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Russia's Virtual Economy

Clifford Gaddy and Barry Ickes

Brookings Institution Press 2002

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In the 1990s, the Russian economy was plagued by barterisation and the economy became virtual. What was in the books was not the real (i.e. market) value. After the financial crisis in 1998, the level of barterisation decreased and the economy seems to have turned towards a monetary economy. Not so, according to Clifford Gaddy and Barry Ickes, who argue that the virtual economy is not so much the demonetisation of the economy as it is *a set of informal institutions that permits the production and exchange of goods that are value subtracting...* (p.5) The virtual economy continues to exist after the crash and may even have been strengthened by it.

This book brings together the work of the authors over the years and focuses on the emergence and the continuation of the virtual economy. The authors hold that the model of a virtual economy is the best presentation of what actually happens in Russia and is indispensable to understand why the best efforts of honest and skilled managers are channelled into activity that ultimately is socially destructive.

The Russian economy is split between value adding companies, the so-called value pumps which are mostly active in the energy and raw materials extraction, and value destructing companies, the industrial behemoths of Soviet days. In the book the

value adding sector is represented by Gazprom. Although the reforms in the early 1990s were aimed to induce these loss making enterprises to restructure or to go bankrupt, these firms continued to exist. Bankruptcy proved not to be an option as entire communities depended on these enterprises for employment as well as numerous social services. The existence of a value pump and the co-operation (facilitation) of the local authorities enabled the enterprises to keep up the pretence of value adding. Barterisation, offsets, arrears et cetera helped the companies in their virtual accounting to produce the most helpful balance sheets and to postpone restructuring.

According to the authors, however, the crucial element is not this barterisation, but so-called 'relational capital'. This relational capital, which shows great resemblance to Soviet times 'blat', increases the chances for survival for beleaguered enterprises. The privatisation and liberalisation reforms in the early 1990s were aimed to force enterprises to restructure. They had to invest in physical and human capital to reduce the 'distance to the market'. This would turn them into profitable enterprises that earn their income in the market, and in cash! The existence of relational capital opened up the opportunity to survive without restructuring. Managers could also invest in good relations with authorities to avoid the necessary restructuring, which for many enterprises were no realistic option anyway. With this, surviving turned into a two-dimensional process, rather than the intended uni-dimensional one. This behaviour was so successful that enterprises started to copy one another. Once the virtual economy was established, policies to turn this behaviour around, such as the tightening of money in the mid 1990s, actually had an adverse effect. Before 1995, credit was readily available for enterprises which reduced the incentives to restructure. The tightening of money was supposed to 'force' enterprises into restructuring, but did exactly the opposite, it drove firms to invest more heavily in relational capital to avoid restructuring. This was easier for firms that already had developed a good network to support virtual behaviour. Neither does the decline in barter since the financial crisis in August 1998, according to the authors, indicate a reversal of the virtual economy. Enterprises merely traded off costly barter transactions for cash transactions as cash became more readily available because of the depreciation of the ruble. Furthermore, the ruble depreciation increased the relative weight of the (cash based) export oriented sectors in the economy at the

expense of the (virtual based) domestic sector, and the increased import prices forced Russian consumers to accept lower priced domestic products of low quality.

Although relational capital is the essence of the virtual economy, it could not exist without the continuous value distribution from Gazprom (and the likes) towards value destructing enterprises. Gazprom is drawn into the virtual economy by the non-payment of its customers and its subsequent large tax arrears to the government. As long as Gazprom injects sufficient value, the virtual economy continues to exist. However, if the economy runs out of value, and Gazprom is in need of large investments to maintain its current levels of production, enterprises may be forced into bankruptcy after all, or continue their existence at near subsistence level. Gaddy and Ickes name this shrinkage, where enterprises leave the virtual economy and come to terms with the enormous distance to the market. They divert their activities in all sorts of directions, catering mostly for a local market.

