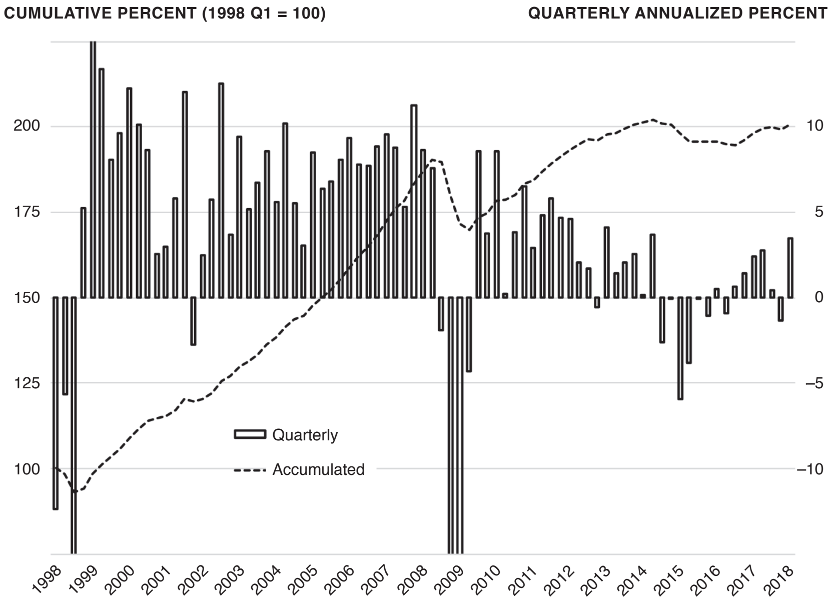
One

ECONOMIC ROLLER COASTER: 2000–17

Vladimir Putin was fortunate as a politician. He became Russia's prime minister in August 1999, when the country's economy had just emerged from the serious financial crisis of August 1998 and was entering a lengthy period of rapid growth. From 1999 to 2008, the Russian GDP grew 94 percent, or an average annual growth rate of slightly less than 7 percent. In dollar terms, the Russian economy grew 8.5 times. Had Russia been able to maintain similar growth rates for another ten to fifteen years, we would now be talking about the "Russian miracle." After the start of the worldwide recession in mid-2008, however, the Russian economy lost its momentum and essentially stagnated, growing just 5.5 percent in aggregate over the next ten years (see figure 1-1).

Many attribute Russia's economic achievements during the period of 1999–2008 to Vladimir Putin and his economic policies, with the "lost decade" that followed explained away as the result of various unfavorable external factors, such as the global recession of 2008–09, the decline in oil prices from more than U.S. $110 per barrel in 2011–13 to an average of $52 per barrel in 2015 and $43 per barrel in 2016, Western financial sanctions against

FIGURE 1-1. Russian Economic Growth, 1998–2018



Source: Rosstat, "Ofitsial'naya statistika. Natsional'nyye scheta. Valovoy vnutrenniy product" [Official statistics. National Accounts. Gross Domestic Product] (http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/accounts/#).

Russia imposed in response to the Russian aggression against Ukraine, and the slowing Chinese economy. Others add changes to Putin's economic policies to this list of causes. These explanations are not entirely convincing, nor do they suggest what should be done to get the Russian economy growing again. If the economic policy of 1999–2008 was right, then a return to the methods of that decade should have given the Russian economy a fresh start. Even if the economy grew at only half its former rate of 7 percent, that would still constitute a decent achievement.

An analysis of Russia's economic policy during Putin's entire eighteen-year reign, however, reveals no major differences in the principles and instruments the government applied to the economy in different periods. Nor was there anything particularly liberal about the economic policy of Russia during 1999–2008 that could account for the rapid economic change of that period.

During his first term as president, Vladimir Putin supported the passage of several laws that significantly changed the rules of the game—but their actual contribution to the growth spurt was secondary. The new Tax Code, for example, simplified the tax system and established a flat 13 percent personal income tax, a standard subsequently adopted by many Eastern European countries. The Land Code institutionalized private ownership of land, a move that no doubt spurred economic activity in the Russian agricultural sector, which has been growing at an average rate of 3.5 percent a year since 1999. But the agricultural sector accounts for just 2.5–3.5 percent of Russian GDP, so its annual contribution to economic growth is insignificant. The Duma—the lower house of parliament—adopted a new Labor Code that made the labor market a little more flexible. Energy reform infused the energy sector with additional investments. Social service benefits were monetized, and pension reform introduced the saving component that initially gave a substantial boost to the domestic corporate bond market (though this part of the pension reform subsequently was terminated by the government in 2013).

