

The Russian Economy in the Year 2006¹

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INTRODUCTION

The good times that Russia has enjoyed for the past six years continued in 2006. I will describe some of the elements of this remarkable recent performance, but only briefly. My main remarks will rather focus on two broader issues. The first is how I view Russia's political economy working today. This is the system of "rent sharing" that Professor Barry Ickes of Penn State University and I have written about. I will also discuss Vladimir Putin's key role in shaping and managing this system. The second topic is the fundamental challenges the economy faces for the longer term. I will especially focus on the pitfalls along the way. In a new book we are writing, Barry Ickes and I describe them as the "Bear Traps." I will conclude by asking how, against this background, Russia's economy may evolve in the shorter and longer term.

REVERSAL OF FORTUNE

The best way to appreciate where Russia is today is to remember how far it has come in the past seven years. Russia's story is one of the most dramatic reversals of fate in recent economic history. When Putin assumed the post of prime minister in August 1999, the country's foreign exchange reserves were down to under \$8 billion and falling. Meanwhile, Russia's debt to the International Monetary Fund alone was \$16.6 billion. Russia was thoroughly bankrupt. Seven years later, the situation was quite different. In August 2006 Russia's foreign reserves totaled \$258 billion. In addition, it had another \$65 billion in its oil stabilization fund. The IMF, in the meantime, had total lendable funds of less than \$250 billion. Right now, the Russian government continues to add cash to the foreign exchange reserves and stabilization fund at a rate of \$170 billion a year.

Russia has thus come a long way since the days when it was so desperately dependent on the financial largess of the West that a telephone call from the Treasury Department in Washington decided the fate of a government in Moscow. Indeed, as holder of one of largest current account surpluses in world, it is one of the biggest financers of the US current account deficit.

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THE TWO PILLARS

The explanation for the reversal of fortune is hardly a secret. The Russian economy rests on two pillars: oil and gas. In exactly the seven years of Putin's tenure, the value of those commodities has soared. The increase in wealth flowing into Russia from oil and gas is staggering. Consider the income from one component alone — crude oil exports. Revenues from foreign sales of crude in the four quarters prior to Putin's appointment as prime minister in 1999 were \$14 billion. For the most recent four quarters, the corresponding number is \$140 billion. (Note that in 1999 Russia's total GDP in dollar terms was only \$200 billion....)

People say: "But there's more there than just oil." Indeed, there is — more and more each year. The pillars support more. The visual image is a platform resting on the pillars I mentioned. Piled on that platform, higher and higher, is business activity in retail, wholesale, consumer goods, construction, real estate. This is the "non-oil economy." So, yes, Russia's non-oil sectors are growing as a share of the total economy. Is oil then becoming less important for Russia? No. It is just the opposite. Oil becomes more important, because more businesses and more jobs depend on the flow from oil and gas.

RENT SHARING³

To illustrate the increased flow of oil wealth into Russia, I just now cited the ten-fold increase in crude oil export revenues. But what is supporting the economy is more than just crude and more than just the cash earned from selling it abroad. It is the total rent from oil and gas. This rent — popularly referred to as excess profits or windfall — is the aggregate market value of these commodities (whether exported, or even sold at all, at the market price) less the normal costs of extraction, including a normal rate of profit. The single most important thing to know about the Russian economy is how this total rent is distributed, or shared, throughout the economy.

I referred to the oil stabilization fund. In theory, it should absorb the oil and gas windfall. In fact, because it is based only on income from oil exports — while Russia's oil and gas rent is much greater than just oil export revenues — the stabilization fund this year absorbed only about 14 percent of total rent. The rest? It is distributed throughout the economy in other forms to different claimants. The owners of the resource companies — the oligarchs — keep a healthy amount as profits. Some of the rest is collected by government in taxes other than those that go straight to the stabilization fund. But an important part of the rent is distributed by the mechanism of "informal taxes." These range from price subsidies (on natural gas, not oil — very little oil is sold at subsidized prices), to bribes, kickbacks, and "voluntary contributions" to especially local governments.

