their required reserves to meet the lower minimum reserve requirements and mitigate the increasing roll-over risk.⁷⁸ The cuts to the

⁷³ The World Bank. "Russian GDP Growth 1991 - 2012." 2012.; McFaul and Stoner-Weiss, 2008. This will be further explained in chapter seven.

⁷⁴ Neil Robinson, "The Contexts of Russia's Political Economy: Soviet Legacies and Post-Soviet Policies," in *The Political Economy of Russia*, ed. Neil Robinson (Maryland: Rowman & Littlefield Publishers, Inc., 2013). 44.

⁷⁵ Bogetic, "Russian Economic Report No. 17," 2008. 29.

⁷⁶ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113, Box 4.4.; Bogetic, "Russian Economic Report No. 17," 2008. 29.

⁷⁷ Bogetic, "Russian Economic Report No. 17," 2008. 31.

⁷⁸ The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 37. Banks in Russia are issued with banking licenses that include special permissions for various activities, and each activity has a different reserve requirement. For example, banks who want to undertake activities in rubles and foreign currency must have capital reserves of ₺900 million, in addition to the ₺180 million

reserve requirements were held in place until 2011, and the ability to average reserves to be maintained until 2010.⁷⁹

The CBR also worked with the Deposit Insurance Agency (DIA) to suspend regulations and create more liquidity for the banking sector by decreasing, and in some instances delaying, insurance payments.⁸⁰ To assuage concerns that this could risk the security of commercial and household deposit accounts, the DIA increased insurance limits from ₱100,000 and ₱400,000, to ₱200,000 and ₱700,000.⁸¹ Given the accusations of capital flight, this was a very costly move for both the CBR and the DIA, as it was more expensive to bailout banks when liquidity injections were not being used for restructuring.

The CBR and government also made several fiscal forbearances. The most prominent was cutting different taxes, particularly the Mineral Excise Tax and export taxes to the hydrocarbon industry in 2008, which cost the government more than ₱200 billion in lost revenue.⁸² These measures were extended as the crisis deepened, aiming to both supply the industry and its banks with more liquidity, and to attract more investment.⁸³ Again, this did not have the intended effect as it helped relieve pressure on the hydrocarbon industry without taking additional measures to stimulate demand in that industry. Various organisations demonstrated that the revenue would have been better spent on infrastructure investments or social spending.⁸⁴ Additionally, the CBR extended repayment schedules and suspended lending requirements in order to provide banks with the additional liquidity discussed above.⁸⁵ For example, uncollateralised Lombard loans were extended for up to 365 days, and 90 repo loans were extended for up to a year.⁸⁶

The various forbearances were extended until 2011, well after the crisis ended.⁸⁷ Banks remained undercapitalised, and the quality of the capital that banks possessed was hard to assess.

required to undertake basic banking practices. For more information, see The Central Bank of the Russian Federation, "Registration of Credit Institutions and Licensing of Banking Activities"..

⁷⁹ The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 37.

⁸⁰ Bogetic, "Russian Economic Report No. 17," 2008. 30.; The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 37. The Deposit Insurance Agency (DIA) was created to insure household and commercial deposits in 2005. It is not mandatory for banks to belong to the DIA, and as of July 2017, 792 out of 900+ banks are members. For more, see The Deposit Insurance Agency, "About the DIA," The Deposit Insurance Agency, <https://www.asv.org.ru/en/dia/>.

⁸¹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113, Box 4.4.; Bogetic, "Russian Economic Report No. 17," 2008. 30.

⁸² Bogetic, "Russian Economic Report No. 17," 2008.28 – 32

⁸³ Bogetic, "Russian Economic Report No. 19," 2009.10.

⁸⁴ Ibid.11.

⁸⁵ The Central Bank of the Russian Federation, "Banking Supervision Report 2009," 2009. 36.

⁸⁶ Ibid. 36.

⁸⁷ Ulatov and Bogetic, 2010. 16.

Additionally, up to 15 percent of loans in between 2010 and 2012 were uncollateralised, which was almost double the eight percent of uncollateralised loans in 2005.⁸⁸ This is a problem as studies demonstrate that the failure to reintroduce regulatory prudence in a timely manner increases the stress on the banking sector and the real economy.⁸⁹ This is what happens to Russia in the aftermath of the crisis: the CBR struggles to reinforce prudential requirements and asset quality, and the government struggles to reinstate taxation mechanisms.⁹⁰ As such, while the regulatory forbearance measures were successful in reducing the stress on the banking sector and provided it with non-inflationary liquidity, it has been more detrimental over the long-term and allowed the banking system to remain vulnerable.

iii) Deposit freeze/ bank holiday. There was neither an implicit nor explicit bank holiday as there was in 1998. The priority was to maintain depositor and investor confidence, and implementing a bank holiday would have drastically undermined that. However, there is some debate over whether capital controls were introduced. Officially, the CBR implemented controls on currency swaps that would vary daily, depending on the exchange rate, to combat currency speculation.⁹¹ This would qualify as capital control as it was used to control the exchange rate and prevent money from leaving the country. However, Jacques Sapir and Sergei Aleksashenko argue that these restrictions were not capital controls because the CBR was relying on the interest rate to stabilize the exchange rate and inflation simultaneously.⁹² Both say that these actions undermine both objectives as they contradict the reasoning behind pegged exchange rate, thus implying that the currency is unstable.⁹³ Additionally, this policy is ill-suited to a currency whose value is tied to the price of one volatile commodity.⁹⁴

While Sapir and Aleksashenko are not incorrect in their assessment of the CBR's misguided attempts to manage inflation, the measures taken in 2008 are not merely an extension of these policies. Pegging the ruble and managing the money supply was indeed the most effective tool the CBR had to combat inflation, and this remained the main policy until

⁸⁸ The World Bank. "Global Financial Development Database," Washington DC. 2017.

⁸⁹ Laeven and Valencia, 2008. 30.; Calomiris, Klingebiel, and Laeven, 2003.

⁹⁰ Aleksashenko, 2012. 46.; The International Monetary Fund, "Russian Federation Financial Assessment Programme: Technical Note — Bank Resolution and Crisis Management Programme" Washington DC. The International Monetary Fund, 2016. 7.

⁹¹ Bogetic, "Russian Economic Report No. 17," 2008. 31.

⁹² Aleksashenko, 2012. 40 – 43; Sapir, 2010. 357.

⁹³ Aleksashenko, 2012. 41.; Sapir, 2010. 351.

⁹⁴ Aleksashenko, 2012. 41.

November 2014, when the CBR unexpectedly floated the ruble.⁹⁵ Yet, the additional restrictions during the 2008 crisis were specifically implemented as a means of trying to slow the ruble's depreciation, which had increased by 10 percent in September 2008, then another 10 percent in October.⁹⁶ Thus, the controls on currency swaps were intended as capital controls. In the end, this did not help stabilize the currency as it continued to devalue, and CBR had to widen the currency board to defend it without draining all its reserves to do so. The problem is that while the CBR and government undertook the above listed measures as a means of instilling confidence in investors, they had the opposite effect: the ruble still depreciated significantly and capital flight still increased. As such, this only contributed to the 7.9 percent GDP contraction that occurred in 2009.

The containment measures undertaken during the 2008 economic crisis overwhelmingly focused on liquidity assistance, with other measures aimed at finding additional sources of revenue for the banks and spending over \$100 billion. In the end, while the government succeeded in preventing the banking system from collapsing, it failed to contain the effects of the crisis. Additionally, it demonstrates a lack of understanding or naiveté of what made Russia vulnerable to the crisis in the first place, as evidenced by Putin's assertion the crisis was the United States' fault. However, these measures are also evidence of the CBR and government's inability to reform the banking system. Rather than using liquidity assistance to support the sectors most viable banks and shut down those that are draining resources, the measures targeted all banks, particularly those owned by the state. Instead of using the reinforcement of regulations as a means of bank restructuring, forbearance was extended well after recovery began to take place, which only hurt the possibility of future growth. As opposed to using the crisis as a means of developing new tools for lowering inflation and stabilizing the exchange rate, the CBR continued to rely on methods that contradict their stated goals. As such, the state is protecting its own interest rather than the interest of the banking sector, and economy, which is a poor foundation for crisis resolution.

2008 Crisis resolution

The Central Bank and government did not consider the 2009 crisis to be a banking crisis because there was enough revenue to bailout the banks. As such, there was little focus on crisis resolution. However, there were several de facto crisis resolution measures that took

⁹⁵ Ibid. 40.

⁹⁶ Ericson, 2009. 221.; Alexander Winning, "Russia's Rouble Steady after Central Bank Float," *Reuters*, 12 November 2014.

place. The primary measure was the use of state owned banks to merge with and take over failing banks, thereby increasing the state's share of the banking sector. As a result, there was little need to restructure the banks or the banking sector because the state had more direct control over them. Because of this, there was no effort to privatise either as a resolution measure or once recovery began. Therefore, the main areas of crisis resolution were ignored and very little institutional development or crisis modernisation takes place.

i) Government owned asset management. The government owned asset management programme enacted in 2008 appears to be a means of increasing state control over the banking sector. Government owned asset management normally involves the state taking control over insolvent or non-performing banks to restructure and resell them. While, the 1998 economic crisis did not see much government owned asset management either by official measure or default, the government enacted several measures to undertake asset management in 2008. The Russian economy was slowly renationalised from 2000, and then more aggressively from 2004, as a part of Vladimir Putin's plan to control the state's strategic industries.⁹⁷ The percentage of private sector's share of GDP was steadily increasing until 2002, when it reached 70 percent, but declined to 65 percent by 2004.⁹⁸ At the beginning of the crisis in 2008, the state's share of GDP was 50 percent, and rises to 75 percent if you include the indirect control the state had in many banks and enterprises.⁹⁹

In September 2008, the government amended the 2008 - 2010 budget to allow liquidity from the National Wealth and Stability Funds to purchase shares of underperforming and insolvent banks. VEB was allocated ₺75 billion in 2008 and ₺175 billion in 2009, the Deposit Insurance Agency was allocated ₺200 billion in 2008, and the State Mortgage Agency was allocated ₺60 billion also in 2008.¹⁰⁰ By the end on 2008 alone, the government controlled half the banking market, and this share increased to 55.8 percent by 2012.¹⁰¹ Furthermore, according to The Federal Agency for State Property Management, there was no intention of

⁹⁷ Putin. This was discussed in chapter three. For more information, also see Hanson and Teague, 2005.; Tompson, "The Political Implications of Russia's Resource-Based Economy," 2005.; Kryshnanovskaya, 2005.

⁹⁸ Estrin et al., 2009. 700.

⁹⁹ Malle, 2012. 75.

¹⁰⁰ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113. Box 4.4.

¹⁰¹ Andrei Vernikov, "Government Banking in Russia: Magnitude and New Features" Internet. Halle Institute for Economic Research, 2011. 2.; Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," 2012. 253.

privatising state controlled banks as of 2014.¹⁰² Even where the state does not directly control banks, they have still become reliant on the support that comes from indirect control, which reinforces the social economy and creates more opportunities for corruption.¹⁰³ The government argues that it has relinquished some of its control over the economy, including the banking sector since 2010.¹⁰⁴ However, much of this claim comes from the occasional selling of a few shares, but not the controlling share. As such, the state remains in control of much of the industry, as will be discussed in the section on the sale of government managed assets.

The 2008 economic crisis allowed the government to renationalise the banking industry. However, the motives were not to profit from the sector as it did from the national champions, but to shelter the industry from the effects of the crisis and keep banks solvent. This is different to previous Government Owned Asset Management programs both in Russia's past and in other states. Normally, a government will purchase or takeover a failing bank, restructure it, and then sell it. In Russia, the government took over banks that were insolvent to justify providing them with stimulus funds and subsidies during the crisis. In a few cases, the bank regained control after the crisis eased, but many did not. It must be noted that many banks are happy with this arrangement — it absolves them of the responsibility to respond to market pressures, and places them in the hands of the government instead. This will not result in crisis modernisation, because the state's softening of the budget constraints prevents it from taking place. As such, market institutions are unlikely to develop and partial reform equilibrium is maintained.

ii) Bank restructuring. Most bank restructuring that took place during and after the 2008 economic crisis was in the form of mergers and acquisitions of smaller banks by the state. The World Bank argued that these measures were productive and helpful as it consolidated the large and fragmented banking sector that was overpopulated with small banks that did little actual banking.¹⁰⁵ Yet this was not as productive as it may seem at first glance, as little restructuring of the banks ensued. As Frye and Iwasaki argue, state controlled firms, including banks, would

¹⁰² Federal Agency for State Property Management, "Russian Federation Privatization Programme: 2011 - 2013 Privatization Results and Plans for 2014 - 2016" Moscow. Federal Agency for State Property Management, 2014. 9. For privatization to occur, the state would have to lose its controlling share of 50+1 percent in the bank.

¹⁰³ Timothy Frye and Marshall Shulman, "Corruption and Law in Russia: The View from the Firm," in *Russia after the Global Crisis*, ed. Anders; Guriev Aslund, Sergei; Kuchins, Andrew (Washington, DC: Peterson Institute, 2010). 18.

¹⁰⁴ Federal Agency for State Property Management, 2014. 2.

¹⁰⁵ Bogetic, "Russian Economic Report No. 17," 2008. 14.

merge and send government directors to manage them and not to restructure or discipline existing management, but collude and rent-seek.¹⁰⁶ This demonstrates that the state is not taking over firms to rescue or restructure them as a means of crisis resolution.¹⁰⁷ By 2010, the state controlled more banks than it could effectively manage, and little was done to consolidate or restructure them.¹⁰⁸ For example, the state used VTB to merge with Globex in 2009, but this bank would have its licenses withdrawn after the CBR determined that there was a \$1.5 billion discrepancy between the official assets listed and what the bank actually had.¹⁰⁹

Thus, any restructuring that occurred because of these mergers was a beneficial by-product, as there was very little active restructuring of debt obligations and, as discussed above, constant postponing of regulatory reinforcement. Private banks reduced their external debt by \$100 billion by the end of the first quarter in 2009, and up to 23.8 percent of loans had been restructured by the end of July 2009.¹¹⁰ However, banks still owed about \$90 billion in payments for the remainder of the year, and meeting these obligations would prove difficult as non-performing loans continued to mount and liquidity was hard to come by.¹¹¹ By the end of 2010, the long-term performance of restructured loans was questionable, due to banks' under-performance and under-capitalisation.¹¹² Additionally, in March of 2009, no bank had fallen below the ten percent requirement for capital reserves, and in 2011, the CBR attempted to raise reserve requirements by three and three and a half percent for domestic and foreign banks respectively.¹¹³ Yet, the quality of assets used to meet these requirements is unknown and difficult to assess.¹¹⁴ In fact, for all his faults, one of the issues Alexei Navalny exposed was how the assets banks officially declared did not match what they actually had.¹¹⁵ This was reaffirmed by a 2010 report in *Kommersant* that demonstrated that almost half of Russia's

¹⁰⁶ Timothy Frye and Ichiro Iwasaki, "Government Directors and Business-State Relations in Russia," *European Journal of Political Economy* 27, (2011): 642 - 58. 656.

¹⁰⁷ *Ibid.* 642, 656.

¹⁰⁸ Vernikov, "Government Banking in Russia: Magnitude and New Features," 2011. 12.; Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," 2012. 254.

¹⁰⁹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 113.; Courtney Weaver, "Russia's Anatoly Motylyov: Rise, Fall, Repeat," *The Financial Times*

¹¹⁰ Bogetic, "Russian Economic Report No. 20," 2009. 11.; The Central Bank of the Russian Federation, "Banking Supervision Report 2010" Moscow. The Central Bank of Russia, 2010. 26.

¹¹¹ Bogetic, "Russian Economic Report No. 20," 2009. 11.

¹¹² Ulatov and Bogetic, 2010. 11.

¹¹³ OECD, "Making the Banking Sector More Efficient and Resilient," 2009.; The Central Bank of the Russian Federation, "Annual Report: 2011" Moscow. The Central Bank of the Russian Federation, 2011. 198.

¹¹⁴ Bogetic, "Russian Economic Report No. 20," 2009. 11.; Katharine Seal et al., "Russian Federation: Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision" Washington DC. The International Monetary Fund, 2016. 22.

¹¹⁵ Dawisha, 2011. 345.

largest banks failed to comply with CBR statutory regulations and capital reserve requirements.¹¹⁶

Meaningful and productive bank restructuring failed to take place after the 2008 economic crisis. While some restructuring did occur, very little of it resulted in a more efficient or stable banking sector. The CBR was more interested in keeping banks solvent than restructuring their debt, resulting in the massive amounts of liquidity assistance offered. Again, we see the CBR substituting crisis containment for crisis resolution, which is unlikely to result in institutional development. Whether the CBR substituted liquidity assistance for bank restructuring in 2008 because it was incapable of undertaking the latter or because it felt restructuring was unnecessary is difficult to discern. It is likely a result of a combination of the two: the CBR may have recognised the need for restructuring, but felt it was disruptive and unnecessary in the middle of a crisis. Nevertheless, the CBR's failure to undertake effective restructuring only maintained sectoral vulnerabilities.

iii) Sale of government owned assets. The state used liquidity assistance measures to gain control over a sizeable amount of the banking industry during the 2008 crisis as a means of keeping the sector solvent. It is expected that as the economy began to exit the crisis, the state would sell the assets it acquired, to private interests that would restructure them and make them profitable.¹¹⁷ In this scenario, the failure of the state to actively restructure the banking sector can be overlooked as the state expected someone else to do it. The problem is that very little privatisation occurred after the crisis. While the state's control was diluted, it retained the controlling share of most banks and other firms it merged with or took over during the crisis.¹¹⁸ According to the Federal Agency for State Property Management, between 1995 and 2010, privatisations made up 10 percent of total business transactions.¹¹⁹ Yet, the Agency also clearly states that the government and CBR intent to maintain the controlling share of banks at 50 + 1 percent.¹²⁰

In 2011, 10 percent of VTB shares were sold to Bank of America for ₹97.5 billion, and was the largest transaction that year.¹²¹ In 2012, the state auctioned a 7.58 percent share of

¹¹⁶ Василий Нантай, Светлана Дементьева, and Юлия Локшина, "Крупнейшие Банки Замутили Прозрачность: Они Скрыли От Общественности Свои Нормативы," *Коммерсант*, 24.09.2010.

