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Coursework Title: How do you account for the virtual collapse of the Russian state in the 1990s? Why was the recovery of the Russian economy so rapid after 1998?

Introduction

In the 1990s Russia underwent a massive transformation. Witnessing a virtual collapse of the state, the country re-launched as a leading world power on a platform of rapid economic recovery within ten years. The transition from communism under single-party rule to a more democratic market capitalist system was very turbulent; however, despite being denounced by many as a hopeless case, Russia successfully survived and flourished.

The first part of this paper explores the main reasons behind why the Russian state nearly collapsed in the early 1990s. The state, as a vague and complex concept, can be difficult to define despite underpinning a country's political and economic framework. For the purpose of this paper, state capacity will assume the definition of being composed of "public authorities who hold monopolies on three functions: the legitimate use of violence; provision of revenues by collecting taxes and the control of monetary emission" (Popov, V. 2004: p1). In the 1990s, the state's institutional capacity was compromised to the extent that its very existence was threatened. The level of political instability in the country, the collapse of government revenue and the loss of the state's monopoly on violence are the main contributory factors of the state's virtual collapse which will be explored.

The second part of the paper will analyse why the Russian economy rebounded so quickly from 1998 onwards. The role of external shocks, namely the rouble devaluation and rising oil prices, will be emphasised, as well as the implementation of government policies which created an economic environment that could harness the benefits of the shocks and achieve stable expanding growth. Russia's economic recovery was comprised of an extensive combination of factors; however the external shocks and effect of governmental policies were the most significant and will subsequently be reviewed.

Part I: Reasons Motivating the Virtual Collapse of the State in the 1990s

1. Political Instability

A series of internal conflicts was a significant contributor to undermining state capacity. Continuous and severe political instability inhibited the state's ability to exercise effective control over their monopolies on the essential aforementioned functions. Focus of state officials was, instead, drawn towards preventing coup d'états and the consolidation of their power. Not only was the functioning of the state subdued by incessant conflicts, but also its very existence, owing to the nature of the political crises.

The August 1991 putsch against Gorbachev largely signified the beginning of political instability. As Yeltsin sought to assume power of a Russia that had been newly liberated from the bounds of Communism, the coup d'état revealed a "deep split in the military, between those who saw Yeltsin as a dynamic leader who could advance the group's interests and those who thought he was plotting to set the army against the people, to threaten its base in society" (Mychajlyszyn, N and Von Riekhoff, H. 2004: p163). As the military can be crucial in maintaining stability between the state, society and external actors and, given that a divided institution is a weak institution, this helped to undermine the Russian state. In facilitating the state's legitimate use of violence by providing the large-scale means of violence, the divided military, as a result of the putsch, weakened one of the state's fundamental components.

Compounding the political instability was the collapse of the USSR. Gorbachev resigned, the Communist Party's activities were suspended and numerous republics of the USSR declared independence. Faced with a new President and the need to pursue a new path of democracy and market capitalism, amidst ensuing political disorder and severe economic chaos (Gidadhubli, R. 2007: p1818-1820), the state had almost reverted back to its infancy after enduring decades of stagnant reforms. An infant state can be susceptible to collapse, owing to its lack of organisation, authority and direction. Occurring at a time when the Russian state was not without weakness, the collapse of the USSR was rather untimely and added to the overwhelming pressure on the already feeble state, ultimately contributing to its virtual collapse.

Political instability culminated under the 1993 Constitutional Crisis – yet another internal conflict. Yeltsin's economic reforms, which had wrought havoc on the country's economy, and decision to dissolve the legislature, spawned conflict between the President and Parliament (Gidadhubli, R. and Kumar, R. 1993); the same Parliament which supported Yeltsin's August coup. Yeltsin's failure to undertake significant political reform to rebuild the post-USSR state fuelled ambiguity and internal conflict, merely pre-empting the actions of his opposition by dissolving the Congress in September 1993 (McFaul, M. 2000: p54). Despite a lack of progress with political reform aimed at state development since the USSR collapse, the crisis undermined any form of stability, legitimacy or even the minutest of improvement in the strength of state capacity, achieved since 1991. Internal conflict has a wide array of damaging implications for the state, from challenging society's faith in the capabilities of the government to detracting focus and resources away from developing the state and the country. In this case it is even more destructive given that it was the second internal conflict within two years and the state was in its infancy after emerging from communist rule.