One particularly important mechanism of rent sharing that also can be classified as an informal tax is excess costs of production. Oil and gas companies order equipment and other inputs from local manufacturing enterprises, even if the products are not competitive. Such orders sustain activity at these local enterprises, which also means jobs, incomes, and

³ For a more detailed exposition of rent sharing in Russia, see Gaddy and Ickes (2005).

tax revenues for local budgets. In other words, by placing the orders, the resource companies share some of the rents locally.

It is obvious why the recipients of the shared rents find this system attractive. But why do the original owners of the rents share them? The answer is that they have to. This is implicit in the word “taxes.” When we say that these are “informal” taxes, we mean that they are not prescribed by formal laws. In practice they are just as mandatory. Writing about the so-called voluntary contributions by businesses to local government “infrastructure funds,” “social funds,” and the like, one Russian scholar used the term “mandatorily voluntary” [*prinuditel’no-dobrovol’nyye*]. They are mandatory in the sense that failure to pay them exposes the owner to serious risks.

Another term for what is going on is “protection racket.” In a protection racket, there is a threat against which someone offers to protect you. The catch is that the threat emanates from the protector himself. Here, the threat is the loss of property rights. Sharing rents locally is one way to pay the protection money. There is also a national version of the protection racket, designed primarily for the very largest companies. At that level the “payment” may be different. Companies are expected, for instance, to pursue certain policies in their foreign activity that further the geopolitical interests of the Russian state, even if they sometimes don’t quite make sense from a strict business perspective. In either case, local or national, the principle is the same: if you haven’t kept current on your protection payments, you won’t have friends when the threats mount.

In sum, companies in this model are expected to do three things: (1) pay their formal taxes; (2) pay their informal taxes (share locally); and (3) serve the foreign policy agenda and promote other strategic interests of the state. It is very important to recognize the informal rent-sharing. This is the part of the iceberg that lies below the surface. That’s the part that is hidden, and the part that tends to be larger. It’s the part that can cause shipwrecks. One victim of the hidden iceberg was YUKOS. Khodorkovsky miscalculated. He refused to pay the excess costs. He tried to be a cost-minimizer (profit maximizer) in a system that dictated that he be a cost-maximizer.

PUTIN AS RENT MANAGER

In any protection racket, the person who threatens you and the person who offers to protect you from the threat are one and the same. The protection racket in Russia that I’ve described is one in which the contrived threat is the loss of property rights. Who then is the protector? Who is it in Russia that has the ability to credibly threaten the property rights of even the biggest companies in Russia? It is Mr. Putin. He is the chief protector. He is the overseer of the protection racket. More broadly, he oversees the entire rent sharing system.

The oil and gas rent gave Putin the power to achieve his main objectives: strengthening the state and maintaining social stability. However, the mere existence of the rent was not enough. The rent had to be managed. That required skill and purpose. In his capacity as manager of the rent, Putin has done three things and done them very well from the vantage point of his own goals. First, he has managed the collection of the rent. Second, he has defined priorities for the use of the rent. Third, he has managed the actual process of rent sharing.

His management of rent collection spans both the informal and formal rents. Putin inherited a large and unwieldy system of informal rent sharing. Barry Ickes and I described this as “Russia’s Virtual Economy.” Rent was distributed informally and mainly locally. Putin reformed this system. In fact, he continued and perfected reforms already initiated in the late

Yeltsin era. While he permitted much informal rent sharing to continue, his main priority was to formalize and centralize rent collection. He collected the rent to the Center through formal taxes. (This explains Putin's early emphasis on tax reform. Although that reform led some people to laud Putin for his progressive policies, there was nothing particularly pro-market about this at all. It was not designed primarily to make life better for business. It was designed to collect rent to the Center.)

Putin defined clear priorities for the use of the formal rent. One main use has been to re-establish Russia's sovereignty. He learned a big lesson from the Gorbachev and Yeltsin experience. In his new book, *Fall of an Empire*, Yegor Gaydar (2006) explains that payments and fiscal discipline had so deteriorated in the late Soviet period that Russia had to take out loans from foreign governments, inevitably with political strings attached. At that point, Gaydar argues, the USSR was doomed. Gaydar's book is subtitled: "Lessons for Today's Russia." Putin learned those lessons well. His macroeconomic and fiscal stability measures have been exemplary. His number one goal was to get rid of the public foreign debt. Obsessively, he paid off Russia's entire remaining debt to the IMF in January 2005 — three and half years ahead of schedule. He did a similar thing this August with the Paris Club debt, retiring some \$23 billion.