¹¹⁷ Calomiris, Klingebiel, and Laeven, 2003. 55.

¹¹⁸ Boris Kuznetsov et al., "Russian Manufacturing Revisited: Industrial Enterprises at the Start of the Crisis," *Post-Soviet Affairs* 27, 4. (2011): 366-86. 376.

¹¹⁹ Federal Agency for State Property Management, 2014. 3.

¹²⁰ *Ibid.* 9.

¹²¹ *Ibid.* 3.

Sberbank for ₪159.30 billion to a variety of buyers including JP Morgan and Goldman Sachs.¹²² However, if the state is only selling minority shares, and still retains the controlling share of 50+1 percent, then privatisation has not occurred. Because the Federal Agency for State Property Management has clearly indicated that the state has no intention of doing this, then it can be assumed that the banking sector will not be privatised soon. Additionally, this is not taking into consideration the indirect control the state has in many banks and firms that occurs in opaque, shady privatisation deals in which control changes hands from the state to a state confidants or lesser known government officials, or investors who remain unknown and untraceable.¹²³ For example, Bank Rossiya, which is chaired by several Putin confidants including Sergei Rodlugin and Gennadi Timchenko, privatised Gazenergoprombank and Sobin Bank, which are both Gazprombank subsidiaries.¹²⁴

iv) Regulatory reforms. As noted, in 2012, it was announced that the state was merging the Federal Financial Market Service (FFMS) with the CBR to improve regulation of the banking sector. This was a means of addressing those problems in the banking sector that were exposed by the 2008 economic crisis, primarily, that it is too large to be properly regulated.¹²⁵ The sector was disproportionate — banks were either small and ineffective, or large, state controlled enterprises.¹²⁶ For example, in 2011, there were over 1000 banks in Russia, and only 20 of them controlled 70 percent of banking assets.¹²⁷ Additionally, the state's dominating presence inhibited the development of private and foreign competition. This prevented the development of proper financial intermediation because it favoured larger, well known clients to individual households.¹²⁸ Finally, the existing regulations were more rules based than risk based, which hindered efficient banking operations without ensuring viability and stability.¹²⁹

At the time of the 2008 crisis, the CBR regulated banks while the FFMS regulated the financial and securities markets and non-credit banks, and the Ministry of Finance supervised the Deposit Insurance Agency (DIA). In the aftermath of the crisis, the

¹²² Russia This Week, "Macroeconomic Review," in *Russia This Week* (Intellinews, 2012).; Federal Agency for State Property Management, 2014. 5.

¹²³ Vernikov, "Government Banking in Russia: Magnitude and New Features," 2011. 14, figures 6 and 7.

¹²⁴ Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," 2012. 262.

¹²⁵ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 116.

¹²⁶ Connolly, 2011. 448.

¹²⁷ Ibid. 449.

¹²⁸ Ibid. 448.

¹²⁹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 116.; Frye and Shulman, 2010. 7, 23.

government and CBR were criticised for not including banking reforms in a list of measures to be undertaken.¹³⁰ In 2009, the OECD released a report on Russia's banking sector describing what needed to be improved, including: a need for more consistent capital adequacy ratios, better risk management, increased transparency, and a need to do more actual banking.¹³¹ In July 2013, the FFMS was dissolved and its regulatory responsibilities were handed over to the CBR, requiring the CBR to restructure itself into three regulatory divisions: banking supervision, financial market regulation, and monetary policy.¹³² The goal of this merger was to improve regulatory and supervisory capacity and efficiency by reducing bureaucratic red tape and closing the loopholes that were created by dividing the regulator.

In theory, it is easier to streamline and regulate the sector with one institution than two in Russia due to the number of licenses banks require and the number of shell banks that do not perform banking services. This is because one bank could have multiple licenses, each requiring a different agency to rescind it.¹³³ For example, revoking a banking license should have fallen under the jurisdiction of the CBR, but if the violations banks undertook fell under the jurisdiction of the FFMS, there was little either agency could do. The consolidation of the two into one mega-regulator, as it is being called, has allowed the CBR to reduce the number of banks in Russia by enforcing reserve requirements and other violations of licensing agreements, and finance related crime more broadly, without having to work with the FFMS. For example, under the direction of Elvira Nabiullina, the CBR closed one of Russia's largest banks in November 2013, Master Bank. The bank was well connected to Putin as his cousin was on the board of directors, and thus should have been untouchable because it falls within Putin's *blat*.¹³⁴ The CBR claimed that Master Bank had undertaken ₺200 billion worth of illegal transactions over the previous year, maintained a capital deficit of ₺2 billion, and falsified statements about the bank's financial situation.¹³⁵

Aside from Master Bank, there have been other high-profile closures, but there is evidence that these are politically motivated. Additionally, there are other instances where the

¹³⁰ Malle, 2012. 79.

¹³¹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 116 – 117.

¹³² Kremlin.ru, "Russia: President Signs Law Abolishing Ffms," (Esmerk Russian News, 2013).

¹³³ For example, there are eleven different kinds of banking licenses, not including the licenses for undertaking financial market services that existed previously. For more information, see 'The Central Bank of the Russian Federation, "Registration of Credit Institutions and Licensing of Banking Activities".'

¹³⁴ The Moscow Times, "State Boosts Grip on Economy with Bank Crackdown," *The Moscow Times*, 25 December 2013.

¹³⁵ Коммерсант, "Отозвана Лицензия Мастер-Банка," 21 November 2013.

CBR has deliberately turned a blind-eye to egregious violations, such as the controversial Bank Rossiya. The total number of banking licences revoked in 2013 was only 32, but this rose to 87 in 2014.¹³⁶ While the number of banks closed in 2014 is not as high as the number of banks closed per year in the early 2000s, it is still a significant change year-on-year. Most of these bank closures are small banks engaging in money laundering practices, doing very little banking, and generally reducing competition. However, there are still major weaknesses that need to be addressed and will be the subject of the next chapter, which discusses the 2014 crisis.

Little crisis resolution occurred during the 2008 economic crisis. The government and CBR were resigned to weathering the crisis until it was resolved, without taking active steps to resolve it. Like the aftermath of the 1998 economic crisis, very little was done to address the vulnerabilities that caused the crisis in the first instance. The difference is that the state took advantage of the oil and gas windfalls from 1998 and early 2000s paper over the weaknesses. This did not occur in the wake of 2008. Gas and oil prices rose, but not to the same levels as 1998. Additionally, the maintenance of soft budget constraints to keep the sector was very costly, and the failure to restructure banks only increased the liquidity needed to keep the industry operational. Some restructuring occurred and measures were taken to improve regulation, but as Russia entered another economic crisis in 2014, it was revealed that many of the same vulnerabilities remained. State controlled banks remained deficient in risk evaluation, banks retained high-levels of external debt, foreign investment continued to decline, and bank evaluation and supervision remained inconsistent, unclear, and opaque. This demonstrates that the CBR and various government agencies failed to address and strengthen industry weaknesses. Therefore, because the state undertook little crisis resolution in 2008, crisis modernisation did not take place.

6.3 Hypothesis testing

To determine whether crisis modernisation has occurred, the above analysis will be used to measure the hypotheses presented in chapter two. These hypotheses test for institutional development by measuring if A) the government and CBR's crisis management responses were appropriate and addressed the causes of the crisis; B) the government and CBR were able to implement crisis containment and resolution measures effectively and efficiently, and C) if the

¹³⁶ Sergey Bobylev, "Russian Central Bank Revokes 3 More Licenses in Banking Sector Restructure," *ITAR Tass*, 10 December 2014.

reforms strengthened institutions by changing the behaviours and expectations of economic actors. Each of the three hypotheses is measured against the null hypothesis, which states that economic crises do not affect institutional development in Russia.

Hypothesis I: The government and Central Bank of Russia will undertake the appropriate policy responses to resolve the crisis at hand.

The government and CBR failed to implement the appropriate policy responses to resolve the 2008 economic crisis. Rather than measures that may have resulted in crisis modernisation, the steps taken to mitigate the crisis only reinforced the partially reformed nature of the banking industry. At first glance, it appears that the CBR indeed enacted the measures necessary to prevent the banking sector from collapsing: it provided liquidity assistance, eased fiscal regulations, and worked with the government to buy struggling or failing banks. However, the World Bank noted that in order for Russia to productively exit the crisis, it would need to increase economic diversification, reduce dependence on foreign loans, improve transparency, and become more profit driven.¹³⁷ Indeed, by 2009, the government announced it would focus on seven priorities to expedite exiting the crisis: protect the vulnerable, stimulate demand, diversify the economy, ease the business environment, strengthen the financial sector, and maintain sound macroeconomic policies.¹³⁸ However, few of the measures implemented addressed these issues.

The crisis containment reforms focused heavily on liquidity assistance, spending over \$100 billion. Bailouts and other forms of financial assistance, including regulatory forbearance, are indispensable tools to help banks avoid bankruptcy during a crisis. Superficially, it appears that the CBR's approach was successful as no banks had fallen below the 10 percent capital reserve requirement by March 2009.¹³⁹ However, several studies demonstrate that when institutions are weak and cannot attach conditions to liquidity, or when liquidity is handed out too easily, it creates a moral hazard problem and banks are less likely to restructure.¹⁴⁰ This is what occurred in the Russian banking industry because of the CBR's liquidity assistance programme: there was no incentive for banks to become more profitable or risk averse. The roll-over risk for banks remained high well into 2009 because debt was not restructured, and

¹³⁷ Bogetic, "Russian Economic Report No. 20," 2009. 12.

¹³⁸ Bogetic, "Russian Economic Report No. 19," 2009. 9.

¹³⁹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009.

¹⁴⁰ Calomiris, Klingebiel, and Laeven, 2003.; Laeven and Valencia, 2008.; Hallerberg and Scartascini, 2011.

the macroeconomic fundamentals of the industry were weak.¹⁴¹ Additionally, banks showed no signs of increasing risk aversion or profit maximisation, nor did they improve transparency.¹⁴² Thus, while the CBR had the liquidity to help the banks, it failed to use it in a way that created hard budget constraints. The level of crisis resolution is therefore limited, and so too is the institutional development that can take place.

As Laeven and Valencia demonstrate, poorly implemented crisis containment policies will undermine the implementation of constructive crisis resolution reforms.¹⁴³ As such, the failure of the CBR and the government to undertake appropriate crisis resolution measures is where the first hypothesis is proven false. While Putin was right that Russia did not cause the 2008 economic crisis, the crisis greatly affected the banking industry because of endogenous institutional weaknesses. For example, Dudin et al list three main steps the CBR should have taken to mitigate creating future financial bubbles: requiring and enforcing adequate reserve requirements, limiting lending, and taxing consumer credit.¹⁴⁴ Successful and appropriate crisis resolution measures would have addressed these issues, but they do not. Even where it appears the government is taking the right steps, it fails to result in meaningful change.

The government owned asset management programme indeed saw the government buy failing and insolvent banks to prevent them from exacerbating the crisis, but it also allowed the government to increase its control over the banking sector. As demonstrated above, by 2009, the state had increased its share of banking assets to 55 percent. While this may have prevented insolvency, little to nothing was done to make banks more efficient or profitable. This creates a barrier to institutional development and crisis modernisation by maintaining soft budget constraints. Hard budget constraints force banks to invest wisely in innovative practices and technology that will increase efficiency and maximise profits, Yet, the state itself has not done this in the past, and is unlikely to do so in the future.¹⁴⁵ Rather, the CBR hopes to attract foreign investment to do it for them.¹⁴⁶ Yet, between the government's policies that restrict and alienate foreign investment, and investors' scepticism of state control, this is unlikely to happen.¹⁴⁷

¹⁴¹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 5.

¹⁴² Dawisha, 2011. 358.

¹⁴³ Laeven and Valencia, 2008. 7.

¹⁴⁴ Mikhail Dudin et al., "State Anti-Crisis Management of Banking Sector: Looking for Optimization Ways and Contemporary Development Trends," *Journal of Advanced Research in Law and Economics* 2, 10 (2014): 74 - 81. 79.

¹⁴⁵ Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," 2012.; Connolly, 2011. 449.

¹⁴⁶ Malle, 2012.

¹⁴⁷ Ibid. 94; Bogetic, "Russian Economic Report No. 17," 2008. 12. A.T. Kearney, "2007: Uncertain Concerns in a New World" Virginia, USA. Global Business Policy Council, 2007. 32 – 33.

Thus, government did not use government asset management as a means of crisis resolution, but as a way of protecting a bloated banking industry.

Bank restructuring also failed to initiate proper crisis resolution as very little of the banking sector was restructured, nor was the debt it held. For Russia, the 2008 crisis was largely a private debt crisis, rather than sovereign debt crisis.¹⁴⁸ As such, bank restructuring measures should have both encouraged and helped banks tackle their debt, as well as develop regulations to mitigate this risk in the future. Yet, the sector's non-performing loans increased over the course of 2009, and were projected to hit 10 percent by the end of the year.¹⁴⁹ While banks repaid \$40 billion of debt in the first part of 2009, this slowed in 2010 and banks were again borrowing short-term loans.¹⁵⁰ Additionally, in late 2009 and into 2010, economists remained insistent that the most pressing problem in Russia's banking industry was the need to improve capital adequacy regulations and enforce liquidity requirements.¹⁵¹ As such, the CBR failed to undertake a bank restructuring programme that would minimise the risks banks posed to the economy and strengthen its role as a regulator.

Furthermore, the CBR did not privatise any of the assets it acquired at the outset of the crisis, nor did it privatise its controlling shares of the country's largest banks, such as Sberbank. In failing to do this, the government and CBR have ensured that the banking industry will remain unproductive. This is supported by La Porta et al, who demonstrate that every 10 percent increase in government control correlates to a .1 to .2 percent decline in productivity.¹⁵² In fact, Russia's economic growth has not returned to its pre-2008 levels: before the crisis, the economy had the potential to grow six percent per year, but has only averaged 2.5 percent growth since.¹⁵³ Thus, maintaining control of the banking sector by the state did not help the economy recover in the aftermath of the crisis, and created no opportunities for crisis modernisation.

The only appropriate crisis resolution measure with the potential to result in crisis modernisation was the merging of the FFMS and CBR to improve regulation of the banking

¹⁴⁸ Bogetic, "Russian Economic Report No. 18," 2009. 8.

¹⁴⁹ Bogetic, "Russian Economic Report No. 19," 2009. 8.; The International Monetary Fund. "Bank Nonperforming Loans to Total Gross Loans," Washington DC. 2016.

¹⁵⁰ Ulatov and Bogetic, 2010. 9.

¹⁵¹ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 120 – 121.; Bogetic, "Russian Economic Report No. 20," 2009. 11.

¹⁵² Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, "Government Ownership of Banks," *The Journal of Finance* 57, 1. (2002): 265 - 301. 288.

¹⁵³ Aleksashenko, 2012. 33 – 34.; Anders Åslund, "Sergey Glazyev and the Revival of Soviet Economics," *Post-Soviet Affairs* 29, 5. (2014): 375-86. 378.

sector. Since the collapse of the Soviet Union, the sector has been too large to be effectively regulated because it has too many small banks that did not engage in legal banking practices. Consolidating supervision responsibilities was one of the keys to strengthening the CBR as a regulator and, by extension banking industry practices.¹⁵⁴ This would help consolidate the banking sector by closing many of the small, unprofitable banks. There is some evidence that this has happened, albeit slowly and with little transparency. Importantly, this reform has not been able to address other regulatory weaknesses in the banking sector, such as the large discretion banks have over lending, the ratio of lending to investing, and the ability of the CBR to verify and assess banks' assets.¹⁵⁵ Additionally, there is evidence that the CBRs use of its new powers has been inconsistent, which raises doubts about the merger's ability to drive institutional development. As such, while a promising step, there is not enough evidence that this reform will result in crisis modernisation, especially as it took place so long after Russia exited the crisis.

The general response to the 2008 economic crisis was more concerned with preserving state control rather than protecting and strengthening the banking sector.¹⁵⁶ Crisis containment measures were used as a means for the state to protect itself and its social network, instead of small to medium sized enterprises (SME) or economic diversification.¹⁵⁷ As such, the majority of liquidity assistance was doled out to state controlled banks and enterprises that did not need the help as much as more vulnerable firms.¹⁵⁸ Furthermore, the CBR and government's only concern regarding the banking sector was keeping it solvent.¹⁵⁹ As a result, the CBR helped the government protect the strategic sectors, such as military development, gas and oil, agricultural production, and various state projects, rather than focus on institutional development and more targeted banking sector reforms.¹⁶⁰ While the CBR FFMS merger would eventually begin address some of these issues, its efficacy is still to be determined. Because neither crisis containment, nor crisis resolution measures addressed the vulnerabilities that caused the crisis in the first place, there were very limited opportunities for crisis modernisation. Thus, the first hypothesis is false.

¹⁵⁴ OECD, "Making the Banking Sector More Efficient and Resilient," 2009. 119.

¹⁵⁵ Bogetic, "Russian Economic Report No. 19," 2009. 11.

¹⁵⁶ Ericson, 2009. 222 – 223.

¹⁵⁷ Robinson, "The Contexts of Russia's Political Economy: Soviet Legacies and Post-Soviet Policies," 2013. 44.

¹⁵⁸ OECD, "Making the Banking Sector More Efficient and Resilient," 2009.

¹⁵⁹ Ericson, 2009. 224.

¹⁶⁰ Ibid. 223.

Hypothesis II: The Central Bank of Russia is strong enough to implement crisis resolution measures effectively and efficiently. Reforms also seek to improve institutional efficiency.

The CBR was unable to implement constructive crisis resolution measures that would have resulted in crisis modernisation. Until the merger between the CBR and the FFMS in 2013, no reforms had directly targeted increasing the former's ability to regulate the market. One reason for this is that the government felt that the crisis was not caused by the banks, even though the it was problems with the banking sector that exacerbated the crisis. Yet, this is compounded the inability of the CBR and government to implement resolution measures. Where institutions are too weak to implement crisis resolution, they rely heavily on crisis containment measures as these do not require the construction of new, or development of existing institutions to be effective.¹⁶¹ In fact, in the approach to the 2008 crisis, this weakness is most clearly seen in the overreliance on liquidity assistance, the increase in state control over banks, and the subsequent failure of the state to restructure the sector or increase economic efficiency.