However important all these decisions were individually, they did not add up to a coordinated reform package.[1] Therefore they did not seriously contribute to Russia's economic growth gains during Putin's first eight years as president. Moreover, none of these reforms were rolled back in 2008–17, nor were any economic counterreforms adopted in 2008–17 that could have weighed significantly on the Russian economy.

Instead, a detailed analysis of the Russian economy from 1999 to 2008 paints a picture of uneven growth affecting disparate sectors rather than a steadily rising tide lifting all boats. Annual growth rates ranged from 2.5–3.0 percent in the second half of 2000 to more than 10 percent growth in some periods. The growth was not distributed equitably across all economic sectors: different sectors acted as the drivers of growth at different times. Within this ten-year period of growth, three different stages can be ascertained, each having its own factors promoting economic growth: 1999–2001, 2001–05, and 2005–08.[2]

RISE AND DECLINE OF GROWTH RATES

The first stage, 1999–2001, bore the characteristics of a classic export and import substitution boom brought on by a sharp devaluation of the national currency in the financial crisis of August 1998.[3] The ruble's devaluation significantly increased the competitiveness of many Russian products on domestic and especially foreign markets. It's not an accident that the sectors that grew most during this period, such as the automobile industry, had unused capacity reserves or else were export-oriented, thus benefiting from lower costs in dollar-equivalent terms. Some examples of the latter were the chemical, metallurgy, and fertilizer production industries.

By 2001 the effects of the devaluation had tapered off as a factor contributing to economic growth, but already by 2000 a new growth-enhancing factor connected to the delayed effects of privatization had kicked in. The post-Soviet redistribution of property was completed by the late 1990s, and the new owners had survived a difficult time of political and economic upheaval. However, the foundations of the new economic system remained unchanged, and businesses realized that nothing threatened their interests and property rights. This realization led to a drastic improvement in managerial efficiency at privatized enterprises, giving rise to a class of efficient owners. Improved efficiency was especially noticeable in the raw materials export sector. A 50 percent increase in oil production for the period 2000–05 illustrates the success of that sector, at a time when privately owned companies were responsible for 80 percent of Russian oil production. In contrast, gas production—95 percent of which was controlled by the state-owned Gazprom holding—grew less than 10 percent. Increases in coal, iron ore, aluminum, steel, and copper production ranged from 17 percent to 29 percent between 1999 and 2005, while nickel production at Norilsk Nickel increased 35 percent between 2000 and 2007. In addition to raw materials production itself, the internal demand generated by the raw materials sector also served as a positive economic driver.

But this period came to an end with the breakup of the oil and gas company Yukos, which had been acquired from the state during the privatization push by Mikhail Khodorkovsky's Menatep Group. The politically motivated arrest of Khodorkovsky and the subsequent forced bankruptcy and nationalization of Yukos undermined the trust big businesses had in political structures—the same trust that had served as a basis for long-term economic forecasting and development programs in the early to mid-2000s. Moreover, once global oil prices began rising rapidly in 2003, the Russian Finance Ministry changed the taxes on oil revenues: since 2006, most of the oil revenue surpluses (up to 85 percent) have gone to the federal budget and have been allocated to fiscal reserves, where they cannot stimulate economic activity. Thus the contributions of the raw materials sector to economic growth has declined steadily since 2005 even as the prices of raw materials have continued to increase.

Fortunately for the Russian economy, the third stage was also a time of wide-open foreign capital markets. Investors recovered from their 1998 losses; the Russian budget was running surpluses, thanks to rising oil prices, and the country's credit ratings improved dramatically. From 2005 to the middle of 2008, Russian external corporate debt (for the financial and real sector combined) increased by almost $400 billion. The financing for foreign mergers and acquisitions to bring Russian companies to foreign markets accounted for approximately half of that amount, leaving about $55–$60 billion annually to finance domestic economic growth (an average of 4.3 percent of GDP for 2006–08).