In essence, the putsch weakened the state; the USSR collapse entailed the collapse of the old Soviet state that reigned for decades and the constitutional crisis exacerbated the situation, impeding the ability of the new state to flourish. The amalgamation of these crises induced a perseverant period of political instability, which chiselled away at the state's capacity and became a significant contributory factor in its virtual collapse.

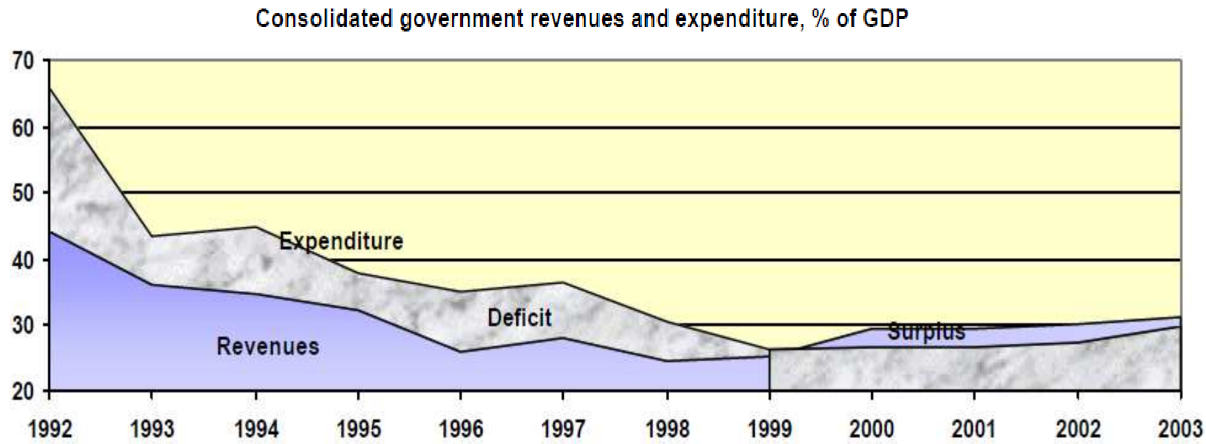
2. <u>Collapse of Government Revenue</u>

The generation of such political instability, coupled with the transition that needed to occur away from a planned economy, ravaged the country's economic performance and diminished government revenues. Without a steady and stable flow of income, largely due to a lack of tax revenue and growth, the Russian state was paralysed into a state of inaction, thereby assisting in its demise. The ability to gather and retain sufficient resources is crucial to fund the essential functions that characterise a state's existence. Subsequently the state's overwhelming deficit also helped to threaten the state with collapse.

During the transition to market capitalism, "Russia lost nearly 30% of its real gross domestic product (GDP); suffered very high inflation, over 800% in 1993, and incurred serious capital flight" (Cooper, H. 2009: p2). The legacy of the planned economy, in addition to Yeltsin's policies, led to a poorly executed transition by state officials who possessed little knowledge of the market system they were striving to achieve. Exacerbating the situation was the lack of IMF help, contingent on Russia's political factions agreeing and implementing IMF policies (George, K. 1993: p7). Owing to the size of the Russian economy and the extent of its problems, the IMF's resources would have been crippled by providing extensive aid. Intensifying the pressure on the rouble and worsening the economic problems, the state found it difficult to extract revenue from firms and workers in a flailing economy.

With an economy in turmoil, Yeltsin commissioned dramatic cuts to government spending and higher levels of taxation to resolve the deficit and bolster state revenues. As shown by the graph, the share of "government revenue and expenditure as a percentage of GDP was cut by more than a half from 1990-99; however GDP also fell nearly 50%" (Popov, V. 2004: p2). Deficit reduction policies were crucial for the state to stabilise its finances, but the radical reforms decimated growth and led to the expansion of the shadow economy and a contraction in tax compliance (Alexeev, M. 1995: p12). The continuing, but falling, deficit during the 1990s, and the rapidly declining growth rate, sustained the state's lack of resources and inability to provide functions like ensuring property rights.