Government owned asset management allowed the government to react quickly to ensure the banks received liquidity.¹⁶² The CBR used state controlled banks to quickly merge with or buyout struggling and insolvent banks, but also banks the state felt were strategically important regardless of their financial situation. Yet, the allocation of the liquidity itself was economically inefficient, which meant that the funding did not reach the places it was most needed. As a result, the government's use of the CBR to increase its direct control over the banking sector did not result in more stability, either for banks or the wider economy. Furthermore, as demonstrated above, the more the government increased its control over the banking sector, the less productive and efficient it became. While economic growth began to slowly resume in 2010, this growth was attributable to the increase in gas and oil prices, not increased demand or profit maximisation.¹⁶³ Thus, although the government owned asset management programme was executed quickly, it was not efficient or effective as it did not seek to undertake institutional development that would foster the growth of a market economy.

The CBR did not undertake bank restructuring efficiently or effectively, because it enforced very little bank restructuring at all. The goal of crisis management was to keep banks solvent and prevent banks from collapsing. For the CBR to have imposed efficient and effective bank restructuring, it would have needed to attach conditions to liquidity assistance packages that would have required banks to increase their productivity and maximise profits. In some

¹⁶¹ Calomiris, Klingebiel, and Laeven, 2003. 28.

¹⁶² Orttung, 2008. 8.

¹⁶³ Aleksashenko, 2012. 36.; Bogetic, "Russian Economic Report No. 20," 2009. 1.

instances, this means using the liquidity to pay down or restructure debt obligations, or restructuring the firm itself. While around a quarter of loans were restructured or paid down, the NPL and roll-over risk remained high. Furthermore, the CBR failed to effectively reinforce regulatory requirements after Russia began to exit the crisis. Both the lack of bank restructuring and the absence of normal requirements maintained systemic vulnerabilities that undermine crisis resolution. Thus, the CBR's failure to restructure banks or even properly address the risks banking practices posed demonstrates its weakness as a regulator as well as a missed opportunity for institutional development.

There was no privatisation of the banking sector in the aftermath of the 2008 economic crisis. The state sold minority shares of VTB and Sberbank in 2011 and 2012 respectively, but officially stated that it has no intention of privatising its controlling share. This fails to increase institutional efficiency by maintaining the blurred line between the economic actor and banking sector regulator, and prevents the development of competition. Consequently, this puts the economy at risk as the underdevelopment of the banking sector forces it to rely on external lending for investment and growth, rather than generate its own.¹⁶⁴ Furthermore, as stated above, by failing to privatise, the CBR was responsible for more banks than it could properly regulate. As a result, this maintained the partially reformed nature of the social economic relationship between the state and the banking sector, undermining prospects for crisis modernisation.

The merger between the CBR and the Federal Financial Market Service is the only crisis resolution measure that had the ability to result in crisis modernisation. However, because it took so long to do this, it fails the first part of the hypothesis as it was not undertaken efficiently. The reform itself was passed in 2012, three and a half years after crisis management measures were undertaken, and the merger was completed in 2013, which is a time difference of four and a half years. Thus, while the reform aimed to improve the CBR's regulatory efficiency, the time it took for the measure to take place is far outside the two-year assessment mark in most studies, as well as the three-year mark specified in the methodology.¹⁶⁵ Initially, it appears that the merger does lead to institutional development. Yet, there is evidence that this optimism may be unfounded, which will be discussed below. Nonetheless, because the reform ultimately falls outside the time-period specified, the hypothesis is false. Therefore, the CBR FFMS merger cannot be considered an instance of crisis modernisation.

¹⁶⁴ Malle, 2012. 80.

¹⁶⁵ See chapter two for more details. See also: Laeven and Valencia, 2013.; Laeven and Valencia, 2008.; Hallerberg and Scartascini, 2011.

The second hypothesis fails on each measure of crisis management. While the CBR and government indeed enacted emergency measures quickly, there was little long-term focus on strengthening the sector. The ability to implement crisis containment measures is not indicative of institutional strength because they do not require strong institutions to be implemented. Furthermore, the CBR was unable to undertake measures that aimed to improve institutional strength, and sectoral efficiency. If the CBR and government cannot implement long-term crisis resolution reforms, then it is unlikely that crisis modernisation has taken place. In fact, as Russia exited the 2008 economic crisis, with the state controlling more of the economy than it had since the collapse of the Soviet Union, and using it for market purposes, partial reform equilibrium was more strongly entrenched than ever.

Hypothesis III: New regulations are fairly and universally enforced, leading to reliance on formal rules and organisations to resolve conflicts.

The third hypothesis is false. It tests whether crisis modernisation occurred, and how it has affected institutional development, but there is little evidence to support that this has occurred. Had modernisation ensued, the CBR would have improved its ability to consistently enforce regulations that mitigated banks' borrowing risks, consolidated the swollen banking sector, and fostered competition among the remaining viable banks. The crisis containment measures that were implemented allowed Putin to stabilise the banking sector, but neglected to introduce reform measures that would ensure long-term stability.¹⁶⁶ Instead, the CBR managed the 2008 crisis by undermining market economy principles and increasing the power of the social economy as the state gained control over most of the banking sector. As a result, banks failed to evolve as financial intermediaries. Rather, they became a tool of the state. Additionally, none of the crisis resolution measures addressed the problems within the industry that made Russia so vulnerable to the crisis. Furthermore, while the consolidation of regulatory powers into the CBR was a promising step, the latter's use of its new powers raises concerns about fair and predictable regulation enforcement. Therefore, crisis modernisation did not occur after the 2008 crisis, and it is argued that the crisis management measures that were implemented only reinforced the social economy and partial reform equilibrium.

Because of the 2008 economic crisis, the government increased its control over the banking sector, which undermined the development of market institutions. While the state has privatised some of its stakes in a few banks, this does not mean the state has relinquished

¹⁶⁶ Robinson, "Russian Patrimonial Capitalism and the International Financial Crisis," 2011.

control. The government has maintained indirect control through appointing low-level ministers or other members of the *sistema* to indirectly control or influence a bank. As a result, the state does not need to own the controlling share of a bank to have control over a bank.¹⁶⁷ In fact, banks have become a tool used by the state in raiding cases.¹⁶⁸ Åslund explains, Putin has been using his social network to raid and increase the state's share of corporations in strategic sectors.¹⁶⁹ As a result, since the crisis, the main source of corruption and threat to private property rights has stemmed from the state rather than gangsters.¹⁷⁰ Thus, the government and CBR's increased involvement in the banking sector resulted in failed reforms, or reforms that were contrary to or undermined the establishment of market institutions, or were incompatible with good governance.¹⁷¹

Consequently, instead of turning to institutions and formal rules to resolve conflicts, trust in said institutions has been eroded and they have become weaker as a result. On the one hand, people have more trust in the state to run banks and the economy than private entities.¹⁷² Yet, the general trust in banks and the market is so low that this means very little. As such, it is unfair to consider whether Russians trust the state over private economic actors when genuinely private enterprise and market competition has been unable to develop and individuals have so little interaction with it. For example, the extent to which interaction with banking services has increased since 2008 is debatable. There has been an increase in bank use as more employees are paid with plastic bank cards rather than cash or cheques, but the number of people who engage with banks for long-term financial services varies. The Financial Inclusion Project claims that 46 percent of individuals use banks to receive their salary, whereas only 18 percent have a deposit account.¹⁷³ However, The World Bank's Global Financial Development Indicators suggest that as few as 30 percent use banks to receive wages, and as much as 48 percent of the population has an account at a formal financial institution.¹⁷⁴ Finally, there were 37 bank branches per 100,000 adults in Russia in 2011, which is higher

¹⁶⁷ Frye and Iwasaki, 2011. 656.

¹⁶⁸ Andrei Yakovlev, Anton Sobolev, and Anton Kazun, "Means of Production Versus Means of Coercion: Can Russian Business Limit the Violence of a Predatory State?," *Post-Soviet Affairs* 30, 2-3. (2014): 171-94. 187; Rochlitz, 2014. 100.

¹⁶⁹ Åslund, "Sergey Glazyev and the Revival of Soviet Economics," 2014. 378.

¹⁷⁰ Jordan Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression," *Post-Soviet Affairs* 28, 3. (2012): 263-95. 380.

¹⁷¹ Hedlund, S. (2005). 162.

¹⁷² Malle, 2012. 76.; Timothy Lyman, Stefan Staschen, and Olga Tomilova, "Landscaping Report: Financial Inclusion in Russia" Washington DC. The World Bank, 2012. 11.

¹⁷³ Lyman, Staschen, and Tomilova, 2012. 10.

¹⁷⁴ The World Bank. "Global Financial Development Database." 2017.

than most developed countries.¹⁷⁵ Although this may be an indication of the scope of the banking sector, the fact that only half the population interacts with banks demonstrates its lack of depth. Finally, there is little evidence that individuals trust the banking sector more after the crisis than they did before it.

Additionally, FDI has decreased since the crisis, with many investors stating that regulation is too inconsistent and the increasing reach of the state makes them nervous.¹⁷⁶ In 2010, Kearney reported that Russia fell from ninth to 18th place in its FDI confidence index.¹⁷⁷ Although this improved in 2012 as Russia prepared to join the World Trade Organisation, rebounding to 12th place with more respondents saying they expect the regulatory environment to improve.¹⁷⁸ However, by demonstrating that access to finance is directly correlated to levels of investment, Connolly argues that while state control is a disincentive for both domestic and foreign investors to undertake long-term investment in Russia, poor financial mediation surpasses it.¹⁷⁹ This is a problem because most developing economies are encouraged to invest up to 25 – 35 percent of their GDP in order to compete with more developed economies, but the government only contributes a third of this amount, and FDI normally contributes 10 – 15 percent.¹⁸⁰ Domestic investors cannot really contribute to this, however, because business lending or micro-lending is not sufficiently developed. While the government and CBR have discussed increasing access to credit for SME's, firms consistently rank access to credit as one of the largest barriers to investment with over half of respondents in the Financial Inclusion Project stating that getting a business loan was difficult if not impossible.¹⁸¹ Admittedly, 61 percent of firms said access to credit in 2011 was a problem, compared with in 75 percent 2008, so there has been some improvement.¹⁸² Nonetheless, barriers to credit remain high, which undermines economic investment and diversification.

The consolidation of regulatory responsibilities into the CBR is a promising step in addressing many of these issues, but it has not yet resulted in increased predictability or a

¹⁷⁵ Lyman, Staschen, and Tomilova, 2012. 16.

¹⁷⁶ Aleksashenko, 2012. 31.

¹⁷⁷ A.T. Kearney, "2010: Investing in a Rebound" Virginia, USA. Global Business Policy Council, 2010..

¹⁷⁸ A.T. Kearney, "2012 FDI Confidence Index" Virginia, USA. Global Business Policy Council, 2012.. Because this study is concerned with the effects of economic crises on institutional development, the effects of WTO membership on institutional development is not analysed.

¹⁷⁹ Connolly, 2011. 432.

¹⁸⁰ Ibid. 432.

¹⁸¹ Lyman, Staschen, and Tomilova, 2012. 20 – 22.; The World Bank, "Beeps at-a-Glance 2011: Russia" Washington DC. 2013. 4.; Connolly, 2011. 447.

¹⁸² The World Bank, "Beeps at-a-Glance 2011: Russia," 2013. 13.

change in expectations. Although the merger took place too long after the crisis to be considered crisis modernisation, it is important to analyse its initial implementation to determine if concerns borne out of the crisis are addressed. On the one hand, the CBR has succeeded in accelerating the consolidation of the banking sector. However, IMF observers have noted that there is no transparency regarding the decisions to revoke banking licenses, and there is no external supervision to ensure that these decisions are fair.¹⁸³ Thus, if the revocation of banking licenses has been inconsistent, as discussed above, and there is no transparency to how these decisions are reached, then it is unlikely that the CBR has developed into an organisation that can reliably resolve or mediate conflicts fairly.

Furthermore, the inconsistent enforcement of regulations leaves the economy vulnerable to more economic crises. One of the key issues that needed to be addressed through crisis resolution was mitigating banks external borrowing, or ensuring banks are not borrowing more than they can repay. If banks know that they have a soft budget constraint, they will continue to borrow more than they can repay, thus perpetually maintaining a financial bubble.¹⁸⁴ As demonstrated by Fungacova and Poghosyan, state controlled banks, which make up over half the banking sector, do not take credit risks into account when considering profit and efficiency maximisation.¹⁸⁵ Given that the government or CBR controls most of the banking sector, this raises serious concerns about its ability to properly regulate the banks. While the IMF has found no concrete evidence of favouritism or leniency, it also admits that the lack of transparency makes this difficult to ascertain.¹⁸⁶ Because that the merger between the CBR and FFMS has not helped implement hard budget constraints, risks remain and command economy practices remain in place.

Because the merger takes place too long after the 2008 crisis, it fails to support the third hypothesis that it resulted in crisis modernisation by improving regulatory expectations and predictability. Additionally, it provides no solid evidence to support the hypothesis on its own, independent of the implementation efficiency hypothesis. However, the CBR only existed in this new capacity for a little more than a year before the next crisis struck in late 2014. As such, it is fair to reserve judgement until more time has passed and trends can be established. A more detailed discussion will be included in the following chapter, which briefly discusses the 2014 crisis.

¹⁸³ Seal et al., 2016. 20, 24, 32.

¹⁸⁴ Zuzana Fungacova and Tigran Poghosyan, "Determinants of Bank Interest Margins in Russia: Does Bank Ownership Matter?," *Economic Systems* 35. (2009): 481 - 95. 489.

¹⁸⁵ Ibid. 491.

¹⁸⁶ Seal et al., 2016. 41.

6.4 Conclusion

The Central Bank of Russia and government failed to undertake the appropriate crisis containment or crisis resolution measures in the wake of the 2008 economic crisis. As a result, crisis modernisation did not take place. In fact, because of the excessive liquidity assistance and increased state control, the economy struggled to grow as it exited the crisis, averaging 3.5 percent per year. This is further reflected in the deteriorating post-crisis business and banking environment. The Ease of Doing Business Survey ranked Russia 118th in 2009, 166th in 2010, 124th in 2011, and 120th in 2012.¹⁸⁷ Furthermore, the difficulty in obtaining credit ranking remained low during this period, at 109th in 2009, 87th in 2010, 89th in 2011, and 97th in 2012, and the strength of legal rights pertaining to credit remained three out of ten.¹⁸⁸ Though there is some variation among the rankings, there is a steady decline from the time Russia exits the crisis in 2010, indicating that no serious attempt to reform the business environment or strengthen institutions takes place.

Thus, Russia suffered more from the effects from the 2008 economic crisis because the government did little to address the fundamental problems within the banking sector. The government's policy was to 'pay for the crisis,' or inject as much liquidity needed to stabilise the economy, rather than initiate or undertake the reforms necessary to ensure the next crisis would not be as bad. These measures targeted banks and enterprises, and very little was spent on stimulating demand or protecting the population. Given the cost of these measures, it would have been better to invest in building new infrastructure, which the state badly needs, rather than softening budget constraints, which undermine market economic principles. As a result, Russia found itself in a position where it could not compete with either developing or developed economies.¹⁸⁹ Although oil prices recovered, they did not return to a pre-2008 level. As such, the economy continued to experience low levels of growth until the next crisis hit a few years later when sanctions were imposed after Russia annexed Crimea.

The 2008 global financial crisis challenged Russia in a very different way from the

¹⁸⁷ The World Bank, "Reforming through Difficult Times" Washington DC. The World Bank, 2010.; The World Bank, "Making a Difference for Entrepreneurs " Washington DC. The World Bank, 2011.; The World Bank, "Doing Business in a More Transparent World" Washington DC. The World Bank, 2012.; The World Bank, "Smarter Regulation for Small and Medium-Sized Enterprises" Washington DC. The World Bank, 2013..

¹⁸⁸ The World Bank, "Reforming through Difficult Times," 2010.; The World Bank, 2011.; The World Bank, "Doing Business in a More Transparent World," 2012.; The World Bank, "Smarter Regulation for Small and Medium-Sized Enterprises," 2013.

¹⁸⁹ Aleksashenko, 2012. 33.

1998 crisis. Yet, in both instances the CBR and the government failed to undertake proper crisis resolution reforms, which reinforced the partially reformed nature of the banking sector. The increase in state control over the industry reinforced the command economy institutions that necessitate the use of the social economy. The need for social connections to navigate economic transactions is reflected in the deterioration of The World Bank's Rule of Law Governance Indicator for Russia. It was at a low at -.95 on a scale of 2 to -2 in 2008, it improved to -.77 during the crisis, but then worsened as the economy exited the crisis, declining to -.84.¹⁹⁰ This demonstrates that the crisis management measures that were undertaken during the crisis indeed helped stabilise the economy temporarily, but ultimately failed to strengthen institutions or initiate economic development.

Russia had ten years to recover and profit from oil wealth between the 1998 and 2008 economic crises, but the government and CBR ignored fundamental institutional weaknesses. One of the patterns that emerges from the two crises is that, contrary to crisis modernisation, the most promising institutional reforms occur after the economy has exited the crisis, not as a resolution measure. The tax reforms were implemented three years after the 1998 crisis, and the consolidation of regulatory power in the CBR occurred nearly five years after the onset of the 2008 crisis. Although both reforms are imperfect, they are attempts to address issues that exacerbated the crises in the first instance, which must be commended. However, before a pattern of potential institutional development can be established, this must be compared to the crisis that occurred in 2014. As this crisis is too recent to justify an entire case study, it is briefly analysed in the following chapter before determining whether Russia defies crisis modernisation.

¹⁹⁰ The World Bank. "World Governance Indicators," 2015.

CHAPTER 7 PLUS ÇA CHANGE...