The third thing Putin has done is to successfully manage the rent sharing process itself. This is important because of the inherent tension in rent sharing. If not kept under control, it could tear the country apart. Putin kept the old protection racket that had been run by regional officials and elites. But he brought it under his central control. He made sure that governors would see their primary task as enforcing centralized rent collection. This was the reason for his reform of the political system with direct appointment of governors. Putin needed governors to serve as "regional rent managers" within a national structure of "Russia, Inc."

Putin's model for managing Russia, Inc. comes from his study, beginning in his KGB days, of the concept of "strategic planning." His 1997 dissertation for the degree of *kandidat ekonomicheskikh nauk* focused on that theme. Under his scheme, Putin plays the role of chief executive officer of Russia, Inc. He manages the organization on the strategic level. Others — his "division managers," some of whom we know as oligarchs, others as governors — implement the strategic directives within well-defined bounds. The rent-management model helps us understand why discussions of state versus private ownership in today's Russia can be confusing. Renationalization is not necessarily an objective for Putin. In his scheme, what is important is not who has formal (legal) ownership of a company — property rights are always contingent in Putin's model — but rather who controls the rent flows, to what ends.

Secure control of rent flows by players loyal to the Kremlin is essential, regardless of whether the company in question is privately owned or state owned. As discussion of the protection racket shows, private ownership of a company is not necessarily an obstacle to its performing its function in the rent sharing system. Conversely, state ownership alone may not be enough to ensure that the rents are properly distributed. There must be loyal agents in the right positions in those state companies. We were reminded of this fact in recent days as the name of one individual, Valeriy Golubev, was in the news. Golubev, just promoted to be the new deputy head of Gazprom, had since February 2003 been head of the department for investments and construction for Gazprom. There is arguably no single position in Russia that rivals Golubev's when it comes to volumes of rents shared. Who is he really? He was another former KGB colonel from St. Petersburg. This vast and well-functioning protection racket needs skilled and loyal managers.

CORRUPTION IN RUSSIA

I have referred to a system that includes bribery, kick-backs, sweetheart deals, rackets. The system exhibits every form of extortion and venality imaginable. Yet I intentionally avoided using the term “corruption.” The term is confusing. We are all against corruption. But corruption serves a purpose. We need to understand the purpose in Russia. The notion of rent sharing offers such a context.

Corruption is omnipresent in Russia. Some of the protection rackets are for personal enrichment; others are part of the system of rent sharing for the purpose of social stability (providing jobs and incomes), or for state interests. The fact that the same behavior can have different motivations reminds us of the classic observation by the journalist Yuliya Latynina (1997) when writing of theft in the Russian economy. It is a mistake, she wrote, to think that Russian enterprise directors are divided into those who steal and those who don't steal. They all steal. It's just that some steal *from* the plant and others steal *for* the plant. That is, in the later case, their theft helps keep the plant alive and thus preserves jobs and incomes for workers.

It's very much the same today. From the standpoint of the manager of the rent sharing system and *all those who benefit from that system*, there is thus “good” corruption and there is “bad” corruption. Good corruption greases the wheels and broadens support for the system. Bad corruption allows personal greed to undermine the system. The job of the system manager (Mr. Putin) is to limit the bad corruption while encouraging the good corruption.

It should be evident that there might be a problem with an anti-corruption campaign in this context. The rent sharing system has millions of beneficiaries. You may conduct a survey that finds that “the Russian people” hate corruption. Of course they do. When asked this way, it is like asking whether they like being ripped off, harassed, and humiliated by people more powerful than they. They hate corruption by that definition. But you will find a different answer if you ask, say, the thousands of workers at noncompetitive “dinosaur” manufacturing factories in Tomsk oblast whether it was bad to demand that the YUKOS subsidiary Tomskneft place orders with those plants, even though those orders were part of a local protection racket involving extortion, kickbacks, bribes, and other corrupt practices. Khodorkovsky said he was against corruption and refused to play that game. He made many enemies in Tomsk.