Much as in other emerging economies, external financing primarily went to nontradable sectors of the Russian economy, such as construction, trade, finance, and market services. These were the key economic growth drivers at this stage, against the backdrop of increased raw materials prices, which overheated the Russian economy. However, the global financial crisis drastically curtailed access to external financing; moreover, some of the previously received loans had to be repaid (this was especially painful for banks), which stemmed the growth these loans had supported.

Two related conclusions can be drawn from all of the above. First, the rapid economic growth in the decade of 1999–2008 did not apply equally to all sectors and was sustained by a succession of unconnected factors over a long period. Hence the idea entertained in some quarters that Putin masterminded the economic growth of the 2000s through certain policy changes simply is not supportable. Second, the factors propelling the Russian economy forward between the 1998 financial crisis and the global recession of 2008–09 were unique and unlikely ever to be repeated in the same form.

The upheavals in the global economy that triggered the crisis in Russia in 2008 were so profound, however, that the government had an easy time attributing all its problems to external factors. And to some extent, this attribution was correct. The dramatic decline in demand for raw materials was indeed a powerful factor in the crisis (railroad shipments declined more than 20 percent in two months at the end of 2008 compared to the previous months; oil and gas shipments fell 7 percent and 20 percent respectively in the fourth quarter of 2008 relative to late 2007; and gas exports fell as much as 60 percent in the first quarter of 2009 relative to 2008 levels). But the decline in demand proved to be short-lived. The global financial system rebounded in the spring of 2009, boosting the global economy as a whole. Russia felt the change as well. After hitting its nadir in April 2009, the country's economy gradually began to improve.

The recovery was slow and uncertain. From mid-2008 to the spring of 2009 the Russian economy fell by 10 percent. Only in early 2012 was it able to surpass its precrisis maximum from mid-2008, but the growth rate soon fell below 2 percent, even though oil prices consistently topped $100 a barrel after January 2011 and the Russian invasion of Ukraine and the Western economic sanctions were not yet in sight. The decline in oil prices beginning in mid-2014 dealt a painful blow to the Russian economy. Export revenues fell precipitously, which drastically reduced contributions to the federal budget, which relied heavily on oil production and export proceeds.[4] Declining oil prices and Western financial sanctions imposed in August 2014 led to a devaluation by half of the ruble by the end of 2014. Russia's countersanctions against the West—specifically the food imports ban—had an adverse impact on the Russian population, driving inflation up to 18 percent.

In the midst of a new crisis, the Russian economy was in a slump, although a much less profound one than in 2008: the drop from the precrisis maximum in mid-2014 to the crisis minimum in mid-2016 was "merely" 3.6 percentage points, as opposed to the ten percentage point drop during the 2008 worldwide financial crisis. Several factors accounted for the gentler fall. First, in contrast to the 2008 crisis, the demand for Russian raw materials continued to grow,[5] and the Russian mining industry grew at an annual rate of 1.5 percent. Second, in contrast to its 2008 practice, the Central Bank of Russia refrained from selling currency reserves at the beginning of 2015, which sent the right signals to the economy, allowing it to make less painful adjustments to the changed environment. Third, in 2012 Russia embarked on a massive campaign to rearm its military, which was financed from the country's fiscal reserves. As a result, arms production grew 12–15 percent annually, propping up the whole manufacturing sector. Fourth, agricultural harvests were at record highs three years in a row (2015–17), lending momentum to food industry and grain exports. But while the 2014–16 economic slump was less profound than the 2008–09 one, it lasted for eight successive quarters—much longer than the earlier recession. The average annualized growth rate that Russia has struggled to achieve since the second half of 2016 remain below 1.5 percent, indicating that the forces that slowed the Russian economy from 2012 to 2014 are still in effect. Moreover, moving from an economic decline to a growth trajectory is not a sign of recovery per se, since growth is the normal state for any economy.[6] As Russia is an emerging economy, a full-scale economic recovery can be expected only when its economic growth starts running ahead of global economic growth indicators. But only the most hopeless optimists could promote this scenario now.

THE LOST DECADE

From a financial perspective, the Russian economic slowdown that first clearly manifested in 2012 can be attributed to a decline in investment activity, and that in turn has a significant political dimension. Private investment has been steadily decreasing, and the statistical totals have been sustained by means of grand-scale infrastructure projects paid for out of the federal budget; some examples are the APEC summit in Vladivostok in 2012, the Sochi Olympics in 2014, the 2018 soccer World Cup, the Crimean infrastructure, including the Kerch Strait Bridge, and the modernization of the defense industry. These investments indeed improved the statistics and hence the optics for investing, but they did nothing to expand economic potential or sustain growth.