There are three kinds of reforms implemented during a crisis that make crisis modernisation more likely: numerical rules, procedural rules, and transparency rules.¹ Crisis modernization did not occur as a result of the 1998 and 2008 economic crises as one or more of these reforms was lacking. During both crises, there are instances when promising reforms that signal development of the Central Bank of Russia's (CBR) role and powers are drafted and implemented. Yet, the enforcement of these measures is often inconsistent, do not fully address the problem, and / or are subsequently undermined by the government. For example, the CBR FFMS merger increased the former's ability to consolidate the banking sector. However, the actual process of revoking banking licenses, forcing mergers, and closing banks lacks transparency or predictability, making it difficult for banks to understand which rules and regulations they must follow.² As such, the CBR has remained an unpredictable and under-developed agency. This fails to generate new expectations and behaviours, which prevents market institutions from being established and reinforces the need for social networks to mediate economic transactions. This chapter will first illustrate how the Russian economic 1998 and 2008 crises fail to result in institutional development, and how this reaffirms the partially reformed economy rather than shifting toward a market. The tax reforms of 1998 will be discussed, followed by an analysis of the CBR / FFMS merger of 2008. Second, the 2014 crisis will be examined for any evidence of potential crisis modernisation. To conclude, the chapter will evaluate what the implications of the case studies for institutional development and partial reform equilibrium.

7.1 Summary of case study findings

The 1998 and 2008 economic crises illustrate how Russia's economic institutions remain partially reformed, and that no transformation recession has taken place. Each of the crises appeared to have elements of crisis modernisation, because the reforms that were implemented addressed institutional weaknesses as the economy exited the crisis. However, the inconsistency with which these reforms were implemented, as well as the failure to undertake supporting crisis resolution measures result in weak incentives to change economic behaviour.

¹ Hallerberg and Scartascini, 2011.

² Seal et al., 2016. 20.

The two sections below will analyse the tax reforms to emerge from the 1998 crisis and the banking regulation reforms of the 2008 crisis respectively. These reforms do not improve the long-term prospects of economic agents, and forces them to focus on the short-term. Furthermore, the measures do not encourage the use of institutions to mediate conflict or economic transactions, thereby strengthening the social economy.

The 1998 economic crisis and tax reform

Many scholars see the 1998 economic crisis as a major transitional crisis for the Russian economy — if the transition to the market was incomplete before, then the crisis forced them to complete it.³ The evidence for this largely centres on the government's improved fiscal position as it reduced spending and improved tax collection. While the government did cut spending, this was due to a lack of liquidity rather than more disciplined spending; and the two percent budget surplus in 2000 was due to an increase in oil prices, not austerity measures.⁴ Tax collection improved significantly, partly because the 2001 tax reform simplified the procedure for paying, but also because profits and incomes increase as the economy grew.⁵ However, while the 1998 economic crisis was a triple crisis (currency, sovereign debt, and banking), it was ultimately a banking crisis. Poor bank regulation, as well as the use of the banks to increase government revenue, allowed the government to maintain soft budget constraints that ultimately bankrupted both itself and the banking sector, and this was not addressed.

Many use the increase in the state's revenue stream and its increased fiscal discipline as evidence of successful tax reforms. Yet, the state's improved financial position is directly and positively correlated to the increase both in gas and oil prices, as well as production.⁶ As discussed in chapter three, Putin's economic plan for Russia was the renationalisation of what he termed the 'National Champions': Russia's most lucrative industries — mostly hydrocarbon based enterprises. To this end, the tax reforms of the early 2000s increased the taxes paid by the hydrocarbon industry, thereby forcing those firms that remained private to contribute to the revenue stream.⁷ Thus, it is in the pursuit to capture as much oil and gas wealth as possible that

³ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009.; Åslund, 2001.; Ericson, 2009.; Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000.; Hanson, 1999.. For more, see chapter two.

⁴ Martinez-Vazquez et al., 2001. 510.

⁵ Appel, 2004. 303.

⁶ Ahrend and Tompson, 2005. 7.

⁷ Ibid. 12.

the state used tax reforms to renationalise many gas and oil companies.⁸ Putin used these gas and oil windfalls to establish the Stability Fund and the National Wealth Fund, and to repay the loans given to Russia by the IMF, World Bank, and other international agencies. It is important to understand that the increase in gas and oil prices and tax reform both contributed to post-1998 economic growth, but not because either strengthened institutions or encouraged market development. Income tax collection alone cannot account for the improvements to the state's budget, but it did contribute.

Furthermore, the increase in tax collection is due to implementation of a flat tax, which lowered the number of taxes people were supposed to pay, and streamlined the process. In many ways, the tax reforms that spanned the first few years of the 2000s would be part of a shift toward economic and political stability in Russia that signalled a transition away from the chaotic Yeltsin era to the more predictable Putin presidencies. However, while the tax reforms did lead to some tangible change, the tax collecting institutions themselves were not developed or strengthened. This is primarily evidenced by the fact that tax evasion is still a large problem. Enterprises often collude with their employees to avoid paying taxes by underreporting wages in favour of cash payment.⁹ Furthermore, the worst offender regarding tax evasion is the state.¹⁰ Additionally, the CBR's maintains its role in the tax collection process, so that the state can use it as a means for project financing.¹¹ Finally, much of the evidence that is used to prove institutional change (increased revenue, etc.) is spurious when controlled for gas and oil revenues. As the gas and oil industry was renationalised, there was little resistance as the state increased its share of revenues from gas and oil windfalls.¹² Thus, without sustained, high energy prices, the revenue the state earns from tax collection alone would not cover its expenditures.

Furthermore, the tax reforms largely focused on individual income taxes, but not so much on corporate taxes. This left many large loopholes in the tax code for enterprises to exploit. The flipside, though, is that these loopholes also created more opportunities for the state to prosecute corporations for tax code violations. While on the surface this might seem like progress, it is not. Because the corporate tax code was not simplified, all corporations are violating it somehow. Some do it on purpose to illegally maximize profits or seek large rents;

⁸ For more information, see chapter three.

⁹ Gorodnichenko, 2009. 509.

¹⁰ Ibid. 518 – 520.

¹¹ Tompson, "Financial Backwardness in Contemporary Perspective: Prospects for the Development of Financial Intermediation in Russia," 2000. 70.

¹² Kryshtanovskaya, 2005. 57.

others do it unknowingly or in small ways because the law itself is contradictory: in order to follow the law, you also have to break it.¹³ However, the state does not accuse the maximum number of corporations in order to create a precedent for new set of behaviours, it arbitrarily prosecutes them. These cases are often undertaken as a means for the state to liquidate or takeover a corporation itself.

It would be false to say that the government's increased revenue stream did not benefit from these measures, or that they had no positive effect at all. The tax reform made it easier for individuals to pay taxes and it relieved banks, and the Central Bank of Russia, of a large burden. This not only streamlined the collection of taxes, but went a long way in restoring trust in the banks. It can be inferred that if consumers mistrusted the banks before the crisis for fear of the banks garnishing their wages to pay tax arrears, then taking this responsibility from the banks also removes the source of mistrust. In 1994, only eight percent of individuals kept money in any kind of bank account; by 2014 that number increased to 48 percent.¹⁴ On the one hand this signifies that banks are being used to intermediate financial transactions. However, up to 30 percent of this number have an account for no other reason than to receive wages as more firms pay employees with plastic cards instead of paycheques.¹⁵

As such, the tax reform only addresses one of the issues that contributed to the 1998 crisis. While the CBR's role in tax collection was restricted by the reform, it did not address the cause of the crisis. For institutional development to take place, crisis resolution reforms needed to concentrate on the banking sector, particularly bank restructuring. Thus, the tax reform did not result in crisis modernisation as it did not encourage banks to recapitalise, restructure, or improve their ability to meet their loan obligations. In fact, no structural change was attempted after the 1998 crisis.¹⁶ Even procedural reforms that took place long after the economy exited the crisis, such as the adoption of deposit insurance and the improvement of bankruptcy laws, did not actually develop and strengthen the CBR's institutional foundations.¹⁷ Additionally, the CBR used these measures to favour large banks with connections and increase its control over the sector by providing state banks with the liquidity to purchase failing banks, but not liquidate them.

¹³ Ledeneva, *How Russia Really Works: The Informal Practices the Shaped Post-Soviet Politics and Business* (2006).

¹⁴ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 114.; The World Bank. "Global Financial Development Database." 2017.; Ellman, 2000..

¹⁵ Lyman, Staschen, and Tomilova, 2012.

¹⁶ Martinez-Vazquez et al., 2001. 510.

¹⁷ Both of these reforms were implemented in 2005, which is too long after the 1998 crisis to be considered as a part of crisis management.

Many of the reforms listed above were ultimately undermined by the Central Bank and the government for two reasons: they were implemented inconsistently, and they were used as strategic tools by the state. For example, many enterprises and firms, including banks, had their tax arrears forgiven in exchange for nationalisation.¹⁸ Where firms were uncooperative, the state became aggressive and used the new reforms as a tool to take what it needed. This is exemplified by the Khodorkovsky Case, as well as the cases of Bank of Moscow, Master Bank, and Globex. Thus, although the government addressed some institutional vulnerabilities, it undermined the strengthening of rule of law by violating them in spirit, if not by the letter. The reforms were merely parchment institutions, as the mechanism that was created to enforce the law, the creation of tax police, was perverted by the state. As a result, patterns of predictability and trust were not established. This, therefore, did not lead to the establishment of new institutions, but reinforced old command practices.

The 2008 economic crisis and bank regulation reforms

The banking reforms that emerged from the 2008 crisis concerned increasing the CBR's regulatory powers, and consolidating the banking industry. However, while these reforms have produced some change, it was not progress toward a market economy. In fact, the consolidation of the industry involved the government and CBR merging banks with state controlled banks. These measures are more command in nature, and thus undermine any attempt to establish market institutions. Indeed, some positive change has arisen as banks have been closed and reserve requirements are more likely to be met. For example, the CBR only closed 32 banks in 2013, but this more than doubled the following year.¹⁹ Yet, like tax reforms, these have not been consistently implemented long enough for meaningful institutional practice to emerge. This is important because the role and function of banks are vital to a market economy.

The merger of the CBR with the FFMS changed the composition and structure of banking regulation in Russia by increasing the power and responsibility of the former, and dissolving the latter along with other regulatory agencies. However, since the measurement of institutional change relies primarily on the behaviour of economic actors and not the composition of the regulator itself, this cannot signal more than the intention to change. In fact, when we actually examine the effectiveness CBR in this capacity, the evidence for institutional development is weak. As demonstrated in the case study, while the CBR has been able to

¹⁸ Kryshstanovskaya, 2005. 303.; Easter, 2013.

¹⁹ Bobilev, 2014.

revoke more licenses since 2013 than the during the 2008 economic crisis, there has been little predictability in when and why the CBR revokes licenses, thereby failing to generate new expectations. For example, MasterBank was foreclosed in 2013 while Sberbank, Bank Rossiya, Otkritie Bank, and others that could be accused of the same violations remained operational.²⁰ Furthermore, the merger has not completely streamlined the process for closing banks. In order for the CBR to revoke a bank's license, it must get permission from the Deposit Insurance Agency (DIA), which is located within the Ministry of Finance.²¹ While neither the DIA nor the Ministry of Finance can prevent the CBR from revoking a bank's license, its authority is required because it finances the liquidation and dissolution of a bank. This undermines the CBR's authority and decreases the efficiency with which it can consolidate the sector. Thus, if the intention behind the reforms is to improve efficiency and reduce the number of shell banks, then this cannot be considered a success.

The enforcement of reserve requirements and other accounting standards has also proved to be ineffective. On the one hand, the OECD noted that no banks fell below the 10 percent capital reserve requirement in 2009, indicating that the sector was solvent.²² However, it is worth noting that this is after the CBR allowed banks to average their reserves to meet this requirement. Furthermore, this is also before the CBR's powers increased, and in 2016, the IMF observed that the CBR struggled to verify the quality of banks' assets and liabilities.²³ As such, if the CBR was having trouble verifying the quality of banks assets and liabilities in 2016 after its mandate was increased, then it is likely it was also unable to do so during the 2008 economic crisis. The result is that it is difficult to assess the level of risk that banks undertake when they borrow or lend. This increases banks' roll-over and default risk, and also increases the ease with which banking crises can be triggered.

Exacerbating these risks is the increased level of state control. Vernikov illustrates that the number of banks directly and indirectly controlled by the state increased from 35 in 2000 to 47 in 2009.²⁴ While this number declined to 38 by 2011, the state still controlled 55.8 percent of banking sector assets in 2012.²⁵ This indicates that, rather than privatise, the state officially merged some of the private banks it acquired through crisis containment with state controlled

²⁰ Коммерсант, 2013.

²¹ The International Monetary Fund, "Russian Federation Financial Assessment Programme: Technical Note — Bank Resolution and Crisis Management Programme," 2016. 13.

²² OECD, "Making the Banking Sector More Efficient and Resilient," 2009.

²³ Seal et al., 2016. 22.

²⁴ Vernikov, "The Impact of State-Controlled Banks on the Russian Banking Sector," 2012. 252.

²⁵ Ibid. 253.

banks such as VEB. However, state control often means soft budget constraints, which increases risk or default as it increases moral hazard. While injecting liquidity into otherwise productive banks during a crisis to prevent systemic upheaval is an acceptable form of crisis containment, supporting banks that would not survive under market conditions is not. Doing so prevents parasitic banks from being liquidated or foreclosed at the expense of a healthier, stronger banking sector and economy.

Furthermore, that these regulations are interpreted in such a way that allows the state to increase its control over the banking sector undermines the rule of law. For example, because the CBR finds it difficult to assess the assets and liabilities of the largest banks in the sector, it is unclear why some banks have their licenses revoked and are liquidated, while others are not. The CBR revoked the licenses of Master Bank, Bank of Moscow, and Globex Bank between 2011 and 2014 for violating reserve requirements and engaging in various illegal activities.²⁶ Conversely, there are numerous banks that blatantly flout regulations and avoid foreclosure, notably Sberbank and Bank Rossiya. For example, Sberbank was fined ₺50,000 for violating anti-money laundering laws in 2012, and Bank Rossiya openly undertook illegal transactions long before the Panama Papers were released; neither of these banks have had their licenses revoked.²⁷

If some banks are prosecuted for violations while others are not, then it is difficult to establish any expectations based on the predicted actions of the CBR. Furthermore, this reinforces the reliance of social networks and *sistema* to avoid liquidation instead of following the law. This creates two problems for the development of the banking sector. First, there is little assurance that long-term investments, of both domestic and foreign entrepreneurs, will not be confiscated. Second, it undermines consumer confidence in banks, making it less likely they will be used to mediate economic transactions and more likely that individuals will use cash or their *blat*. Therefore, as the CBR remains an underdeveloped institution and a weak industry regulatory, it incentivises command economy practices and the social economy at the expense of a market.

²⁶ It should be noted that Master Bank and the Globex Banks had their licenses revoked and were liquidated. Bank of Moscow was bought by, merged with, and is currently owned by VTB. VTB had been in the process of buying part of Bank of Moscow, and the revocation of the latter's license enabled it to purchase it outright.

²⁷ Коммерсант, "ЦБ снова оштрафовал Сбербанк" *Коммерсант.*; Myers, Becker, and Yardley, 2014.

7.2 The 2014 sanctions induced crisis

The 2014 economic crisis that struck Russia is classified as a currency crisis. The ruble lost 46 percent of its value in less than a year, including an 11 percent devaluation in a single day, and inflation rose to 11.4 percent.²⁸ However, it is different from the previous crises because economic growth began slowing before the crisis hit, indicating that it was an endogenous systemic problem that caused the downturn, not an exogenous shock. The source of economic malaise began in 2012, when the economy began reaching its productive capacity, meaning that without new inputs, future growth would be limited. This downturn turned into a currency crisis a few months after the West levied sanctions on Russia in response to the annexation of Crimea in March 2014. Like the crises before it, systemic vulnerabilities exacerbated its effects. As such, because the root of the crisis was institutional weaknesses within the economy itself, the 2014 crisis appears to force the state to address the partially reformed nature of the economy. Because the economy was headed for trouble both before oil prices fell and sanctions were imposed, the government's approach to crisis management was different. While crisis containment reforms still aimed to recapitalise and stabilise the economy through renationalisation, there is undeniably more of a focus on crisis resolution at an ideal time to result in crisis modernisation. However, even before the crisis is resolved there is evidence that the state is again using crisis resolution reforms to increase its control over the economy, rather than complete its transition to a market.

For example, given the scarcity of domestic financing and investment, the banking sector was on the verge of collapse. So in addition to the currency crash, the crisis exposed the weakness of the CBR's regulatory capacity. In fact, the IMF reported in 2016 that one of the CBR's glaring obstacles to efficiency was that its mandate to manage monetary policy and police the banking sector is too broad.²⁹ This is illustrated by the deterioration of the banking sector in the years before the imposition of sanctions, and its misguided attempts to prevent the ruble from collapsing.³⁰ As a result, several resolution measures are passed to help the CBR better mitigate these risks. For example, the law 'On the Securities Market,' was updated to better regulate foreign exchange dealers, and focus on improving supervision by adding a third

²⁸ Brigit Hansl and Et Al., "The Dawn of a New Economic Era?" Washington DC. The World Bank, 2015. 10.

²⁹ Seal et al., 2016. 28 – 33.

³⁰ An examination of the CBR's monetary policy is beyond the scope of this study. However, the conclusions of other scholars are overwhelmingly that the CBR's use of the interest rate to control inflation overlooks more fundamental problems, and far from being the appropriate tool, it actually makes it more difficult to bring inflation down. For more information, please see: Connolly, 2011.; Sapir, 2010..

tier to the banking system. It is still too soon to tell whether or not these measures will lead to institutional development. However, preliminary analysis suggests that these measures only further undermine the transition to a market economy.