Subsequently, economic crises, together with radical reforms to the taxation system and the rise of the shadow economy, helped strip the state's ability to afford the operation of crucial functions and to provide a key source of revenue for the country. A bankrupt state is largely a non-existent one, therefore the Russian state's crippled economy and persistent deficit was a factor in the state entertaining the possible prospect of collapse.



3. <u>Loss of the State's Monopoly on Violence</u>

Amidst an economy plunging into an ever-deepening crisis and the chaos of political instability, the Russian state lost some its monopoly over the legitimate exertion of violence. Such a monopoly on violence is required to maintain the authority and respect of the state, essentially underpinning its existence. Moreover, by possessing a monopoly on violence means the state will not lose control of different regions that could become subject to independent rule by different factions, which would divide and reduce the state's domain.

The shadow economy became relatively untouchable by the state and the mafia acted as a source of authority for this underground realm of illegal transactions. As the state cannot enforce contracts or maintain law and order in the black market, the mafia could provide such services and "even play a positive role in this hidden part of the economy" (Alexeev, M. 1995: p13). The role of the mafia consequently questioned the state's universal authority and its ability to manage all aspects of the country. A poll by the "Public Opinion Foundation in 1994 showed that 23% of Russians living in urban areas believed that organised crime and not the government runs the country and in 1994 the government reported that 70-80% of private businesses were paying extortion money to organised criminal gangs" (Boylan, S. 1996: p2014). These statistics reveal that the mafia's existence was prominent enough to have a significant impact on the economy and on society's opinion, thereby reducing the state's legitimacy.

Moreover, high crime rates further illustrated the state's weakening influence. By the "mid-1990s, the murder rate in Russia was over 30 people per 100,000 compared to 1 to 2 persons in Europe. When the murder rate reaches 40 to 50 people per 100,000, like in Colombia in the 1990s, the country faces collapse of state authority" (Popov, V. 2004: p1). Despite the murder rate in Russia falling short of the theoretical level required for the state's authority to fail, the high figure indicates how close the state was to a virtual collapse.

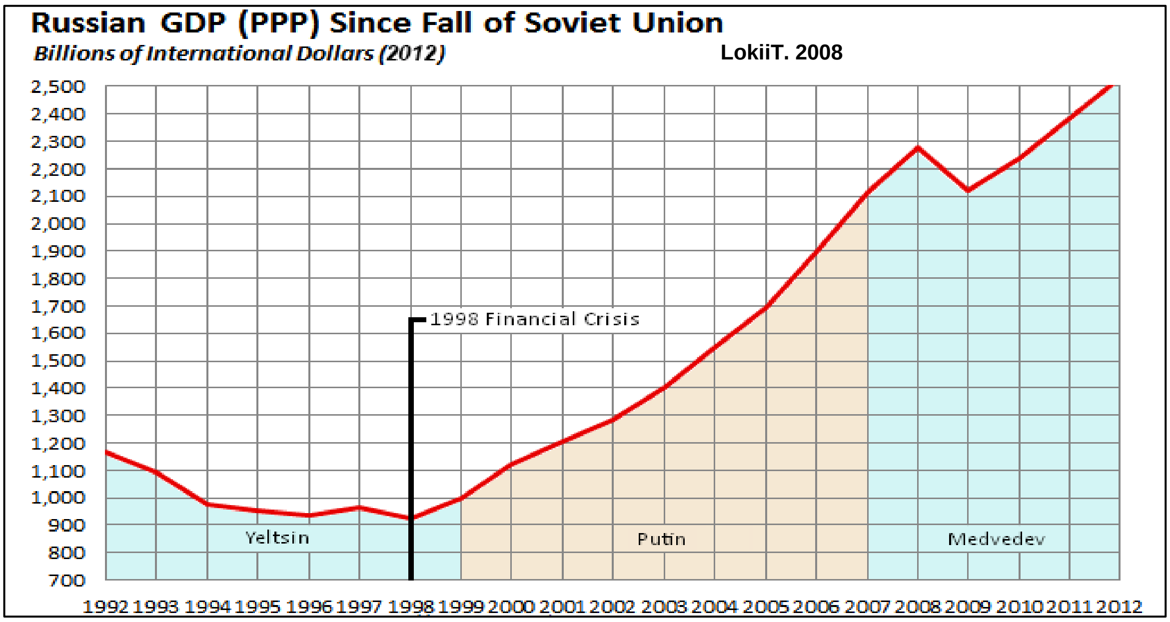
The decline in state authority therefore played a major role in the state's virtual collapse, manifesting in the increasing presence of the mafia, providing a sense of security in areas where the state's presence was diminishing, and the increasing crime rate, in an environment where people perhaps thought being caught and convicted by the state was increasingly unlikely. The state's ability to enforce its decisions and command the respect of society is pivotal to its existence and its functioning; without it, the state would struggle to maintain its position.

