Summit Sarkar
14 April 2022

A History of Russian Economics & Modern Applications

Russia invaded Ukraine on 24 February 2022. Prime Minister Vladimir Putin's "special military operation" has simply expedited the precipitous decline of the Russian economy over the past decade.

But first, some context as to how this debacle unfolded. Following the collapse of the Soviet Union in 1991, Russia was in a state of turmoil, and a select group of influential men seized the opportunity during the transition period when the first president Boris Yeltsin announced a plan to privatize the state-run economy. In theory, the process was a voucher system, where said licenses were first distributed to the Russian public *en masse*. These vouchers could then be exchanged on the secondary market or used to purchase a stake in the roughly 15,000 enterprises available between 1992 and 1994 (Rosalsky, 2022). However, this plan quickly unraveled as Russia suffered from hyperinflation from poor government policies, often too extreme and dubbed "shock therapy". As a result, only individuals with extraordinary liquid assets (often bankers, mafia, or former government officials) had the ability to purchase these vouchers and then redeem them for a disproportionate stake in new companies.

Simultaneously, the newly formed Russian government was forced to cooperate with oligarchs to acquire loans. The Russian government provided stakes in the most lucrative industries, especially natural resources, as collateral for the loans. When the government then defaulted on such loans, the oligarchs wielded even more control over the Russian economy than they did during the voucher rounds (Rosalsky, 2022).

From this point, the status quo in Russia was established. A group of seven elite oligarchs, known as the Semibankirschina, controlled much of the economy while propping up the government, while the government ensured that agreeable oligarchs remained in economic control (Rosalsky, 2022).

These oligarchs handpicked the young ex-KGB agent Vladimir Putin as Yeltsin's successor, erroneously believing that Putin would not meddle with their interests. They could not have been more mistaken. Under Putin, the new government quickly pressed charges against the Semibankirschina, seizing their assets on charges including fraud and embezzlement, reneging upon the gentleman's agreement involved with his election (Parfitt, 2008). These formerly influential oligarchs soon faded into obscurity in the realm of Russian politics, and the new set of Russian oligarchs did not dare make the same mistakes that ruined Berezovsky and Khodorkovsky (Parfitt, 2008).

Life under Putin's early rule coincided with improvements for the average Russian citizen. Annual inflation fell from 21.48% in 2001 to 5.08% in 2012; similarly, real GDP per capita rose from about $2100 to $15000 over the same period (O'Neill, 2022 & World Bank, 2021). This explosion in GDP was in part fueled by the price of a barrel of oil climbing from about $47 to $125 over the same period of time (MacroTrends, 2022). As a result, this increase in real GDP per capita may not have translated linearly to direct improvement in Russian quality of life, but overall advances are inarguable nonetheless.

If the price level and value of output are not sufficient gauges of economic health, other statistics include real wages and FDI (foreign direct investments). Monthly real wages grew rapidly, with double-digit year-on-year growth of real monthly wages each year between 2000 and 2008 (Trading Economics, 2022). In addition, international investors found Russian investments appealing, marked by the first twelve or so years of the millennium seeing enormous FDI in Russia, jumping from 3 billion in 2001 to the high-water mark of 75 billion in 2008 (the Great Recession halved these figures, but they recovered to pre-recession levels by 2013) (World Bank, 2021).

This growth came to a dramatic halt in 2014, when unidentified Russian soldiers appeared in parts of Crimea, replaced the government in a largely bloodless coup, and *de facto* annexed the region into the Russian Federation. This was the result of the 2013 Euromaidan, where then-Ukrainian President Yanukovych chose to reject the EU-Ukraine Association Agreement and instead align itself with Russia, with subsequent wide-scale protests throughout Ukraine.

The international community applied pressure upon Russia, but not enough to force a withdrawal from Crimea. Russia's GDP only fell about 1-8% as opposed to without sanctions, in part because Russia lessened the economic fallout by raising interest rates and applying pressure on the foreign exchange markets (Ricart, 2022). These same strategies are being used again in 2022, and Russia has become more resistant to sanctions in these eight years.

In this period of time, the Russian Federation dramatically reduced its holdings of American dollars and other securities by a factor of 4.5 (Cotterill, 2022). Simultaneously, it has increased its holdings of the Chinese yuan and gold. Why does this matter for Russia? In times of sanctions, Russia will strengthen the weak Ruble: because China will not freeze Russian assets in yuan as the West will for euro/dollar-based assets, the Russian government will flood the foreign exchange by selling these yuan-based assets. Supply/demand will raise the yuan/ruble exchange rate, with spillover effects on other currencies. In addition, gold is far more difficult to freeze because as a uniform commodity, it has no shortage of buyers. Finally, all but 7 percent of Russian assets are at least A-rated, so they should remain indefinitely liquid in the face of sanctions (Cotterill, 2022).

However, the United States working in conjunction with other major economies can prevent these assets from reaching the international markets in the first place. The banking system will not accept sell orders from Russian banks, already removing some banks from the SWIFT network. As a result, financial intermediaries will not aid Russia in completing these transactions. In theory, the ruble should not be able to recover as quickly.

Immediately after the invasion, the Russian government raised interest rates by 13 percent, up to 20 percent (Turak, 2022). This rewarded Russian citizens for keeping their checkable deposits within the domestic system, allowing for the survival of Russian banks. In addition, the nation barred exchanges between the ruble and the dollar at a measly 10,000 USD (Ljunggren, 2022). It is very difficult for citizens to liquidate their Russian assets when the very transactions for currency exchange are blocked.