The Russian economy began to recover from the 2008 crisis when oil prices increased again in 2010, but it was predicted that this trajectory would be short lived. In 2012, the GDP fell to 3.5 percent from 4.5 and 4.2 percent growth in 2010 and 2011 respectively.³¹ The most promising development at that time was that post-crisis economic growth was fuelled more by domestic production and consumption than exports.³² However, this growth was not very sustainable due to the CBR's approach to monetary policy, which heavily relied on increasing the interest rate to control for inflation. This only resulted in higher inflation, as it limited the amount of credit available for longer-term investments and economic growth.³³ In fact, this contributed to the economic decline as it restricted the economy from producing at a higher capacity, which resulted in a decline in both production and consumption.³⁴ Indeed, by late 2012, and early 2013, the economy began to slow, output began to fall, and investment became even more dependent on public funds as foreign investors fled.³⁵ In fact, in 2013, Russia was ranked 112th place out of 185 countries in the Ease of Doing Business ranking.³⁶

The terms of Russia's WTO accession in 2012 required the state to privatise more of the banking sector as a means of improving competition and creating opportunities for growth.³⁷ Yet, the lack of economic diversification was beginning to slow the economy down, especially the banking sector. By the end of 2012 The CBR acknowledged the slowdown, but said it would not use either fiscal or monetary tools to intervene.³⁸ The extent of government control prevented new banks and firms from competing with state banks, which also limited the amount of credit available, and by extension, new economic innovation and capacity for growth. In 2013, the inability of banks to increase their productivity or profitability was beginning to show as profits began to fall. Banks had begun to find other more volatile sources of profit even before sanctions were imposed 2014. For example, Sberbank began trying to compensate for these losses by increasing its lending portfolio despite the CBR urging it to cut

³¹ Sergei Ulatov et al., "Recovery and Beyond" Washington DC. The World Bank, 2013. 4.

³² Ulatov and Bogetic, 2010. 6.

³³ Ibid. 3.

³⁴ Birgit Hansl et al., "Policy Uncertainty Clouds Medium-Term Prospects" Washington DC. The World Bank, 2014. 2.

³⁵ Ulatov et al., 2013. 3.

³⁶ Ibid. 28.; The World Bank, "Smarter Regulation for Small and Medium-Sized Enterprises," 2013.

³⁷ Ulatov et al., 2013. 24.

³⁸ See CBR + Sberbank 19.12.2012.

back.³⁹

The banking sector began to feel the effects of sanctions immediately as reserves fell below their 2008 level, the retail lending sector experienced a 10 percent decline in new loans, and private investment declined from \$295 million in 2013 to \$35 million in 2014.⁴⁰ As a result, banks' loan to deposit ratio increased to 120 percent, and forced many of them to turn to CBR for assistance.⁴¹ Furthermore, Herman Gref, the head of Sberbank declared that Russia was facing a massive liquidity crisis and that 13 percent of the banking sector was operating on short-term loans from the CBR, making it difficult to fund long-term projects.⁴² By late 2014, Standard and Poor declared that over half of the banks in Russia had been directly affected by the crisis as the sector faced tighter finance restrictions, causing several banks' market value to drop and further restricting their access to credit.⁴³ This forced banks to resort to inter-bank lending, which is poorly regulated and only increased sectoral risk of collapse.⁴⁴ Moreover, the CBR struggled to ensure banks' capital adequacy ratios were high enough to mitigate the risk of loans rolling over, or becoming delinquent.⁴⁵ Thus, the banking sector posed a significant risk to the already struggling economy and in December 2014, Putin warned that the economy would likely fall into a recession in 2015 and that Russians should prepare for 'hard times ahead.'⁴⁶

In addition to the risk of a banking sector collapse, the CBR struggled to control a rapidly devaluing ruble and currency speculation. The CBR intended to switch to a floating exchange rate in April 2015, so it implemented an exchange rate corridor, in which it would make no interventions as long as the ruble's value remained the within it corridor's boundaries.⁴⁷ However, currency speculation made maintaining the corridor so costly that the CBR floated the ruble unexpectedly in November 2014, nearly six months earlier than planned. This allowed the CBR to cut currency interventions by 97 percent in November 2014 alone.⁴⁸ The effect was limited, however, and the CBR enacted a sudden increase in the interest rate from 10.5 to 17 percent on 15 December 2014 in an attempt to gain control over the run-away

³⁹ Moscow Times, 28.11.2013.

⁴⁰ Moscow Times 12.09.2014 / 17.09.2014

⁴¹ Hansl et al., 2014. 11.

⁴² Moscow Times 04.12.14

⁴³ Bloomberg. 20.11.2014.

⁴⁴ Moscow Times 12.09.2014.; Ulatov et al., 2013. 24.

⁴⁵ Ibid. 24.

⁴⁶ BBC News, "President Putin Urges Russian Resilience for Hard Times," *BBC News*, 04 December.

⁴⁷ Hansl et al., 2014. 10, Box 5.

⁴⁸ Moscow Times 10.11.2014.; Russia Today 02.12.2014.

ruble, but to no effect.⁴⁹ The next day, the ruble collapsed falling from ₺58 to \$1, to ₺88 to \$1, constituting the single largest fall in value since 1998.⁵⁰ As a result, foreign exchange dealers halted trading out of fear that the CBR was on the verge of implementing capital controls, although this never happened as both the CBR and Ministry of Finance insisted that this was never an option.⁵¹ Over the next few days, many blamed the CBR's lack of intervention to support the ruble after the surprise interest rate hike for undermining confidence in the currency and causing the devaluation.⁵²

The most significant cause of the economic crisis, however, was not the sanctions, but the state's control over the economy. The economy had reached its maximum production capacity, or total factor productivity (TFP), meaning that there was no way to increase output or production in its current state. Because state control over the economy is very high, it limits the scope of both foreign and domestic private investment, which stifles the emergence of more efficient economic actors.⁵³ As a result, the number and variety of inputs are considerably limited, and output is diminished. Thus, before the sanctions hit, the Russian economy was operating as efficiently as possible, but the resulting production was not profitable. This is also taking into account the slow improvements to infrastructure that began in 2007.⁵⁴ As such, the amount of domestic capital available for increasing investment was constrained before the sanctions were imposed, and this only became more difficult when they were. Even without the sanctions Russia would have entered a recession as the economy had reached its maximum potential. Thus, the 2014 crisis was the result of the economy reaching its potential in a partially reformed state. If real economic growth, not oil fuelled growth, is to resume institutional development that would complete the transition to a market economy needs to be undertaken.

In order for crisis modernisation to emerge from this crisis there must be a focus on institutional development, and the state must diversify its assets. A study on diversification and economic growth undertaken by the World Bank suggests a strong correlation of diversification of assets and increased efficiency, rather than diversification of exports.⁵⁵ This is why state investment in, and control over the economy has not been able to increase TFP, because there is no diversification of inputs.⁵⁶ Thus, institutional strength and privatisation are vital to strong

⁴⁹ NYT 05.12.2014.

⁵⁰ Moscow Times 16.12.2014.

⁵¹ Reuters 16.12.2014.

⁵² Financial Times. 16.12.2014.

⁵³ Hansl et al., 2014. 49.

⁵⁴ Ibid. 43.

⁵⁵ Ibid. 38.

⁵⁶ Ibid. 39.

and sustained economic recovery because the state has a finite number of inputs it can contribute. In addition to the state allowing and encouraging more private investment, the best way to attract this investment is to make law enforcement and policy implementation more predictable.⁵⁷ As such, reforms should aim to improve the fairness, transparency, and efficiency of regulation.

Furthermore, the aforementioned World Bank report lists three roles that the Russian government must develop to support economic recovery and growth: fiscal, monetary, and exchange rate policies that help manage currency volatility; the ability to efficiently administer public services; and the ability to regulate private firms to foster and protect a competitive environment.⁵⁸ Of these three, the CBR fulfils two roles. Thus, ensuring that crisis resolution reforms address the CBR's capacity to effectively and efficiently fulfil these roles is necessary for crisis resolution to take place and the partially reformed nature of its institution to be broken. When the ruble crashed, it was vital for the CBR to both stabilise and consolidate the banking sector to prevent the currency crisis from inciting a banking crisis as liquidity became scarcer and debt obligations mounted.⁵⁹ This required a careful mix of liquidity assistance, and asset management and restructuring, as well as more development of the CBR's regulatory capacity. As such, the CBR enacted a number of measures to recapitalise banks, lower the risks of their lending portfolios, and consolidate its own regulatory abilities so that it can more efficiently liquidate insolvent banks, and develop a more risk-based rather than rules based approach.⁶⁰ The latter is the most important as it is the difference between the CBR being an active versus passive regulator. As of 2017, the success of these measures is mixed, with crisis containment reforms being more effective. While crisis resolution measures are cautiously optimistic, there is plenty of room for doubt.

The CBR implemented liquidity assistance and regulatory forbearance measures as a means of crisis containment. However, while liquidity assistance is still favoured by the CBR, it is the regulatory forbearance measures that maintain sector vulnerabilities during the 2014 crisis. In January 2015, government issued a ₺2.4 trillion plan to stabilise the financial sector and other parts of the economy.⁶¹ The CBR made ₺100 billion worth of 28 and 365-day repo loans available in 2014 and 2015, in addition to various forms of liquidity assistance totalling

⁵⁷ Ibid.

⁵⁸ Ibid. 46 – 47.

⁵⁹ Hansl and Al., 2015. 29.

⁶⁰ Seal et al., 2016. 19.

⁶¹ Birgit Hansl and Et Al., "Balancing Economic Adjustment and Transformation" Washington DC. The World Bank, 2015. 17.

₽1 trillion.⁶² Several forms of regulatory forbearance freed up extra liquidity for banks. For example, until 2 January 2016, the CBR allowed banks to calculate foreign assets using a fixed exchange rate of ₽39, 45 and 55 per USD, in December 2014, 2015, and 2016 respectively, varying from the actual exchange rate by 25 to 30 percent on average.⁶³ Additionally, banks were allowed to reclassify overdue loans, which enabled them to postpone or write-off debt that would otherwise make them insolvent.⁶⁴ In fact, most banks only maintained the 10 percent capital adequacy ratio because of CBR assistance.⁶⁵ The problem is that while the liquidity assistance measures prevented a banking crisis, they did not address the structural weaknesses within the CBR or the banking industry. It cannot substitute for bank restructuring or other crisis resolution measures, without which the sector remains vulnerable.⁶⁶

For example, because the forbearance measures allowed banks to calculate their assets based on pre-crisis values, NPL and capital adequacy ratios are likely higher than reported.⁶⁷ Specifically, while the CBR reported that NPLs were only at seven percent, the actual level was closer to 10 percent.⁶⁸ To further obscure the risk level, the CBR maintained the Russian Accounting Standard (RAS) to reduce the number of banks that may have become insolvent or otherwise compromised when it was due to begin using Basel III accounting standards in 2016.⁶⁹ Basel III is a set of banking regulations and accounting standards used to calculate the amount of reserves banks must hold in order to meet the required capital adequacy ratio of 4.5 percent. Furthermore, there is currently no deadline for shifting away from the RAS, and the only institution that uses Basel III exclusively is the Ministry of Finance.⁷⁰ This increasingly complicates the consolidation process as the CBR and the Ministry of Finance have to work

⁶² Jason Bush and Alexander Winning, "Analysis - No Easy Options for Russia's Central Bank to Halt Rouble Slide," Reuters <https://uk.reuters.com/article/uk-russia-economy-analysis-idUKKCN0IC1NO20141023>.; Jason Bush, "Russian Central Bank to Lend Dollars to Offset Western Sanctions," Reuters.; Hansl and Al., 2015. 10, Box 5.

⁶³ The International Monetary Fund, "Russian Federation Financial Assessment Programme: Technical Note — Bank Resolution and Crisis Management Programme," 2016. 12.

⁶⁴ *Ibid.* 12.

⁶⁵ Birgit Hansl and Et Al., "The Long Journey to Recovery" Washington DC. The World Bank, 2016. 47 – 48.

⁶⁶ Hansl and Al., "Balancing Economic Adjustment and Transformation," 2015. 37.; Laeven and Valencia, 2008. 22.

⁶⁷ Hansl and Al., 2015. 11 – 12. It should be noted that the fixed exchange rates were based on the ruble's value in October 2014, and then it was rate was increased as the measure was renewed and extended.

⁶⁸ The World Bank. "Global Financial Development Database." 2017. 26 – 27.

⁶⁹ Seal et al., 2016. 14.

⁷⁰ *Ibid.* 14.

together to liquidate and consolidate banks.⁷¹ If each uses different accounting standards, then the criteria for bank liquidation and consolidation will differ for each. In fact, the IMF's assessment of the Basel Core Principles in Russia in 2016 found that the CBR is 'materially non-compliant' in its role in mergers and acquisitions, and that there are barriers to its ability to consolidate the market.⁷² Thus, although these measures stabilised the banks, they made it difficult to assess the banking sector's risk of default. More importantly, these measures obfuscate the reasons for which the CBR and the Ministry of Finance liquidate and consolidate banks. As such, it is difficult to predict how regulations will be implemented, and encourages banks to rely more on their social networks than formal institutions.

Bald and Nielsen demonstrate that financial institutions should be conducive to the development of efficient capital markets and encourage investment in profitable assets.⁷³ As such, crisis resolution reforms should help the CBR and government facilitate this role, but the resolutions measures of the 2014 crisis do not appear to do so. If crisis resolution measures are to result in crisis modernisation, then the CBR should be strengthened as a financial institution. Yet, for every measure that appears to resolve institutional weaknesses, there is evidence that the resulting policies are more form than substance.⁷⁴ To start, the government owned asset management and restructuring programmes were undertaken much more aggressively than 1998 or 2008 as the CBR consolidated or liquidated 16 percent of Russia's banks between 2013 to 2015; but the banking sector still poses a large risk to economic stability.⁷⁵ Even more promising was the 2016 privatisation plan Putin announced, which listed a number of lucrative state controlled firms to be sold. However, none of the stakes were enough to reduce state control.⁷⁶ Finally, The CBR's increased regulatory powers granted in 2013 have not improved the transparency or predictability of banking regulation. For example, the implementation of 'On the Securities Market' has effectively shut down the forex market and halted the relicensing of private pension funds. Each of these issues will be examined in turn to demonstrate that the means by which the government and CBR are implementing crisis resolution measures appear to undermine any chance of institutional development.

The CBR closed 49, 41, and 53 non-viable banks in 2014, 2015, and 2016 respectively,

⁷¹ The International Monetary Fund, "Russian Federation Financial Assessment Programme: Technical Note — Bank Resolution and Crisis Management Programme," 2016. 10.

⁷² Seal et al., 2016. 67.; The International Monetary Fund, "Russian Federation Financial Assessment Programme: Technical Note — Bank Resolution and Crisis Management Programme," 2016. 31 – 33.

⁷³ Bald and Nielsen, 1998. 81.

⁷⁴ Hansl and Al., "The Long Journey to Recovery," 2016. 50 – 51. Box

⁷⁵ Bloomberg.

⁷⁶ BBC News, "Russia Lines up State Assets for Privatisation," *BBC News*, 02 February 2016.

with most licenses being revoked for money laundering, fraudulent reporting, inability to pay creditors, and overvalued assets.⁷⁷ However, the banking system remained on the brink of collapse as non-performing loans (NPLs) rose and banks struggled to meet capital adequacy requirements. Short-term debt became the tool of choice for banks and some regional governments to survive the crisis, with subnational loans accounting for 1/3 of short-term debt.⁷⁸ Thus, despite the mounting roll-over and default risks, banks were still lending. The NPL risk rose from 6.5 in at the end of 2013, to 8.2 percent in June 2014, and then increased to 10 percent in 2017.⁷⁹ Furthermore, Russia's largest banks, which are controlled by state, continued to support banks regardless of NPLs.⁸⁰ More concerning is that the actual level of NPLs was obscured by the regulatory forbearance measures. Liquidity assistance and regulatory forbearance helped banks appear adequately capitalised even as their profit margins approached zero, falling from 7.9 to 2.3 percent between 2014 and 2015.⁸¹ As such, despite the CBR's increased ability to revoke licenses, this did little to reduce the risk the banking sector posed to the economy.

Hoelscher and Quintyn demonstrate that poor policy coordination raises the costs of crises because it undermines efforts to resolve it.⁸² In order to resolve the crisis and ensure future economic growth, the state needed to increase economic production capacity through privatisation.⁸³ Yet, the state undertook very little privatisation, thereby reinforcing the problem of growth capacity. The government announced a privatisation programme for 2016, including selling stakes in lucrative and strategic firms such as VTB, Aeroflot, Alarosa, Bashneft, and Rosneft, as a means increasing budgetary revenue.⁸⁴ In the end, the privatisation of VTB was postponed until after sanctions have been lifted.⁸⁵ However, none of the other stakes sold reduced the state's majority share, so this cannot not qualify as privatisation. For

⁷⁷ The Central Bank of the Russian Federation, "Information on Registering and Licensing of Credit Institutions".

⁷⁸ The World Bank. "Global Financial Development Database." 2017. 7.

⁷⁹ Hansl et al., 2014. 11.; Hansl and Al., "The Long Journey to Recovery," 2016. 22.; The World Bank. "Global Financial Development Database." 2017. 26 – 27.

⁸⁰ Hansl and Al., "The Long Journey to Recovery," 2016. 47 – 48.

⁸¹ Ibid. 22, 23 Figure 1-24.

⁸² Hoelscher and Quintyn, 2003. 4.

⁸³ Estrin et al., 2009.702; Simeon Djankov and Peter Murell, "Enterprise Restructuring in Transition: A Quantitative Survey," *Journal of Economic Literature* 40, 3. (2002): 739 - 92.. Also see previous chapter for more analysis on the limitations of state control over the economy.

⁸⁴ Hansl and Al., "The Long Journey to Recovery," 2016. 26.; BBC News, "Russia Lines up State Assets for Privatisation," 2016.; Hannah Lilley and Emily Ferris, "Russian Privatization: A Fresh Start," *Forbes*, 27 July 2016.

⁸⁵ Reuters Staff, "Russia's Vtb Ceo: No Privatisation of Bank until Sanctions Scrapped," *Reuters*, 01 December 2016.

example, in October 2016, Rosneft purchased the oil company Bashneft, which had been seized from Sistema CEO Vladimir Yevtushenkov in September 2014, for \$5 billion.⁸⁶ If the state controlled company purchased another oil company, then the state is increasing its assets, not privatising them. Additionally, the state did sell a 19.5 percent share of Rosneft in December 2016 for \$11 billion to a combination of the Swiss firm Glencore and the Qatar Investment Fund.⁸⁷ However, the state still controls 50.001 percent of Rosneft, and other government agencies control the other 30 percent. As such, Rosneft was not privatised as it remains both directly and indirectly controlled by the state.