Business requires investment. Private enterprise inherently gravitates toward expansion into new markets and increased efficiency. To realize these goals, businesses have to invest in growth. It's abnormal for businesses not to do so; nevertheless, such abnormal behavior often appears quite justifiable and rational in Russia.

Businesspeople contemplating growth and investment want to guarantee that they will be the ones to reap the benefits of their investments (whether by profit-taking or by enjoying the company's rising value). To protect their property, businesspeople need independent courts to secure equal protection for all, regardless of power or position or wealth. And to protect their interests, business owners need political competition to ensure that elected officials represent their interests. For political competition to work, business owners should have the opportunity to support politicians who are willing to protect their interests. And to do that, there must be a system of political checks and balances preventing narrow interest groups from monopolizing state power or resources. Business owners also benefit from independent media capable of revealing the malfeasance and corruption of politicians and government officials.

Today's Russia lacks all these things, but just twenty years ago the country seemed as if it had broken the communist deadlock and begun to build political institutions that would eventually yield a stable democracy. The lost decade for the Russian economy is a logical outcome of the political processes that have been unfolding in Russia since 2000. The country's movement toward democracy has stopped. The system of checks and balances was replaced by President Putin's power vertical, in which the president and his administration assign themselves the majority of government powers. Basic state institutions such as political competition, separation of powers, an independent judiciary, a federative state structure, and independent media have been virtually eradicated in Russia. This has created an unfavorable investment climate and has undermined property rights, which are at the basis of all economic activities. As a result, businesses were unwilling to invest in growth, bringing about the economic slowdown and stagnation.

Instead, Russia ended up with a nigh-omnipotent secret police, the FSB, whose permissiveness significantly exceeds that of the KGB, its Soviet predecessor. It ended up with a ruling political party eerily reminiscent of the Soviet Communist Party, with the presidential administration playing the role of the Central Committee and a circle of Putin's lieutenants and cronies acting as the Politburo. It ended up with a parliament where discussions aren't supposed to happen and whose future composition is known long before the elections. And finally, Russia has ended up with a parallel justice system that is prepared to sustain any charges against any individual if that's what the higher-ups want. Once again, Russian jails are home to hundreds of political prisoners, and Russian courts prosecute people for dissenting opinions.

Vladimir Putin is both author and beneficiary of this gradual evolution of the country. In the course of his eighteen years in power, Vladimir Putin and his administration, the Kremlin, have made a plethora of choices, each of which has pushed Russia a little bit farther from the goal pursued by Putin's predecessor, President Boris Yeltsin.

In his brilliant memoirs Albert Speer, Hitler's architect and later Reich minister of armaments and war production, described his personal transformation by quoting the British physicist Sir James Hopwood Jeans: "The course of a railway train is uniquely prescribed for it at most points of its journey by the rails on which it runs. Here and there, however, it comes to a junction at which alternative courses are open to it, and it may be turned on to one or the other by the quite negligible expenditure of energy involved in moving the points." This metaphor fits perfectly the history of Putin's Russia: none of his decisions were radical or energetic enough to upend the country's transformation all at once, but Putin's actions have moved enough points along the way to shift the train gradually onto a track going in the opposite direction. This book is about those junctions—about the decisions that changed Russia and undermined its transformation and its economy. The early buds of democracy were first frozen and finally destroyed, to be replaced by authoritarian rule.

In the closing days of 1999, a little-known figure became the acting president of Russia, and many of his later actions and decisions were shaped by his experiences during a very brief political maturation period.

Though Vladimir Putin easily won the presidential elections of 2000, he saw himself as fighting multiple enemies to do so. In battling real or imagined threats to his rule, Putin destroyed, piece by piece, Russia's unstable democracy, as well as its foundational checks and balances. Free speech fell first before his repressive tactics. Putin undermined the formation of the federative state in Russia by depriving the regions of any real power or finances and by depriving the Russian people of the ability to elect regional governors and city mayors. He put the judiciary system in Russia under his personal control and created a dual-track legal process in the country in which the courts are prepared to do the bidding of the government. He obtained control of the Russian parliament and regional legislatures. Block by block, Vladimir Putin built his "vertical of power"—the hierarchical management system that concentrates all powers in the hands of the president.