It all depends on who benefits from corruption, and to what purpose. Most people who benefit from the excess costs mechanism of rent sharing — a form of corruption — are ignorant of what is going on. They are involved in a form of what Gregory Grossman in the context of the Soviet economy described as the “loot chain.” At the bottom of the chain were a diverse group of individuals who shared some of the loot without necessarily being aware of where their income came from. Most did not see themselves as beneficiaries of corruption at all. On the contrary, they saw themselves as honest, hardworking people who deserved what they got. Today's “rent chain” operates in the same way.

Moreover, an anti-corruption campaign is itself likely to be incorporated into the protection racket. Consider this: to operate a business in Russia, you're forced to pay protection. If you do, you break the law. You are guilty of corruption. Your only recourse to avoid prosecution is to pay off the right people, to participate in another protection racket. It's a classic Catch-22.

“BEAR TRAPS”

Let me now turn to my second topic, the challenges for the future. I said that Putin has achieved much in the three facets of rent management: collection of the rent, use of the rent, and the process of rent sharing. Let me now identify what he failed to do. He has not helped *create* the rent. This of course is the real issue for any economy: How to ensure sustained generation of wealth. The most immediate concern for Russia in this regard is to ensure continued flows of wealth from oil and gas. Ultimately, wealth generation has to come from other sources.

We are familiar with the conventional laundry lists of recommendations for economic policy that come from outside and inside Russia. From the outside the emphasis tends to be suggestions such as: introduce “rule of law,” improve the investment climate, build an “institutional framework.” Inside Russia, people stress policies to remedy problems such as the low technological level of production, high cost and resource intensity, degradation of capital, and lack of large-scale investment programs. Many of these are correct. But they are rather abstract. Let me speak of the fundamental challenges. In a new book we are writing, Barry Ickes and I call them the “bear traps.” Our subtitle is “Pitfalls Along Russia’s Road to Sustainable Economic Growth.”

What do we mean? We are trying to underscore the fact that there are different ways one can fail to adequately meet a great challenge. One is to simply ignore it, out of choice or out of ignorance of its severity. If you do that, you don’t solve the problem. It may even grow worse. But at least you have not wasted effort. A second way to fail to meet the challenge is to do something, but an irrelevant something. Then you do waste funds and effort. The third, and worst, wrong way to address the challenge is to exert an effort that makes the problem even worse than it was to begin with. You dig yourself deeper in the hole. This is what we mean by the bear traps. You can fall into a bear trap even when you try to do the right thing, but in the wrong way.

Now let me illustrate this in the case of dealing with the challenges to economic growth. The factors that generate economic growth are well-known. Growth depends on adequate accumulation of physical and human capital and on improvements in efficiency with which these factors are used. This part is simple enough. But we stress that there are two important additional points. First, you need to understand growth factors correctly in the Russian context. Second, you must recognize how each is associated with hidden pitfalls. I can illustrate with physical capital.

PHYSICAL CAPITAL

Physical capital accumulation is just another term for investment. Investment is necessary for Russian growth for two related reasons. First, investment in physical capital — purchase of new plant and equipment and construction of new facilities — is crucial to restructuring Russian enterprises, that is, reorganizing their production structure. Second, investment is critical because it is a means of upgrading technology. Many important technological changes are embodied in capital goods. Consequently, it is no surprise that investment is one of the few robust correlates of growth in cross-country growth regressions.

Many observers have noted that capital accumulation in Russia is low compared to fast-growing “tiger” economies. The share of Russia’s GDP that it devotes to investment is low, only around 18 percent. The so-called Asian Tigers and Japan and Korea before them

had investment shares of 30-40 percent. This observation is correct. But there is an even more important point: effective investment in Russia is inhibited by a price that is very high relative to other uses of GDP, especially consumption. The international comparison project — the same exercise that gives us purchasing power parity measures of gross domestic product — produces breakdowns of GDP by so-called international prices. These prices give a picture of the true opportunity cost of investment in an economy. Investment is foregone consumption. When the investment price is high, it means that you forego more consumption to attain a given investment result than you would if the investment price were lower.