The privatisation of Rosneft is also an example of how the CBR has not drastically improved its ability to regulate the banks. Anastasia Gnezditskaya illustrates how oligarchs and firms hide shareholder identities from banks: the CBR requires banks to disclose the identity of single investors who purchase stakes of 20 percent or more.⁸⁸ To avoid this, companies will sell stakes of less than 20 percent to multiple individuals, which absolves them of any responsibility. Gnezditskaya further demonstrates that this erodes investor confidence because it increases firms' moral hazard since they cannot be held responsible for poor decisions.⁸⁹ Thus, among the various reforms the CBR has been able to implement, requiring the full disclosure of all investors is not one it has undertaken, nor does it have explicit plans to do so.⁹⁰ This is particularly striking given the economic need for investment. For example, it is unknown who exactly funded the purchase of Rosneft as loans to secure the stake were initially issued by VTB, Italian Bank Intesa, and Qatar, and the amounts paid that can be traced leave a \$2.6 billion shortfall.⁹¹ Additionally, although Putin forbade state banks from participating in the auction, VTB initially provided the entire \$11 billion via a loan agreement, which ended on 22 December 2016. While the shares were transferred as collateral to a bank

⁸⁶ Bierman, Mazneva, and Pismennaya, 2016.; Joe Nocera, "Putin Shows His Hand," *The New York Times*, 11 October 2014.; TASS Russian News Agency, "Russia State Property Agency Considers Disputed Bashneft Assets as Russia's Property," *Itar Tass*, 30 October 2014.; Bloomberg, "Russia May Widen Claims on Sistema as State Seeks Bashneft," *Bloomberg*, 09 October 2014..

⁸⁷ Katya Golubkova, Dimitry Zhdannikov, and Stephen Jewkes, "How Russia Sold Its Oil Jewel without Saying Who Bought It," *Reuters*.

⁸⁸ Gnezditskaia, 2005. 470 – 471.

⁸⁹ *Ibid.*

⁹⁰ The Central Bank of the Russian Federation, "Guidelines for the Development of the Russian Financial Market in 2016 - 2018" Moscow. The Central Bank of the Russian Federation, 2016. In this report, the CBR addresses the problems with disclosure and that something should be done, but it lays out no particular

⁹¹ Golubkova, Zhdannikov, and Jewkes, 2017.; Polina Nikolskaya, Darya Korsunskaya, and Katya Golubkova, "Russian State Bank Lent Billions to Fund Rosneft Privatization Deal," *Reuters*, 17 January 2017.; Karina Orlova, "Rosneft's So-Called Privatisation Gets Murkier," *The American Interest*, 18 January 2017.

in Singapore, and then Intesa in Italy, VTB never clarified that entire \$11 billion had been paid.⁹² The failure to disclose where all the funding for the stake came from, especially considering the value of the sale, and who all the owners are, undermines the CBR's credibility and investor confidence.

North describes how limited access orders control competition and the number of economic actors to reduce disorder and chaos, but this only works if competition is suppressed.⁹³ This results in high barriers to entry and the necessity of a *blat* to overcome them. The CBR's approach to new licensing schemes in the update to the forex trading law and the new regulations for private pensions, reflects this. When the ruble crashed in December 2015, most of the foreign exchange dealers that had speculated on the ruble operated within banks, but the CBR had no power to regulate this.⁹⁴ On 1st January 2016, the law 'On the Securities Market' came into force. The law requires forex dealers to meet four requirements, including a minimum net capital of ₺100 million and a CBR issued license, which places the dealers under CBR supervision.⁹⁵ The problem is that the CBR has used this law as a tool to prevent foreign exchange traders from operating at all. As of March 2017, only seven traders were granted licenses to operate, with others concerned about the lack of transparency over the licensing process as the CBR has not spelled out exactly what additional criteria the banks must meet to be licensed.⁹⁶ Thus, in this instance, as the CBR increases its power, it incentivises players to use and reinforce informal institutions.

Further evidence of this are the new regulations for private pension funds and the dissolution of Globex. In 2014, the government implemented a reform to ensure the security of the growing private pension fund market, which would require all private pension funds to change their status from non-profit organisation to joint stock company, and obtain the corresponding CBR license.⁹⁷ In the interim, the government froze private pension accounts and diverted payments from these accounts to the public pension budget because the extra-

⁹² Nikolskaya, Korsunskaya, and Golubkova, 2017.; Orlova, 2017.

⁹³ North et al., 2007. 7 -10.

⁹⁴ The Central Bank of Russia Press Service, "On Activity of Companies Rendering Services in Otc Forex Market," news release, 2014, http://www.cbr.ru/eng/press/PR/?file=02122014_102126eng2014-12-02T10_15_10.htm.

⁹⁵ LeapRate, "Tighter Rules Loom for Russian Forex Companies," <https://www.leaprate.com/news/tighter-rules-loom-for-russian-forex-companies/>; Елена Гостева, "Центробанк Может Лишить Форекс Клиенов," *Bankir.ru*.

⁹⁶ LeapRate.; Finance Magnates, "Analysis: A Year Infot Russia's Forex Regulation, Bank of Russia's Filter Is Low."

⁹⁷ Darya Korsunskaya and Maya Dyakina, "New Russian Pension Reform Fuels Nationalisation Fears," *Reuters*, 03 October 2013.; Krystyna Krzyzak, "New Pensions Law Goes into Effect in Russia," *Investments and Pensions in Europe*, 03 January 2014.

budgetary fund use to pay pensioners was in deficit.⁹⁸ In September 2015, the CBR revoked the license of the largest private pension fund Globex, and all of its subsidiaries. The reason given was that the funds paid into the accounts were used for other activities, such as Globex CEO Anatoly Motylyov's real estate businesses, and that the ₺109 billion assets were outweighed by the ₺210.5 billion of liabilities.⁹⁹ It is highly likely that the CBR's accusations are true. However, given the number of banks with NPLs that were allowed to remain operational, the singling out of Globex over others only increases the regulator's unpredictability. This makes the CBR, like the government, appear predatory, which undermines the rule of law and the transition to the market.¹⁰⁰ This uncertainty undermines confidence in formal institutions and encourages the use of informal ones.¹⁰¹

There are a few recent reforms that bear mentioning as they will be important to the future health and structure of the banking industry. First, there has been a growing number of small non-finance institutions specialising in micro-lending and loans for SMEs.¹⁰² Until 2013, these banks were regulated by the Federal Financial Market Service, but now come under CBR supervision. There have been two steps taken to ensuring these banks can provide funding to SMEs, as well as improving bank regulation more generally. First, as these banks provide micro-loans or smaller loans, capital charges on SME loans were lowered and the CBR has been working on enhancing the financial support mechanisms offered by non-bank financial institutions.¹⁰³ Second, in January 2018, the CBR is implementing proportional bank regulation by adding a third tier to the banking sector. This will divide banks into three licensing categories with different licensing and reserve requirements: systemically important banks, universal banks, and basic banks.¹⁰⁴ It is likely that non-bank financial institutions will need to be relicensed as universal banks, but this contradicts some of the exceptions just listed. As such, these measures seem promising on paper, but their implementation will determine how much they will actually improve banking sector regulation and financial intermediation.

Russia has only just begun to exit the 2014 economic crisis, and crisis modernisation and long-term recovery is questionable because the reforms that would diversify assets and

⁹⁸ Hansl and Al., "The Long Journey to Recovery," 2016. 27.; Korsunskaya and Dyakina, 2013.

⁹⁹ Weaver, "Russia's Anatoly Motylyov: Rise, Fall, Repeat," 2015.; The Central Bank of the Russian Federation, "On Activities of Ojsc Rossiyskiy Kredit Bank," news release, 2015.

¹⁰⁰ Barnes, 2003. 156.

¹⁰¹ Hansl and Al., "The Long Journey to Recovery," 2016. 46.

¹⁰² Lyman, Staschen, and Tomilova, 2012. 15 – 19.

¹⁰³ The World Bank, "From Recession to Recovery" Washington DC. The World Bank, 2017. 27.

¹⁰⁴ Ibid. 28.

increase output have not been undertaken.¹⁰⁵ The privatisation plan announced in 2016 did very little to privatise the economy, thus doing very little to increase asset diversification. Furthermore, the banking industry still remains a substantial risk to the country's long-term economic health because the lack of transparency makes it difficult to determine banks' true financial status. The CBR's new power as a consolidated regulator did not help to clarify the rules of the game in the banking industry either, as evidenced by the new laws on forex traders and private pensions. The regulators actions make it appear like a predatory institution. While this cannot be ruled out, it is possible that these actions are not purposeful. Rather, that the CBR's own weakness, confronted with the strength of rigid informal institutions and *sistema* constrains its ability to evenly and universally enforce regulations. In which case, the logical conclusion does not change. If the CBR is unable to fairly and universally implement regulations, regardless of whether the weakness stems from its internal machinations or outside constraints, it fails to create a stable, predictable environment within which it can mediate conflicts and economic transactions. This restricts the impact it can play in fostering and sustaining a strong economy. Thus, the 2014 crisis forces Russia to reckon with the limitations of partial reform equilibrium as prospects for economic growth, outside of oil prices, are restricted. Without reform, or a sustained increase in oil prices the economy will stagnate and could eventually begin to contract.

7.3 The crisis modernisation fallacy

The case studies illustrate that Russia's banking institutions are trapped in partial reform equilibrium, because banking policies fail to result in crisis modernisation. To refresh, partial reform equilibrium is defined as, 'the selected introduction of market mechanisms into an economy in which substantial spheres of economic activity still operate according to alternative mechanisms of coordination.'¹⁰⁶ As such, economic crises fail to result in crisis modernisation, because the mechanisms necessary to undertake crisis resolution measures are inherently market mechanisms, which have not yet been established. Each of the crises has a different cause and necessitates a different response, but all of the crises demonstrate the weakness of banking institutions through the reliance on crisis containment measures, and as a result, the difficulty in containing additional economic risks, such as inadequately capitalised banks. Furthermore, comparing the crisis resolution measures that should have been undertaken with

¹⁰⁵ The World Bank. "Global Financial Development Database." 2017. 11.

¹⁰⁶ Hellman, 1998. 218 – 219.

those that were (or in some cases were not), show how economic crises have only reinforced partial reform equilibrium by supporting the command practices of patrimonial state control and the use of the social economy. Thus, the CBR's approach to economic crises is an example of further attempts to modernise Russia's economy rather than focus on institutional development. This will be demonstrated first by synthesising how crisis management policies support partial reform equilibrium, and why it endures. Next, the implications of this on the future of institutional development will be enumerated. Finally, we will conclude that partial reform equilibrium will be broken once the economy becomes primarily command or market, and that this will take time regardless of the outcome.

As noted, historical institutionalists argue that institutions are fixed until major events force them to change, or what they call punctuated equilibrium.¹⁰⁷ This is supported by numerous economic studies demonstrating how economic crises can result in institutional development, or what this study has called 'crisis modernisation.'¹⁰⁸ However, the case studies and above analysis demonstrate that this has not happened in Russia. If crisis modernisation had taken place, then partial reform equilibrium would be broken as crisis resolution reforms would result in institutional development by creating the economic coordination mechanisms necessary to foster either a market or command economy. None of the measures undertaken in response to either the 1998, 2008, or 2014 crises appear to fulfil this criterion. This will be demonstrated by examining the impact of the crisis modernisation and crisis resolution measures on partial reform equilibrium.

To begin, the burden of proof that the Russia's economic institutions are weak and partially reformed is the overwhelming reliance on crisis containment measures to stabilise and resolve economic crises. As a result, the weaknesses that caused the crises are not addressed, thereby establishing an unstable foundation for future economic growth. All of the crisis containment measures maintain soft budget constraints (SBCs), because they do not require banks to take responsibility for their poor financial decisions, or risk they pose to the entire economy. While no blanket guarantee of liquidity assistance was issued in 1998, the Central Bank of Russia still recapitalised banks with little regard to mitigating future risk. Conditions were not attached to liquidity assistance, so there was no way to ensure banks used the funds appropriately. As a result, banks continued to exploit systemic weaknesses with little regard to the risk their actions posed to the banking sector and the wider economy. In fact, this directly

¹⁰⁷ See chapter two for more information. See also, Steinmo, 2008. 129.; Thelen and Steinmo, 1992.

¹⁰⁸ Kornai, 1994.; Hallerberg and Scartascini, 2011.; Laeven and Valencia, 2008.; Drazen and Grilli, 1993.

contributed to the cause and severity of the 2008 crisis in Russia. During this crisis, the state undertook bank recapitalisation with few conditions, aiming to stabilise the sector and keep it solvent. While these measures did stabilise the banking sector, they did not prevent the economy from contracting severely, nor did they result in a proportional economic recovery. In 2014, the use of liquidity assistance was again the dominant measure, but this time the CBR also heavily relied on regulatory forbearance to create a liquidity buffer for banks. That the containment measures stabilised the banking sector in 2008 and 2014 is irrelevant as they do not require strong institutions to be effective.

These measures reinforce the patriarchal nature of the state and SBCs, which are the backbone of command economy institutions and at odds with market institutions. As a result, the necessity for banks to be as efficient and effective as possible is undermined, and the market drive for profit maximisation is missing. This approach to crisis containment measures demonstrates that the CBR and government are pursuing contradictory objectives regarding the banking sector. On the one hand, they want the banking sector to be as vibrant, productive, and profitable as those in the West. For example, the financial hub Moscow City is being built to rival Manhattan or London.¹⁰⁹ However, the maintenance of SBCs allows inefficient banks that are a drain on economic resources to remain operational. This is a disincentive for banks to undertake medium and long-term investments, without which the sector cannot be as robust and profitable as the government and CBR would like. Hard budget constraints are necessary to make banks as efficient and profitable as possible, and the continued softening of these constraints prevents this from transpiring. Thus, the reliance on crisis containment measures not only demonstrates institutional weakness, but replicates it, reinforcing those practices that maintain partial reform equilibrium.

Second, this is sustained by the failure of crisis resolution reforms to make economic transactions more predictable maintaining a weak rule of law and high barriers to entry. As discussed in the first chapter, there are three main principles of the rule of law: 1) there can be no crime without law; 2) law is universally applied — no one is above or out of reach of the law; 3) the law will be analysed and enforced by a neutral third party.¹¹⁰ In order for crisis resolution measures to break partial reform equilibrium, they would adhere to these three criteria. None of the measures that were undertaken do so. As such, these reforms are merely parchment rules, which are laws that have been written to solve a problem, but the means of

¹⁰⁹ Andrew Kramer, "In Moscow, a Financial District in Name Only," *The New York Times*, 25 November 2014.

¹¹⁰ Kahn, 2006.

enforcement render the laws' application unpredictable.¹¹¹ To demonstrate this, the analysis of major reforms from each crisis will be examined against these criteria.

The first principle, there can be no crime without law, is where most scholars fail to appreciate the role that institutions play. Tax reform after 1998, CBR consolidation after 2008, and the new licensing requirements for forex traders and private pensions are the measures most likely to result in institutional development, because they seemingly target specific institutional weaknesses. Additionally, these measures have actually resulted in some tangible change: tax revenues have increased, the CBR has managed to bring the number of banks below 700, and private pension funds and forex traders will be required to hedge their risks and put their clients' interests first. Yet, these laws are often vague, enabling the state to use them as a political tool, and obscure what is and is not legal. For example, the implementation of the 2001 tax reform was not as straightforward and effective as initially believed, because while the rate of flat tax payments from individual incomes increased, the same could not be said for businesses.¹¹² Furthermore, the new measures enacted by the CBR to regulate licensing are too vague to be strictly enforced. There has been little transparency regarding decisions to revoke licenses from existing banks, and there has been little light shed on the criteria that forex traders and private pensions need to fulfil to be granted licenses.¹¹³ Thus, while laws have been written down they do not clarify what is and is not a crime. As a result, barriers to entry remain high and market institutions are diminished.

The second principle, that the law applies to everyone, is where continued institutional weaknesses are evident despite crisis resolution measures. Because the laws are not clear, anyone can be prosecuted for criminal activity as many are breaking the law. For example, the cases of Khodorkovsky, Globex, and Master Bank illustrate the selective implementation of the law. In these cases, the problem was not state intervention; by all accounts the charges brought against each were true and easily substantiated. The problem is that many others have committed the same crimes as Khodorkovsky, and many banks have committed the same crimes as Globex and Master Bank. Furthermore, the increase in raiding cases demonstrates the use of law as a tool to enact the government's agenda.¹¹⁴ As a result, power and authority are vested not in the law or even institutions, but in the state, in individuals. The law does not

¹¹¹ As discussed in chapter one. For more, see: Carey, 2000.; Levitsky and Murillo, 2009. Gelman, 2004.

¹¹² Sakwa, *Putin: Russia's Choice* (2008). 245.

¹¹³ Seal et al., 2016. 20 – 33.; LeapRate.; Finance Magnates.

¹¹⁴ Sakwa, "Systemic Stalemate: Reiderstvo and the Dual State," 2013. 73.; Yakovlev, Sobolev, and Kazun, 2014. 187; Rochlitz, 2014. 100.

proscribe how the state and state agents should act, but individual agents determine how the law will be interpreted and used on a case by case basis, making it impossible to ever predict what the safest or even most profitable course of action will be. This necessitates the reliance on the social economy over institutions to navigate the economy, thereby reinforcing command economy practices. This is antithetical to market institutions, and prevents partial reform equilibrium from being broken.

The final principle is that the law is enforced by a neutral third party. The role of institutions is to mediate conflict and remain neutral when enforcing the law. North demonstrates that institutions are built to distil order from chaos.¹¹⁵ However, because laws and their implementation are chaotic, third parties cannot be neutral in their enforcement as there is no precedent for them to refer. Indeed, Solomon illustrates how the development of the judiciary system, and law as a practice, has taken place alongside the development of private property rights.¹¹⁶ It is inferred that if private property rights are weak, so too is the legal profession. This is because under the command economy, there was no private property, and economic crimes were committed against the state.¹¹⁷ Furthermore, this principle is compromised by the fact that the state has too much control over the economy, which results in a conflict of interest. Thus, because private property rights are weakened as the state increases its direct and indirect control over the economy, it is difficult for third party enforcers, such as judges and lawyers, to fairly uphold and implement the law.