Besides banking policies, the nation as a whole has undergone a dealignment with the West technologically: notably, entities like Apple Pay, VISA, and MasterCard have halted services to Russia (BBC, 2022). Nonetheless, because the majority of Russian credit and debit cards operate under the MIR system, domestic transactions can largely continue unhindered. The MIR was already growing rapidly prior to the invasion of Ukraine, and the global sanctions will simply expedite its growth (Adams, 2021).

Russia has an obscure financial network compared to SWIFT, christened SPFS. While very few major economies utilize it, Russian officials have connected it to Chinese and Indian banking networks, along with ten others (Big Asia, 2022). Historical precedent highlights how removing national banks from the SWIFT network is akin to a double-edged sword.

Under the Trump administration, the United States sought to remove Iran from the SWIFT network and cripple its international trade when it exited the JCPA (Iran Nuclear Deal). European governments rightfully noted that a reliance on SWIFT was subject to controversial American policies. European countries seek to temper American financial influence when their interests do not align, and the same could continue should American & European governments disagree on handling Russia.

Similarly, Europe's heavy reliance on Russian exports compared to America's relative disconnect from it may test the potency of currently unified sanctions. In the long run, however, Europe can decrease its reliance on Russian gas and fossil fuels, a rare positive in this bleak scenario. These long-term policies will depend on whether European policymakers and by extension, citizens, can stomach the costs of a decouplement from Russia.

Oligarchs will suffer from targeted sanctions, but Putin is likely to remain in power in the near future. A unified effort from the Russian elite can reduce sanctions, but the risks of opposing Putin remain substantial. In terms of game theory, the Russian government's dominant strategy is to continue interfering in global affairs and asserting influence, and the Nash Equilibrium for oligarchs is to maintain their symbiotic relationship with Putin in spite of global consequences.

The Russians are a persevering people. They will continue to adapt to their new economic situation, much like they have since the fall of the Soviet Union. Nonetheless, current and subsequent economic pressures will not bring an end to the ongoing conflict. Russia has the leverage domestically—diplomatic concessions on Ukraine and the West's part may be the only way out.

References

Adams, J. (2021, December 10). *How u.s.-russia tensions could hurt Visa, MasterCard*. American Banker. Retrieved April 14, 2022, from https://www.americanbanker.com/payments/news/how-u-s-russia-tensions-could-hurt-visa-mastercard

BBC. (2022, March 6). *Visa and MasterCard suspend Russian operations*. BBC News. Retrieved April 14, 2023, from https://www.bbc.com/news/business-60637429

Cotterill, J., & Jones, C. (2022, February 28). *Russia's FX reserves slip from its grasp*. Financial Times. Retrieved April 14, 2022, from https://www.ft.com/content/526ea75b-5b45-48d8-936d-dcc3cec102d8

Crude oil prices - 70 year historical chart. MacroTrends. (2022). Retrieved April 14, 2022, from https://www.macrotrends.net/1369/crude-oil-price-history-chart

Foreign direct investment, net inflows (BOP, current US$) - russian federation. Data. (n.d.). Retrieved April 14, 2022, from https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?locations=RU

GDP per capita (current US$) - russian federation. Data. (2021, April). Retrieved April 14, 2022, from https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=RU

Ljunggren, D. (2022, March 8). *Russian Central Bank imposes $10,000 limit on foreign cash withdrawals*. Yahoo! Finance. Retrieved April 14, 2022, from https://finance.yahoo.com/news/russian-central-bank-imposes-10-211856000.html

O'Neill, A. (2022, July 27). *Russia: Inflation rate from 1997 to 2027* . Statista. Retrieved April 14, 2022, from https://www.statista.com/statistics/271376/inflation-rate-in-russia/

Parfitt, T. (2008, February 19). *Billionaires boom as Putin puts oligarchs at no 2 in Global Rich List*. The Guardian. Retrieved April 14, 2022, from https://www.theguardian.com/world/2008/feb/19/russia

Ricart, R. J. (2022, April 7). *Can the Russian economy withstand the sanctions?* Elcano Royal Institute. Retrieved April 14, 2022, from https://www.realinstitutoelcano.org/en/analyses/can-the-russian-economy-withstand-the-sanctions/

Rosalsky, G. (2022, March 22). *How 'shock therapy' created Russian oligarchs and paved the path for putin*. NPR. Retrieved April 14, 2022, from https://www.npr.org/sections/money/2022/03/22/1087654279/how-shock-therapy-created-russian-oligarchs-and-paved-the-path-for-putin

Russia and China will be able to exchange payments without SWIFT. Big Asia. (2022, March 17). Retrieved April 14, 2022, from https://bigasia.ru/content/news/businness/rossiya-i-kitay-smogut-obmenivatsya-platezhami-bez-swift/

Russia real wage - 1998-2021 historical - January forecast. Russia Real Wage Growth. (2022). Retrieved April 14, 2022, from https://tradingeconomics.com/russia/wage-growth

Turak, N. (2022, February 28). *Russia Central Bank more than doubles key interest rate to 20% to boost sinking ruble*. CNBC. Retrieved April 14, 2023, from https://www.cnbc.com/2022/02/28/russia-central-bank-hikes-interest-rates-to-20percent-from-9point5percent-to-bolster-ruble.html