Summary

One can account for the virtual collapse of the state in Russia in the 1990s by the interaction and impact of political instability, a lack of state revenue and a loss of the monopoly on violence, the complete reverse of three of the most important factors which help form the cornerstones of the state's very existence. Internal conflicts and the USSR collapse plunged the state and the economy into complete disarray, resulting in radical policies, the rise of the shadow economy, the continued existence of the mafia, increasing crime rates and decreasing tax compliance and economic growth. The intertwined series of events are at the heart of why the post-USSR state struggled to survive its first years of existence.

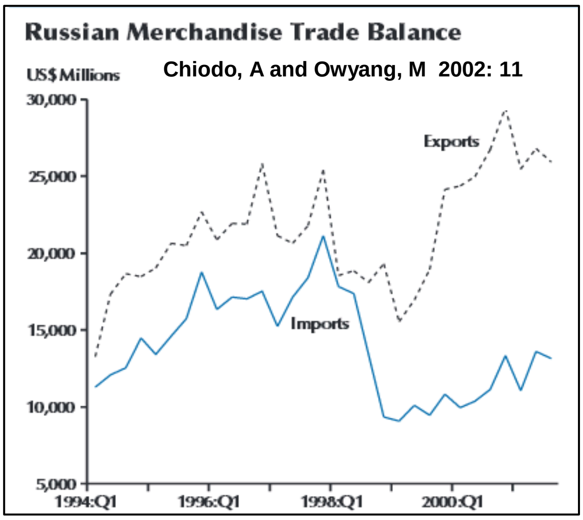
Part II: Explaining Russia's Rapid Economic Recovery, 1998 Onwards

In the wake of almost a decade of economic and political turmoil and the 1998 Financial Crisis, the Russian economy underwent a rapid economic recovery. The rouble devaluation acted as a crucial external shock, necessary for providing a pivotal lifeline to the fragile economy. The windfall gains of the devaluation, coupled with rising oil prices, were strengthened by government policies and led to the economy's revitalisation. "From 1999 – 2001 alone, GDP growth averaged more than 6% per annum, with industrial production leading recovery by growing more than 9% each year" (Süppel, R. 2003: p55), and the graph below illustrates the significant economic recovery.



1. Rouble Devaluation

After years of economic reform, "privatization and macroeconomic stabilization had experienced some success, however the financial crisis of August 1998, forced Russia to default on its sovereign debt, devalue the rouble and declare a suspension of payments by commercial banks to foreign creditors" (Chiodo, A and Owyang, M. 2002: p9). "Nominal depreciation that exceeded ensuing inflation meant the real value of the rouble was only about 36% of its immediate pre-crisis value at the end of 1998, after the Russian stock, bond and currency markets collapsed" (Gaddy, C and Ickes, B. 2000: p2). Subsequently, even without significant changes in the conduct of Russian exporters who were wrestling with the economy's transition, the falling value of the exchange rate made their exports hugely more competitive, facilitating import substitution and large current account surpluses. As a key component of growth, the increased consumption for Russian exports helped prop up the economy, which had few options available to prompt a recovery in such desperate times. After all, the country's crippling debt meant loans were becoming unfeasible and it was difficult to find willing lenders anyway, owing to the economy's dismal state. Moreover, extensive capital flight led to a drought of investment; however this was useful in reducing the pressure on the turbulent inflation level. Consequently the "devaluation allowed the trade surplus to increase from $9.7 billion to $35.5 billion, a difference worth almost 10% of GDP, from August to October 1998" (Süppel, R. 2003: p47). Even amidst falling domestic incomes, which were roughly 75% of the 1995 level in 1999 (Gaddy, C and Ickes, B. 2000: p3), the more competitive exchange rate was the much-needed impetus to rescue the Russian economy.