The perpetual weakness of Russia's banking institutions is the source of its weak rule of law. This maintains partial reform equilibrium as individuals resort to the social economy and *sistema* to navigate economic transactions and mediate conflict in the absence of strong institutions, thereby sustaining command economy practices at the expense of those that are market. As Vladimir Gel'man explains, 'The "legacy of the past" is not just an obstacle to the rule of law, but it is also a resource for risk aversion.'¹¹⁸ It is difficult to overcome the legacy of the command economy as the practices that maintain partial reform equilibrium are how things have worked and how people have avoided trouble. As argued by Anders Åslund, the pillars of a command economy, such as planning committees and state-run distribution channels, have been abolished and prices are largely free.¹¹⁹ However, as the case studies have

¹¹⁵ North. Loc. 1394.

¹¹⁶ Peter H. Solomon, "Authoritarian Legality and Informal Practices: Judges, Lawyers and the State in Russia and China," *Communist and post-communist studies* 43, 4. (2010): 351-62. 353.

¹¹⁷ Favarel-Garrigues, (2011).; Nove, (1986).

¹¹⁸ Gelman, 2004. 1024.

¹¹⁹ Åslund, "Why Market Reform Succeeded and Democracy Failed in Russia," 2009. 4.

demonstrated, the economy is not a market either. The state maintains very soft budget constraints, which permits inefficient and unproductive firms to remain open. This both undermines the drive to maximise profits and fails to allow demand to dictate production, which is antithetical to Polanyi's definition of a market as an economy 'directed by nothing but market prices... and is capable of organising the whole of economic life without outside help or interference.'¹²⁰ Therefore, as the economic crises of 1998, 2008, and 2014 have been unable to result in the institutional development necessary to strengthen rule of law and complete the transition to a market economy, Russia's banking institutions remain neither command, nor market oriented, as they are trapped in partial reform equilibrium.

* * *

This study has demonstrated that Russia's economic transition has stalled and that it is trapped in partial reform equilibrium. As a result, Russia is not a market economy. This was established by tracing the origins of partial reform equilibrium from *perestroika* to the second Putin presidency to demonstrate its presence in Russian history and how significant historical events have been affected by partially reformed institutions. Specifically, the study analysed how the partial reform of the CBR has inhibited its development, and thus its ability to perform normal central bank roles, such as regulating inflation and the banking sector. The failure to upset partial reform equilibrium has been demonstrated by analysing the effects of economic crises on CBR development, and the evolution of the banking sector more broadly. These case studies concluded that economic crises not only fail to result in the institutional development of the banking sector, but that they also reinforce partial reform equilibrium by reaffirming the role of the state in the economy, the need for *sistema*, and the maintenance of command economy practices, such as soft budget constraints.

The banking sector's initial development conditions provide a pointed example of how the partially reformed nature of Russia's banking institutions created a self-replicating limited access order. Banks play a vital role in a market economy because they are the backbone of all things financial: business transactions, investments, loans, savings, and so on. Yet, during the initial transition period, banks were cut out of the economy in a fundamental way as they were barred from participating in either the privatisation programme, or the retail savings and deposit market because of Sberbank's monopoly.¹²¹ As a result, banks became tools of the government and elites because they could not work with entrepreneurs, investors, or household clients. This

¹²⁰ Polanyi, (1944). 45.

¹²¹ Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (2000). 103 – 111.

severely limited the role banks could play in economic development. As gas and oil prices increased, the government used the rents to compensate for the lack of a proper financial market that could finance investment projects. Thus, although the initial barriers to banks' economic involvement have been significantly reduced, they exist in an economy that has developed means of functioning without them. As such, the development of the banking sector, and its regulator, have not been a priority and predatory banking practices have continued. This undermines confidence in banks, which further reinforces the social economic institutions that have evolved to compensate for the lack of a proper banking sector.

In the first chapter, it was presented that Russia deviated from the ability of GDP per capita to predict the level of rule of law by three standard deviations. The case studies have demonstrated that the banking institutions, specifically the CBR as a regulator, have remained underdeveloped. While this explained the low level of rule of law, it did not explain the increased GDP per capita. However, the inability of economic crises to result in institutional development has constrained opportunities for economic growth. Thus, as the economy has reached its limitations because of the failure to develop economic institutions, as illustrated by the 2014 crisis, it has begun and will continue to contract. There are two likely outcomes. Either the CBR and other economic agencies will be forced to develop and strengthen their role in the economy to facilitate investments, which will increase the level of rule of law until it is commensurate with the country's GDP per capita. Or the failure to do so will restrain opportunities for further economic growth until the GDP per capita shrinks and is more reflective of the weak rule of law. Thus, while GDP per capita may be a good predictor of the strength of rule of law, a high GDP per capita itself may not be enough of an incentive to develop and strengthen the rule of law. In fact, consistently low growth may be more of an incentive to invest in institutional development in order to encourage economic expansion. It is likely that these are the conditions that will break partial reform equilibrium and incentivise Russia to complete its economic transition.

CHAPTER 8

CONCLUSION

This study has demonstrated that Russia's banking institutions are trapped in partial reform equilibrium and do not play the role they would in a normal economy. By extension, given the role and importance of the banking industry to a market economy, its underdevelopment has complicated the general economic transition. This was illustrated with evidence from case studies that analysed the Central Bank of Russia's responses to 1998 and 2008 economic crises, and how these responses affected banking sector development. First, many scholars claim these crises were transformational recessions, which forced the Russian government to make hard decisions that ended command economy practices and resulted in a robust market economy. The implication is that Russia's transition is complete, but its market economy has endemic corruption problems that poison the business and investment culture. However, the case studies provide sufficient evidence to counter this claim. They demonstrate that budget constraints are still very soft, and that the state has used this to increase its control over the economy. This is a vital contribution, as it changes how we see and understand Russia and its post-Soviet development.

Second, this study significantly enhances the literature on Russia's transition by reframing much of the pre-existing data and analyses to demonstrate that the barriers preventing Russia from completing its transition are constructed by institutions, rather than individuals. Most of the scholarship on Russia's transition focuses on individual actions and choices, which fails to adequately capture the complexity of why the transition is incomplete. This does not explain why, despite genuine attempts at reform, the economy has not been able to modernise and become a fully-fledged market economy. This study has contributed to that answer by demonstrating how entrenched command economy practices in the banking industry prevent the establishment of market banking institutions. These practices stem from trying to create a market banking industry using command institutions.

Finally, this study establishes that the attempt to implement market oriented banking reforms without dismantling command practices prevents market institutions from taking root. Modernising the banking industry requires strong institutions. If Russia's institutions are weak, and institutional development has not taken place, then attempts to introduce modernising reforms will fail. Therefore, Russia's focus on modernisation over institutional development has only strengthened the power of the individuals within those agencies that embody the institution, rather than the institutions themselves. Thus, Russia's current banking institutions

do not provide a clear and predictable set of rules, which obscure rather than structure and clarify economic transactions. As such, the economy and society are not fully subordinated to this particular market institution. The result is that firms struggle to increase production, maximise profits, and drive economic growth. This contributes to Russia's economic stagnation, which could become contraction unless the transition is complete.

This study does not deny that Russia has made significant progress in transitioning away from a command economy, as genuine attempts at strengthening rule of law and implementing market practices have been undertaken and measurable change has resulted. However, these attempts fail to address the remaining command practices that continue to undermine market institutions, such as the banking sector. For example, soft taxation practices cannot generate enough revenue for the government to balancing its spending. Furthermore, because of soft taxation, the concept of paying and collecting taxes is still unfamiliar. As such, it is to be expected that this would be a time consuming, trial and error process. However, despite the fact that tax reforms increased the amount of tax collected, the concept of soft taxation provided the government with an incentive and vehicle to renationalise or exert some control over strategic industries. That way it can ensure taxes are paid, and have additional sources of revenue for budgetary spending and saving. This presents two problems. First, maintaining soft taxation also maintains soft budget constraints. Consequently, firms have no impetus to meet the needs and demands of the economy, or to maximise profits and be self-sufficient. More concerning is the second problem: that government's role in, and control over, the economy prevents competition from generating more efficient and profitable sources of income. This effect is readily apparent in the banking industry. The CBR's enhanced regulatory powers have indeed reduced the number of banks in Russia, but this also favours the large, state owned banks. As a result, there is no competition among banks to provide the financial services necessary to a market economy, such as financing for long-term investments, which limits the economic actors to what state banks can offer.

The case studies provide evidence for this by demonstrating that economic crises did not act as critical junctures for institutional development in Russia's banking sector like they do in other countries. Economists such as Kornai, Laeven, Valencia, and Hallerberg demonstrate how crises can be transformational recessions.¹ Specifically, they claim that crises instigated by exogenous rather than endogenous factors result in the most drastic institutional

¹Kornai, 1994.; Hallerberg and Scartascini, 2011.; Laeven and Valencia, 2008.; Drazen and Grilli, 1993.

developments.² This is because exogenous shocks uncover weaknesses that economic actors normally compensate for by using informal institutions. The 1998 and 2008 economic crises were examples of this. In 1998, the state postponed reforming tax collection mechanisms until the lack of revenue triggered a sovereign debt crisis. Soft taxation was still largely practiced, as enterprises knew that the more arrears mounted, the more difficult it would be for the government to collect them, and the more likely they would be forgiven.³ The result was that tax arrears reached ₺129 billion in 1998.⁴ Similarly, in 2008, the failure to properly develop the banking sector left few opportunities for domestic sources of funding, forcing banks to resort to external borrowing.⁵ Furthermore, the inability to regulate banks resulted in risky borrowing practices as external loans reached 40 percent of GDP with a 125 percent loan-to-deposit ratio.⁶ In 1998, the government compensated for weak revenue streams by selling GKO bonds. In 2008, the banks were able to use gas and oil prices to obtain good credit, borrow abroad, and find sources of short-term investment to make loan payments. However, neither of these practices were sustainable, and each crisis exposed these weaknesses.

According to the crisis modernisation economists, the crises would have forced the state to address both tax collection and bank regulation in order to resolve and exit the crisis. The outcome would have been a clearer definition of the CBR's role in the economy, and thereby more consistent and predictable tax collection and bank regulation practices. This would have changed the expectations and behaviours of economic actors by encouraging them to use formal rather than informal institutions to mediate economic transactions and resolve conflicts. Yet, this is not what happens in post-1998 or post-2008 Russia. In theory, reforms to address these issues have been implemented: a simplified tax code was introduced in 2001, and the CBR merged with the Federal Financial Market Service (FFMS) in 2013 to reduce regulatory confusion and increase the former's authority. In practice, the results are less straight forward. Tax collection improved, but there are other explanatory variables, such as the overall increase in personal income and the government's renationalising several industries that could account for the increase in revenues. The CBR's new regulatory powers have reduced the number of banks, but they have not increased transparency or predictability, and thus there is no way to determine if its actions are fair or proportional.⁷ Furthermore, the state uses both tax arrears

² Calomiris, Klingebiel, and Laeven, 2003.

³ Perotti, E. (2001). 382.

⁴ EBRD Annex 1.1 p. 16

⁵ Connolly, 2011. 450.

⁶ Ibid. 446.; Bogetic, "Russian Economic Report No. 17," 2008. 35.; *ibid.* 28 – 32.

⁷ Seal et al., 2016. 20, 24, 32.

and compliance, and bank finances in raiding activities. This signals that the state is using the reforms as a tool to increase its own power.⁸ Thus, neither of the reforms implemented adequately strengthen institutional weaknesses, as they do not clarify or restrain the role of the government or CBR. The actions of both remain unpredictable, which is antithetical to the purpose that institutions serve — to create order out of chaos.⁹

However, the failure to fully address institutional weaknesses does explain the incentives of the state and other economic actors to use the social economy and exploit formal institutional weaknesses for profit. As defined in chapter one, North defines institutions as ‘...the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic.’¹⁰ Thus, weak institutions encourage economic actors to resort to informal networks, both to exploit them for financial gain and to expedite economic transactions and mediate conflicts. As such, if the institutional weaknesses that encourage this behaviour are not fully addressed in the reform process, then they will not disappear. Because crisis resolution and other reforms do not do this, they fail to address the specific weaknesses that incentivise these actions and provide no new incentives or behaviour template for economic actors. More simply, because the reforms’ implementation fails to illuminate clear paths for economic transactions and conflict mediation, actors, including the state, continue to resort to informal networks.

Furthermore, this study provides evidence that defies both the structuralist and agent centred models of institutional change. As discussed, the agent centric model of institutional change argues that the impetus for institutional change lies in the choices and intentions of individuals.¹¹ Conversely, the structuralist school argues that institutions are difficult to change because of cultural and historical practices.¹² Yet, neither school of thought explains the state of Russia’s transition. The case studies both demonstrate the intention to change, and actual change in the banking industry. Because Russia’s institutions are so weak, it is tempting to say that the structuralist school has more explanatory power as it explains why, despite genuine attempts to reform, little institutional development has taken place. However, while it is true that banking institutions are still weak and partially reformed, they have changed, even if that change has not resulted in stronger institutions. For example, taxes are collected more efficiently and the CBR can more efficiently close banks and consolidate the banking sector.

⁸ Gans-Morse, 2012.; Rochlitz, 2014..

⁹ North. Loc. 1394.

¹⁰ North, (1990). 1

¹¹ Johnson, "Path Contingency in Postcommunist Transformations," 2001. 254.

¹² Pipes, 2004. Johnson, J. 2001. 254.

Conversely, the agent centric model would use this evidence to claim that the changes we do see are evidence of institutional development. Yet, because the implementation of these reforms has not created more predictable behaviour or changed expectations, the institutions have not actually developed.

Indeed, one of the shortcomings of most scholarship on Russia's transition is that it focuses on the consequences of individuals' actions and decisions. This is a problem, because agents of change do not make decisions in an institutional void. For example, North and Weingast's elucidation of a limited access order (LAO), attempts to determine how individual's actions frame and influence institutions and institutional development.¹³ As such, in the 'doorstep conditions' that North and Weingast state as necessary to progress from an LAO to an OAO, they include first adopting rule of law among elites, and then extending it to impersonal contacts.¹⁴ This is similar to one of Fukuyama's signals of institutional change and development: the inclusion of outsiders' perspectives.¹⁵ However, this has happened in Russia. As demonstrated in chapter three, the *nomenklatura* eventually included the new oligarchs like Khodorkovsky and Abramovich in the 1990s. Then more elites from Putin's inner circle, like Miller, Timchenko, and Sechin joined throughout the 2000s. Yet, the inclusions of new social groups and other outsiders has not resulted in stronger institutions. Thus, while Russia is an LAO, this is more of a symptom, rather than a cause of institutional weakness. Furthermore, the case studies demonstrate that as the group of elites has grown, so too has state control over the economy, which is antithetical to a market economy.

From chapter one, this study has used Karl Polanyi's definition of market economy to evaluate Russia's transition. Polanyi defines a market economy as one that is 'directed by nothing but market prices... and is capable of organising the whole of economic life without outside help or interference.'¹⁶ Polanyi specifies that a market economy is an institution, or a set of institutions, that have been constructed slowly over time, rather than a set of natural instincts or reactions to price signals as argued by classical economists.¹⁷ Classical economics oversimplify many issues; most egregiously, its theoretical foundations presume the presence market institutions regardless of whether or not they actually exist. This study has demonstrated that market banking institutions do not exist in Russia, which undermines the assumption of a market economy. Thus, most classical economic theories do not apply. For example, the crisis

¹³ North et al., 2007. 7 – 8. For more information, please see chapter one.

¹⁴ Ibid. 21 – 24.

¹⁵ Fukuyama, (2014). 463.

¹⁶ Polanyi, (1944). 45.

¹⁷ Ibid. 40.

resolution measures analysed in the case studies are the same measures that are used in market economies, albeit with a much higher degree of success. Whereas, in Russia these measures can only be partly implemented, because the necessary institutional framework to fully do so does not exist. Specifically, in a market economy, the CBR would regulate the banking sector to both prevent the risk of a banking crisis, but also to ensure that the clear and fair enforcement of the regulations maintains low barriers to entry. Doing so would foster competition and create a strong banking sector that generates financial opportunities for investors, as well as helps households manage their finances. This would create more economic growth in the long-run, as the most effective and efficient banks would respond to whatever banking services the economy needs.

However, this is not what happens in Russia, neither after the collapse of the Soviet Union, nor after economic crises. In theory, crisis resolution reforms should have encouraged the CBR to develop this role. The consolidation of the CBR's regulatory powers should have directed it to close only those banks that were detrimental to the overall health of the economy. Indeed, the CBR has liquidated a number of predatory banks and shell banks used for illegal purposes. However, as discussed, its decisions and actions have not been transparent. This makes it difficult to understand why some banks, such as MasterBank, the Globex banks, Trust Bank, and others, have been foreclosed, where Bank Rossiya, Otkrite Bank, and Sberbank, and others who have committed the same violations remain operational. Additionally, inspections by the IMF reveal that despite the CBR's consolidation of the banking sector, the risk of non-performing loans remains high.¹⁸ This suggests that the CBR has not actually mitigated the risky practices of the banking sector. Furthermore, the CBR's actions in rescinding banking licenses appear to favour the state and its control over the banking sector rather than fostering competition. The IMF has even said that while it cannot find evidence of preferential treatment, that this would be difficult to isolate.¹⁹ Overall, while the crisis resolution reforms did result in change, they did not result in institutional development. This is an important distinction because while the reforms increased the power of individuals at the CBR, they did not strengthen the banking institution. Strong institutions promote and strengthen the rule of law. Yet, if powerful individuals use the law as a tool, then the institution is compromised and can no longer be used as a means of objective mediation.

This distinction is vital to understanding how Russia's institutions have developed.

¹⁸ Seal et al., 2016. 22.

¹⁹ Ibid. 41.

Actual institutional development would have curbed individual power, not enhanced it. Institutions, as described by North, Kahn, and Carey, and others, moderate, curb, and constrain individual power.²⁰ If Russia's institutions had developed and strengthened since the collapse of the Soviet Union, then there would be a clearer moderation of individual power by the institution. However, as demonstrated by the case studies, and the analysis of partial reform equilibrium in chapters three and four, we see the opposite. Chapters three and four illustrate how individual power in the *vertikal* has increased overtime. For example, after Putin became president, he increased both direct and indirect control over the economy by placing members of his social networks and government ministers in strategic economic positions. This was illustrated by the micro-study that showed how the government has increased both direct and indirect control over the gas and oil industry from 2010 to 2017. Furthermore, the formal case studies demonstrate that each economic crisis sees the further amplification of individual power over market banking institutions. This explains why the CBR's enhanced regulatory responsibility has resulted in the non-transparent closure of banks — it is not protecting the banking sector or its institutions, it is looking out for its own interest (and that of the government).