To put it another way, if the relative price of investment is high, it means that although you may be spending, say, 20 percent of your GDP on investment, the result in terms of machinery, equipment, and so on, is much less than that. At international prices, Russia's investment share falls to half: 9 percent. This is 9 percent compared to Japan's or Korea's rates of over 30 percent. So Russia gets little result from its investment effort.

The reasons for Russia's high price of investment relative to consumption are myriad. One is that the consumer goods market in Russia is fairly competitive. There are a lot of imports. This keeps prices down. The investment goods market, on the other hand, is less subject to competitive discipline. We have looked at the main reason why this is so: the "protection racket" that forces the resource companies to inflate their costs of production. One of the main components of these inflated costs is investment goods. Thus, the rent sharing scheme acts as an extra tax on investment, raising its price.

So far, what I have discussed just says that the investment needs in Russia are even greater than usually assumed. Here's the bear trap: a big investment program in Russia today would carry a huge risk of lock-in of the existing structure. That is, investment could make Russia's problems worse. The need to diversify the economy is a current and constant refrain in Russia. This usually refers to plans to invest some of the oil windfall in other sectors. Most such plans really represent another way to express a claim on rents. The frequent arguments for diversification are less a challenge to the current structure of the economy than an attempt to lock it in. The current abundance of oil and gas rents permits a misallocation of resources and assets that perpetuates Russia's inherited economic structures and thus inhibits opportunities for long-term growth. So, you can do the right thing in the wrong way. Then you are worse off than if you did nothing.

HUMAN CAPITAL

Human capital accumulation is the other critical factor for growth. Human capital is people. I will offer only a few snapshots to illustrate the bear traps here.

Demography.

Russia's population is shrinking. On average, 840,000 more Russians have died than were born each year since 1993. The country is now on track for a population of 130 million by 2030 and 110 million by 2050. Of particular immediate concern is the declining number of draft-age males. Within ten years, the number of 18 year-olds will be only half what it is today. This may explain why Putin has seemed to focus almost only on the birth rate. In his State of the Union address this year and in subsequent remarks, he has emphasized pro-natalist policies, including maternity bonuses.

Here's the bear trap: this focus on numbers does not address — and can even undermine — the true concern, which is the *quality* of Russia's human capital. Quality has many dimensions, among them health, age structure, education, living standards, and even location. In other words, how old are people; how are they educated; how well do they live; and where do they live? I will not deal with these in detail, but merely offer brief snapshots that point out some issues.

Health.

It is difficult to convey how dramatic the picture of male mortality in Russia is. Male life expectancy is now at the level it was in the early 1950s under Stalin. Russian males in prime working age — 25-55 — are dying at rates much higher than those in most other industrialized countries. And the biggest discrepancy of all is among the youngest groups, those in their 20s and 30s. Russia's death rate for 25-34 year-olds is around five times that of US and most of Europe and a whole order of magnitude higher than Scandinavia, the Netherlands, and Japan. Russian 35 year-old men die at same rate as Swedish or Japanese 60 year-olds.

The reasons for the high mortality are surely complicated. But it seems evident that alcohol plays a key role. All too many Russian men are drinking themselves to death. I will mention just one economic aspect of the alcohol issue. The real (inflation-adjusted) price of vodka today is roughly one-tenth of what it was in 1988 under Gorbachev. Some of that relative cheapening of alcohol occurred after abandonment of Gorbachev's anti-alcohol campaign. But much of it happened under Putin. Add to that the rise in workers' wages in the past few years and we have the following fact: when Mr. Putin came into office 1999, the average industrial worker could buy 28 liters of vodka for his monthly wage. Today, he can buy 78 bottles. This is a likely reason why death rates for 30 year-old males have risen by 48 percent under Putin.

Location.

The final bear trap I will mention is location. It may be the biggest and deepest of them all. Barry Ickes and I first dealt with this in our project on "Cost of the Cold." Fiona Hill and I developed it further in the book, *The Siberian Curse* (Hill and Gaddy, 2003). The basic thesis is that all proper investment in human capital or physical capital will be wasted if you don't make the proper locational match. After the collapse of the command-administrative system of economic management in the early 1990s, free market forces in Russia began correcting the spatial misallocation that had occurred during the Soviet era. People migrated out of the coldest and most remote regions. That self-adjustment came to a halt in 1999. Now the trend has reversed. Plans for Siberian development and repopulation are back on the national agenda. For instance, in June 2006 Putin announced a new migration program designed to attract ethnic Russians from abroad to return to Russia in order to repopulate Siberia and the East.