2. Rising Oil Prices

Compounding the economic advantages of the devaluation was the rising world price of oil. Having been "adversely affected by the collapse of the USSR and entering a prolonged period of decline in the 1990s, the rise in oil prices, from $10 a barrel in December 1998 to around $33 a barrel in September 2000, provided a major cash injection into the economy" (Hill, F. 2004: 10). Interestingly, "state-controlled companies barely increased output therefore it was private oil companies which directly accounted for around one quarter of growth; not taking into account the knock-on effects from oil-sector procurement and wages on domestic demand" (Ahrend, A. 2008: p4). However even without increasing oil production, the industry became vastly more valuable, with the profitable incentive and accompanying finances now available to improve productive capacity and capitalise on the favourable economic conditions. Moreover, the oil revenue undoubtedly entailed an increasingly positive impact on government revenues, which could be utilised to stimulate increased domestic consumption, especially in light of the aforementioned falling incomes. The statistics substantiate the point that oil was a key factor in the Russian economy's rapid recovery. "Natural resources directly accounted for roughly 70% of the growth of industrial production in 2001–04, with the oil sector alone accounting for just under 45%, implying natural resource sectors directly contributed more than one-third of Russian GDP growth over the period, and the oil industry alone close to one-quarter" (Ahrend, A. 2008: p4). Subsequently, the oil price rise facilitated a beneficial impact on the economy's rapid recovery.

3. Role of the Government

The factors motivating the recovery and the rising economic growth undoubtedly changed over time. This became more apparent when, despite the waning effect of the devaluation and declining oil prices in 2000-2001, investment and growth continued to thrive. Recovery would have been short-lived if solely reliant on the ephemeral level of the exchange rate and world commodity prices. Government policies helped to enable the recovery's emergence and sustainability and this is substantiated by comparing the situation in 1999 to that of 1994. In 1994, a "similar combination of factors - a weak rouble, cheap domestic energy prices and relatively high export prices for oil - failed to prevent a 12% drop in GDP; however come 1999 the incomplete liberalisation and privatisation allowed for private enterprises to capitalise on the opportunities provided by the external shocks" (Ahrend, A. 2008: p4).

In essence, a wide array of government policies helped foster a more liberal economic environment where private enterprises could emerge, grow and capitalise on the recovery. Putin's tax reform sought to overcome a plethora of high and overlapping taxes, which reflected the decentralised structure of the government where local, regional and federal government authorities were not clearly delineated (Cooper, H. 2009: 10). For example a simpler 13% flat tax replaced a progressive income tax with several tiers and such changes helped prevent tax evasion and subsequent corruption, which assisted in eradicating the potential for a resurgence of the underground economy. Such reform also occurred concerning the complex regulations which inhibited the ability of new businesses to emerge and flourish. Moreover, there was a focus on "paying out a crucial portion of the enormous backlog of unpaid salaries, pensions and other social benefits; stabilising the currency; a gradual remonetarization of the physical economy and providing for an inadequate, but still crucial margin of flow of credit to the productive sector" (Tennenbaum, J. 2002). Consequently, the government's prudent policies allowed enterprises, including the emergence of new ones, to fully utilise the opportunities provided by the external shocks and drive the recovery forward, even after the effect of the shocks began to taper off.

4. Summary

The combination of the rouble devaluation and the rising world oil prices breathed new life into a stagnant economy, crippled by a number of structural and contingent problems. Ready to capitalise on the reinvigorating external shocks was a more liberal and simple economic environment engineered by government policies, to better encourage enterprise and to survive and flourish independently of the shocks. This provides an effective overview of the quintessential components that underpinned the recovery.

Conclusion

In essence, perhaps it was inevitable for the Russian state to flirt with the prospect of collapsing, to begin afresh and better pursue the new economic and political systems of capitalism and democracy. Political instability, the lack of government revenue and the loss of the state's monopoly on violence chipped away at the state's institutional capacity. After nearly a decade of turbulence, the Russian Financial Crisis of 1998 then compounded the country's desperate state of hopelessness concerning their transition. Subsequently, the rouble devaluation and the rising world oil prices became a necessary lifeline for the country, facilitating a rapid economic recovery and acting as a signal of the prosperity that could be enjoyed by the new Russia. Finally, government policies ensured the country utilised this opportunity to re-launch its flourishing capitalist economy.

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