The result is that institutions do not provide a predictable set of outcomes for economic actors, as outcomes are decided by individual discretion. To navigate this, actors resort to informal institutions, such as *sistema* or the social economy. Neil Robinson describes the social economy as patrimonial capitalism, or a system in which formal and informal rules contradict each other, transaction costs are high, reforms serve elite interests, and leaders are not subject to democratic constraint.²¹ Robinson argues that there is a high degree of path dependency that fixes this system in place, and that the 2008 economic crisis was the critical juncture for this.²² This study supports Robinson's argument by providing evidence of how the partially reformed institutions cannot provide clear, low-risk means of undertaking economic transactions. However, Robinson argues that because of patrimonial capitalism, modernisation is unlikely to occur.²³ While this is true, this study has illustrated that this has always been the case, and is not a pattern that emerged after the 2008 economic crisis. Since the collapse of the Soviet Union, the partially reformed nature of Russia's institutions has undermined attempts at modernisation. In fact, this is reinforced by Huntington's articulation of the contradiction

²⁰ North, (1990).; Kahn, 2006.; John Carey, "Parchment, Equilibria, and Institutions.," *Comparative Political Studies* 33, 67. (2000): 735 - 31.; Polanyi, (1944).

²¹ Robinson, "Russian Patrimonial Capitalism and the International Financial Crisis," 2011. 438.

²² *Ibid.* 436 – 439.

²³ *Ibid.* 438.

between development and modernisation.²⁴ Because Russia's institutions were underdeveloped at the outset of transition, they were too weak to implement the modernisation reforms necessary to become a market economy. This study has illustrated why and how this economic state has endured. At no point have the institutions been developed enough to modernise the economy.

Therefore, Russian banking institutions are trapped in partial reform equilibrium, which undermines the general economic transition. The *perestroika* reforms unintentionally introduced market mechanisms into a command economy to make it more productive. These mechanisms conflicted with command practices, which weakened both institutions. This study has illustrated how command economy practices have been upheld in the banking sector, including: soft taxation, soft budget constraints, and the increasing control of the government over the economy. This is established by describing how the government managed to support the banking sector through every crisis. During the economic crises of 1998, 2008, and 2013, the government and the CBR intervened to prevent banks and firms from becoming insolvent. Superficially, these methods of crisis containment appear normal and rational. Yet, while the government is not indebting itself to do this like the Soviet Union did, this patriarchal role echoes the command economy and undermines the market economy by softening budget constraints. As a result, inefficient firms the crisis would have otherwise seen liquidated or restructured, remain operational. These practices directly contradict a market economy and weaken market institutions, as they undermine the principles of supply and demand, and the drive for competition.

Attempts to rectify these weaknesses have only increased the power of individuals rather than the institutions themselves. This only ensures that institutional weaknesses will continue to be replicated, as Robinson outlines in his model on patrimonial capitalism, by reforms serving elite interests. The question that remains to be asked is, how can partial reform be upset? As North describes, the first step is for the individuals within institutions to begin to moderate themselves and their own power.²⁵ How that will come about is pure conjecture and beyond the scope of this study. However, it will likely happen on an institution by institution basis. The conceptual hurdle is substantiating that partial reform equilibrium is not a phenomenon that either exists or not, but a long-term state of being. It will not be broken suddenly or quickly. It will be unravelled and unpicked slowly, like untying a large,

²⁴ Huntington, "Political Development and Political Decay," 1965.

²⁵ North et al., 2007. 21.

complicated knot. To attempt otherwise will only replicate the present system, as it would fail to pay the required attention to properly develop the necessary institutions. If partial reform equilibrium is to be broken anywhere first, it would likely be in the banking sector because the role the state wants it to play is similar to that in a market. Furthermore, the CBR has been focusing how to improve its internal regulation as a means of improving the consistency with which it regulates the banking sector.²⁶ This is again a promising step, but whether it actually results in institutional development remains to be determined.

This study has demonstrated that Russia's economic institutions are trapped in partial reform equilibrium. Its main contribution is a reframing of how we understand Russia's transition, by demonstrating that the success of its economic transition lies in the strength and development its economic institutions, rather than on the laws and rules that are drafted. Without strong institutions, the best laws cannot be properly implemented or enforced. This was illustrated by tracing the genesis of partial reform from the *perestroika* era, to post-2008 crisis recovery. Specifically, the intractability of partial reform was evidenced by using hypotheses to test whether crisis modernisation had resulted from either of Russia's major economic crises in 1998 or 2008. This is important as many scholars had claimed that the 1998 economic crises forced Russia to complete its economic transition. While the hypotheses found evidence of change, it found no support for institutional development in the banking sector. Furthermore, preliminary analysis of Russia's 2014 crisis again confirms these findings. The result is that Russia's banking institutions remain neither command, nor market, but trapped between the two in partial reform equilibrium.

Until now, Russia's economy has continued to function despite partial reform equilibrium because of gas and oil rents. The state uses these profits to fund the economy's less efficient and less profitable enterprises. For example, the government could afford the large liquidity assistance packages provided in the 2008 and 2014 crises because of the Stabilisation and National Wealth Funds, which were created with gas and oil windfalls. As such, the economy has never fully confronted its paralyzing contradictions, as the government could afford to buy its way out of problems or use its power to neutralize threats. While this initially happened in 1998, oil prices increased so shortly after that the imperative for reform quickly diminished. So long as gas and oil rents continue to pour in, the government can be an economic powerhouse without needing to develop strong institutions. Because of institutional weakness, state power is unmediated: The economy does not function according to a set of clearly defined

²⁶ The World Bank. "Global Financial Development Database." 2017. 28.

rules that are enforced by various institutions, the economy functions according to the rule of the state and the elites that comprise it. However, as gas and oil prices have begun falling and have remained depressed, the economy is feeling the limitations of partial reform. It remains to be seen if these limitations will provide a sufficient incentive to begin to dismantle partial reform equilibrium by seriously undertaking institutional development.

APPENDIX I

OLS Multiple Linear Regression GDP per capita and Rule of Law

Dependent variable: Rule of Law score on a scale of 2 to – 2, where 2 is strongest and – 2 is weakest.

Independent Variables:

GDP per capita (GDP)

Population (pop)

Gini index (income)

Geographical location. Dummy variables: Africa (AfDum), Asia (AsDum), North (NADum) and South America (SADum). Constant: Europe.)

Freedom House score: (Dummy Variables: partly free (PFDum), not free (NFDum).

Constant: free).

Regression equation:

$$RoL = \alpha + \beta_1 (GDP) + \beta_2 (Income) + \beta_3 (pop) + \beta_4 (NADum) + \beta_5 (SADum) + \beta_6 (AfDum) + \beta_7 (AsDum) + \beta_8 (PFDum) + \beta_9 (NFDum) + \varepsilon$$

Results

<i>Model</i>	<i>R</i>	<i>R²</i>	<i>Adjusted R²</i>	<i>Standard Error</i>
1	.888 ^a	.788	.774	.46533

<i>Model</i>		<i>Sum of Squares</i>	<i>df</i>	<i>Mean Square</i>	<i>F</i>	<i>Sig</i>
1	Regression	107.81	9	11.98	55.32	.000 ^b
	Residual	29.02	134	.217		
	Total	136.82	143			

<i>Model</i>	<i>Unstandardized Coefficients</i>		<i>Standardized Coefficients</i>				<i>Collinearity</i>	
	<i>B</i>	<i>Std.</i>	<i>Beta</i>	<i>t</i>			<i>Sig.</i>	<i>Tol.</i>

			<i>Error</i>					
1	Constant	.009	.196		.047	.963		
	GDP	2.76	.000	.559	10.67	.000	.576	1.74
	Income	.004	.005	.043	.810	.419	.550	1.82
	Population	5.58	.000	.009	.211	.833	.907	1.10
	Asia	-.162	.136	-.072	-1.19	.238	.431	2.32
	Africa	-.158	.134	-.073	-1.17	.242	.411	2.43
	S.America	-.569	.170	-.173	-3.34	.001	.591	1.69
	N. America	-.306	.175	-.083	-1.75	.082	.700	1.43
	Partly Free	-.706	.109	-.349	-6.50	.000	.549	1.82
	Not Free	-.995	.133	-.393	-7.51	.000	.579	1.73

APPENDIX II

Gas and Oil Company Executives 2009 – 2010 / 2016 – 2017

This appendix contains the names of the current members in the case study company's Boards' of Directors' and Management Committees', as well as each company's corporate governance structure. All material is taken directly from the companies' respective websites; the author's notes are included in italics. The transliteration of names has changed from 2010 to 2017, and I have reflected this by writing down the name as it appears on the website.

Gazprom

Board of Directors – 11 Members

The Board of Directors administers general management in the Company, save for those matters that are, under the Federal Companies Act, the prerogative of the General Shareholders Meeting. The Board of Directors assures the advancement of the goals and vision of the Company as set forth in its Charter. The principal duties of the Board of Directors are to set the Company's development strategy so as to maximize capitalization and investment appeal, to determine the Company's asset management policy and to implement efficient controls over the Company's financial and business performance.

2010 – 11 Members

Viktor Zubkov
Alexei Miller
Farit Gazizullin
Elena Karpel
Valery Musin
Elvira Nabiullina
Sergey Shmatko
Igor Yusufov
Alexander Ananenkov
Burkhard Bergmann
Mikhail Sereda

2017 – 11 Members

Viktor Zubkov
Alexey Miller
Andrey Akimov
Timur Kulibaev
Denis Manturov
Vitaly Markelov
Viktor Martynov
Vladimir Mau
Alexander Novak
Dimitry Patrushev
Mikail Sereda

Management Committee

The Management Committee is a collective executive body that runs the Company on a day-

to-day basis. The Management Committee contributes to the drafting of the Company's strategies and policies and sees to it that the same are properly implemented; it also oversees compliance with resolutions of the General Shareholders Meeting and the Board of Directors. The main duties of the Management Committee are to ensure reliable operation of the Unified Gas Supply System (UGSS) and steady gas supply to consumers, to manage the Company's assets so as to maximize returns, to improve internal controls and risk management, and to advocate the lawful rights and interests of the Company's shareholders.

2010 – 17 Members

Alexei Miller
Valery Gobulev
Alexander Kozlov
Nikolai Dubik
Igor Fyodorov
Viktor Illyshin
Olga Pavlova
Alexander Ananenkov
Sergey Khomyakov
Andrey Kruglov
Alexander Medvedev
Elena Vasilieva
Oleg Aksyutin
Yaroslav Golko
Vasily Podyuk
Vlada Rusakova
Kirill Seleznev

2017 – 16 Members

Alexey Miller
Valery Golubev
Sergey Khomyakov
Alexander Kozlov
Vitaly Markelov
Alexander Medvedev
Elena Vasilieva
Oleg Aksutin
Vsevolod Cherepanov
Igor Fyodorov
Vladimir Markov
Elena Mikhailova
Vyacheslav Mikhaleiko
Sergey Prozorov
Kirill Seleznev
Andrey Kruglov

ITERA

Board of Directors

Corporate governance information is unavailable on website.

2010 – 7 Members

Igor Makarov
Vladimir Makeev
Valery Otchertsov
Gennady Skidanov
Raissa Frenkel
Yuri Pinykh
Andreas Neocleous

Novatek

Board of Directors

The Board of Directors shall be the Company's collegial management body performing general management of the Company's operations, which functions shall be specified in the Regulations on the Board of Directors. The functions of the Board of Directors shall include: Formulation of the Company development strategy and control over its implementation; ensuring efficient management of the Company; control over the activities of the Company's executive bodies and those of the management; ensuring efficiency of the Company's internal control and risk management system; and facilitating exercise and protection of the shareholders' rights.

2010 – 9 Members

Aleksandr Natalenko
Leonid Mikhelson
Andrei Akimov
Brukhard Bergman
Mark Gyetvay
Vladimir Dimitriev
Kirill Seleznev
Ruben Vardanian
Gennady Timchenko

2017 – 9 members

Alexander Natalenko
Andrei Akimov
Brukhard Bergmann
Michael Borrell
Robert Castaigne
Leonid Mikhelson
Viktor Orlov
Gennady Timchenko
Andrei Sharonov

Management Committee

No information on Management Committee corporate governance available.

2010– 15 Members

Leonid Mikhelson
Mikhail Popov
Vladimir Baskov
Lev Feodosiev
Aleksandr Fridman
Viktor Girya
Mark Gyetvay
Evgeny Kot
Tatyana Kuznetsova
Iosif Levinzon
Sergei Protosenya
Valery Rativov
Vladimir Smirnov
Nikolai Titarenko
Kirill Yanovskiy

2017 – 10 Members

Alexander Fridman
Vladimir Baskov
Viktor Belyakov
Sergey Vasyunin
Mark Gyetvay
Tatyana Kuznetsova
Igor Plesovskikh
Lev Feodosyev
Denis Khramov
Ilya Tafintsev

Rosneft

Board of Directors

An executive member of the Board of Directors (executive director)” is a member of the Board of Directors, who is an official of the Company, and who, at the same time, is a sole executive body and member of a collective executive body of the Company. The Board of Directors shall exercise general management of the Company’s activities within the framework of its terms of reference stipulated by law and the Company’s Charter.

Thus, all non-executive members are simply members of collective bodies of the company with no executive power; not a member of an executive body.

An independent member of the Board of Directors is a member of the Board of Directors: -

- who within the last 3 years has not been an official (managing director) or an employee of the Company, or an official or an employee of the Company’s managing entity;
- who is not an official of another company where any of the Company’s officials is a member of the Board of Directors’ Committee on Staff and Remunerations;
- who is not an affiliated person of an official (managing director) of the Company (an official of the Company’s managing entity);

- who is not an affiliated person of the Company, with exception of such ground of affiliation as membership in the Board of Directors, and who is not an affiliated person of such affiliated persons either;
- who is not a party to the Company's liabilities with in compliance with conditions of which he may purchase property (collect cash assets) which costs 10 and more percent of its total annual revenue, except for collecting remuneration for participation in the activities of the Board of Directors;
- who is not a major contracting party of the Company (such contracting party the total volume of transactions of the Company with whom for a year is equal to 10 and more percent of the Company assets' book value);
- who is not a representative of the state.

2010 – 9 Members

Igor Sechin

Sergei Bogdanchikov

Vladimir Bogdanov

Andrei Reus (Non-executive Director)

Yuri Petrov (Non-executive Director)

Alexander Nekipelov (Independent Member of the Board of Directors)

Andrey Kostin (Independent Member of the Board of Directors)

Hans-Joerg Rudolf (Independent Member of the Board of Directors)

Nikolay Tokarev

2017 – 9 Members

Andrey Belousov

Igor Sechin

Matthias Warnig

Oleg Viyugin

Robert Dudley

Guillermo Qunitero

Donald Humphreys

Ivan Glasenberg

Faisal Alsuwaidi

Management Committee

No information of the corporate governance of the Management Committee available.

2010 – 8 Members

Sergei Bodanchikov

Eduard Khudainatov

Sergei Tregub

Viktor Ploskina

Larisa Kalanda

Peter O'Brien

Sergey Makarov

Riso Tursunov

2017 – 11 Members

Igor Sechin
Yuri Kalinin
Eric Liron
Gennady Bukaev
Dider Casimiro
Peter Lazarev
Yury Narushevich
Zlejiko Runje
Yury Kurilin
Andrei Shishkin
Vlada Rusakova

LUKoil

Board of Directors

Board of Directors: Board of Directors shall perform the overall management of the operations of the Company, except for issues assigned by the effective legislation of the Russian Federation and the Company Charter to the authority of the General Shareholders Meeting.
The Board of Directors is elected annually at the general shareholders meeting.

2010 – 11 Members

Valery Grayfer
Vagit Alekperov
Herman Gref
Igor Ivanov
Aleksandr Shokhin
Victor Blazheev
Ravil Maganov
Richard Matzke
Donald Walette
Sergei Mikhailov
Nikolai Tsvetkov

2017 – 11 Members

Valery Grayfer
Ravil Maganov
Vagit Alekperov
Victor Blazheev
Igor Ivanov
Roger Munnings
Toby Gati
Richard Matzke
Ivan Pictet
Leonid Fedun
Lyubov Khoba

Management Committee

The Management Committee is the Company's collective executive body.
The Board of Directors elects the Management Committee.

2010 – 15 Members

Vagit Alekperov
Sergei Kukura
Ravil Maganov
Vladimir Nekrasov
Anatoly Barkov
Ivan Masliaev
Alexander Matytsyn
Anatoly Moskalenko
Valdimir Mulyak
Valery Subbotin
Leonid Fedun
Evgueni Havkin
Lyubov Khoba
Jevan Cheloyants
Vagit Sharifov

2017 – 14 Members

Vagit Alekperov
Ravil Maganov
Alexander Matytsyn
Vladimir Nekrasov
Azat Shamsuarov
Vadim Vorobyev
Ilya Mandrik
Ivan Maslyaev
Anatoly Moskalenko
Stanislav Nikitin
Oleg Pashaev
Denis Rogachev
Gennady Fedotov
Yevgeny Khakvin

TNK-BP

Board of Directors

Board of Directors: TNK-BP is governed by an eleven-member Board of Directors with four representatives from each of the two shareholder groups and three independent directors.
No information on independent directors, but it is assumed that they fit the same criteria put forth by Rosneft.

2010 – 12 Members

Mikhail Fridman
Viktor Vekselberg

Len Blavantik
Alex Knaster
Andrew Inglis
David Peattie
Iain Macdonald
Lord Robertson of Port Ellen
Dimitri Kosolov
Gerard Schroeder (Independent Director)
Aleksandr Shokin (Independent Director)
James Leng (Independent Director)

Management Committee

TNK-BP's senior management team runs the day-to-day operations of the company.
Senior management team = Management Committee

2010 – 14 Members

Mikhail Fridman
Maxsim Barsky
Bill Schrader
Herman Khan
Viktor Vekselberg
Jonathan Muir
Sergey Brezitsky
Francis Sommer
Didier Baudrand
Alexander Kaplan
Sergey Novoselov
Igor Maddanik
Stan Miroshnik
Anatoly Tyomkin

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