An important term that appears in many contexts is *siloviki,* from the Russian root "*sila*," whose meaning combines "power," "force," "might," and "violence." The *siloviki* are a very important group in modern Russia that has colonized multiple governmental agencies, usually denoted by "law enforcement," that are empowered to use violence on behalf of governmental bodies—the police, the prosecutor general's office, the Investigation Committee, the Antidrug Service, and, most powerful of all, the FSB, or secret police. In general, *siloviki* make up the military-security services and promote a narrative of Russia under attack from internal and external forces, against which Russia must defend itself. This narrative has contributed strongly over the years to the formation of Russia's current defense posture, economic weakness, and an absconded rule of law. Vladimir Putin, lacking any public political experience before becoming president, looked for other ways to defend his authority, and settled on the exercise of raw power to deal with his opponents. In Putin's Russia, *siloviki* have de facto free rein to use their agencies' resources for personal benefit or violate the law to put pressure on ordinary people, political opponents, or business competitors; in many cases they do so not just for personal benefit but to fulfill orders handed down from the Kremlin or a local boss. Thus the history of Putin's Russia in the twenty-first century is very much aligned with the rise to power of the *siloviki*, replacing the oligarchs as Putin's inner circle of associates.

Doing business in Russia is risky. It's easy to lose one's property. In the final two chapters of the book I reflect on the effects of Putin's counterrevolution on Russian business and try to explain why Putin himself is powerless to defend business owners in Russia, even in cases in which he understands the injustices to which they are subject.

The stories recounted in this book speak to the enormous pressure placed on business owners by the Russian government: in all but one case, the business owners lost everything. Some of the companies in this narrative were big, others were small. Some were owned by Russian businessmen, others were major international companies. In all cases the Russian courts accepted the actions of the government agencies and provided no relief to the business owners; the imprisonment of the owners of private businesses became a standard means of seizing the business. All of these losses transpired during the rule of Vladimir Putin, who was personally involved in some of them. No parallel situation arose in the 1990s under Boris Yeltsin as president.

What these changes bode for the future of Russian economy is to some large degree unknown but can be speculated about, a task taken up in the conclusion.

One important disclaimer: I do not discuss Russian foreign policy, including the annexation of Crimea, the military conflict in eastern Ukraine, or the influence of Western sanctions on the Russian economy. I omitted discussing this face of events not because the events are of no importance but because doing so would have amounted to a distraction from my analysis of what happened with Russia.

Notes to Chapter 1

1. Such a comprehensive reform plan was prepared in the first half of 2000 at Putin's request by the task force headed by later economic minister German Gref. In 2010 Gref's deputy, Mikhail Dmitriev, said the plan was implemented by fewer than 40 percent, while its ideas on political reforms were not even included in the final version. Dmitri Krylov, "Progamma-2000 — Chto sdelano" [Program-2000: What was done] (https://iq.hse.ru/news/177674728.html).

2. Of course, no periodization is completely accurate; various factors come into play and stop working at different times, and many factors can be in play at the same time. Nevertheless, it is possible to highlight the most powerful factors in operation at a given time.

3. The crisis of August 1998 came about as the result of several economic factors that influenced the Russian economy at the same time: the Asian crisis, which exploded in the fall of 1997; the decline in oil prices, which started at the beginning of 1998; and the inability of the Russian government to impose tax discipline and collect taxes. As well, a couple of political factors affected the situation: parliament was controlled by the left opposition and rejected many legislative initiatives of the government, which blocked the IMF program, and in March 1998 President Yeltsin replaced his longtime political partner, Prime Minister Viktor Chernomyrdin, with the unknown Sergey Kirienko, who failed to get the support of parliament and public opinion.

4. In 2013, revenues from the production and export of hydrocarbons amounted to 50 percent of the overall revenues of the Russian federal budget, while VAT and excises on imported goods amounted to another 13.3 percent. See Federal Treasury of Russia, "Information on the Execution of Budgets of the Budgetary System of the Russian Federation" (http://roskazna.ru/en/budget-execution/the-information-on-execution-of-budgets-of-budgetary-system-of-the-russian-federation/6884/).

5. Crude oil exports grew 10 percent and coal exports grew 21 percent in physical terms in 2015–17.

6. History reveals only a few examples of a country's economy declining for more than two years in a row when it was not subjected to powerful factors such as wars, falling prices for major exports, debt crises, or a loss of macroeconomic stability.