I should also point out that overall geographical mobility remains quite low in Russia, something that impedes reallocation of human capital. Each year only one-third or one-fourth as many Russians move to a new city as do Americans or Canadians. In an economy that needs much more dynamism, this is not a good trend.

Living Standards.

Many of the problems related to quality of human capital — including mobility — can be traced back to low standards of living. Too many people live in poverty. This produces a dilemma for Russia in light of our earlier discussion of investment. All investment is at the expense of consumption in the short term. Investment means foregoing consumption today for the purpose of increasing consumption tomorrow. Underinvestment means overconsumption. It is hard to imagine that can be the case in Russia. So how can Russia raise investment rates without lowering living standards?

The first step in tackling the problem of living standards is accurately recognizing it. We are told that living standards are rising in Russia and that poverty is decreasing. But the true condition of a large part of Russia's population is questionable. Official Russian statistics that report so-called real incomes take nominal incomes and adjust them for purchasing power changes using the consumer price index (CPI). The idea of course is to show how today's incomes compare with those in previous periods in terms of the basket of actual goods and services purchased. Russia's consumer price index, however, is ill-suited as an adjustment factor for the incomes of the poorest part of the population. The CPI is based on the prices of all goods and services purchased by the entire population, rich and poor. Russia's pensioners, to take one large and poor group, do not purchase most of the items included in the CPI. Their consumption basket is very modest. It turns out that the prices of the basic goods and services they consume have risen much faster than the CPI. The bottom line is that, when we use the proper inflation adjustment, we see that the average Russian pensioner today can afford only 80 percent of what he or she could eight years ago. In the Pension Fund's own surveys from September 2004, 41 percent of pensioners sampled said their pension was not enough even for the bare essentials. Another 37 percent said they could manage in a strict austerity regime.

The cumulative loss of pensioners' purchasing power since the 1998 devaluation is quite large: the average pensioner has lost more than 89,000 rubles in today's prices. That is an amount that is 33 times the currently monthly pension. In aggregate, Russia's 38 million pensioners have been underpaid to the tune of more than 3.4 trillion rubles (\$125 billion).

WHERE IS IT HEADED?

I have spent enough time identifying the challenges and the pitfalls. These are long-term issues. While it is true that they need to be addressed as soon as possible, the fact is that their effects are not yet so acute that they shape Russia's near-term prospects. Short and medium-term performance will continue to depend mainly on the volume of oil and gas rents and how they are used. If we therefore want to know whether Putin's success can outlive his term in office, we must ask two questions: (1) will world oil prices allow the rents to continue; and if so, (2) can a successor continue to manage the rents as well as Putin has done so far?

Let us look first at the oil price. A price of around \$60 a barrel for 2007 and 2008 — the level most experts seem to predict for next year, at least — would provide Russia with a strong flow of rents. But then we must turn to the second question: how well can a successor manage the rents? One way to examine that is to recall my statement about Putin's three great accomplishments: (1) he centralized collection of the rent; (2) he centralized use of the rents for strategic state purposes; and (3) he managed the tensions inherent in the rent sharing process itself. Of the three, the first is the most robust. Centralized rent collection —

essentially, the formal system of tax administration and enforcement — has been institutionalized and should therefore endure. As for the use of the rents, Putin defined the priorities well. A successor is likely to stick with them. It is the third task, that of managing the rent sharing process, that is the difficult one. A successor must understand Putin's concept of "Russia, Inc.," subscribe to it, and be capable of putting it into practice. He cannot allow rent sharing to devolve into personal enrichment to the detriment of state interests. A fratricidal rivalry among the elites could threaten use of the rents for state interests. Here is where corruption is relevant. The bad corruption — venality — can take over.

In short, if the oil price remains high, and if the contest for rents can be managed — the second "if" being perhaps a bigger one than the first — then Russia has a good chance to remain stable. Even so, this begs the question of the longer term. The bear traps are waiting.

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