Gaddy and Ickes paint a bleak picture of Russia and do so convincingly. Yet, they seem to be afraid to extend their analysis beyond shrinkage, which could end in concluding that Russia is on its way of becoming a less developed economy. That has until now never been an option in the entire transition literature. Especially in western based literature, there has been an air of optimism. Russia is a well endowed country and it is a potentially rich country. Although the task of developing this wealth has increasingly being acknowledged as difficult and time consuming, the very principle that Russia would develop into a wealthy country rarely has been questioned. This book is almost there. Although the bulk of the book deals with the rise and permanency of the virtual economy as an alternative analysis of Russia's transition, it is the perspective of shrinkage that is most notable in the book. According to the authors, shrinkage is a recognition of the overvaluation of capital and they are only sorry that it includes writing off human capital, which they consider a real loss to society. But why is that? If physical capital has to be written off because there is no demand for its products, why should human capital not be written off? Of course, human capital is versatile, but the emphasis in Soviet days on technicians and science based education does represent a waste when the economy turns towards a market oriented way of production, with its need of accountants and marketeers. The authors seem to shy away from the consequence of their analysis.

This, in a sense, is to their credit, as this is a book that does not treat people as agents that perform their role in the highly abstract models of economics that deal

with some stylised facts. The authors pay ample tribute to the importance of history and ‘heritage’ of the Russian institutions and its consequences, but still write an economic book; it deals with rational behaving actors, individuals (even honest and skilled ones), enterprises and state institutions that try to optimise their goals. This does not mean that there are no economic problems in the book. The authors, for instance, do not explicitly define their market, which makes it difficult to determine the distance that enterprises have to this market. Furthermore, it makes it difficult to determine the size of the virtual economy. The authors use market values for products as a reference, but it is difficult to determine the market value of products for which there is no market. They presumably use the cash value of the product, but the cash value is not so much a result of supply and demand on the market as it is determined by the cash constraint. Enterprises just do need a minimum amount of cash and sell their product for cash to get that amount. But why would that reflect the true market value? In that respect the virtual economy is a conceptual framework, which will be difficult to size up empirically.

Mr. Putin’s dilemma is sketched as a trilemma, with a market economy, democracy and national security as the three corners of which only two can be attained. Trilemma’s are popular these days, but this reviewer fails to see national security as an overriding issue in Russia. Russia is not threatened by any external force. Domestically, the separation program of the Chechens and perhaps some other regions may pose a threat to national security, but whether that justifies making it into an issue that can only be solved if either the market economy or democracy is being sacrificed is questionable. The defence industry can just as easily be analysed as one of the many behemoths with a large distance to the market that try to survive in the virtual economy and doing a good job at that.

The virtual economy created a new reality in Russia. Reforming the economy today is a different task than it was ten years ago. The authors indicate some direction, but fail to take the option a shrinkage into serious account. According to them, the first step is to take away the pretence. But that is exactly what they have done in this study, and its results can not have been a surprise to Russian policy makers. As policy instruments the authors argue in favour of political centralisation to reduce the value of relational capital and to mobilise physical and human capital to relocate in other, more hospitable, areas of the vast country and to keep the value of the ruble as low as possible to reduce the distance to the market and to change the balance between the

(cash based) value adding sector of the economy and the value subtracting part in favour of the former. This may be the case, but where do the investments come from that are needed to set up an internationally competitive industry and agriculture? If the economy shrinks towards self-sufficiency not much investment is needed, but if the economy is to have any substance, these investments are enormous. Thus far, however, capital export is still larger than capital import and even the value adding sector is in need of large investments to maintain its productive balance. If the investment needed to survive in a market economy become too large, there may be another flight into a virtual economy or into looting whatever is left of the wealth. No optimistic prospect. But one that is fully consistent with the arguments of Gaddy and Ickes.

The final chapters, in which the authors discuss Mr. Putin's dilemma and what is to be done are half-hearted attempts to offer some alternatives. These are clearly the weakest chapters of an otherwise excellent and important book. With permission, I took draft chapters from one of the authors website two years ago, just before the book was announced officially (and the final chapter not yet included) and used these in a seminar on the (de) monetisation of the Russian economy in the 1990s. My students, who were 3rd and 4th years students in Russia Studies, greatly appreciated the book, as I did. The book is well written and very clear in its powerful arguments. The technical basis for the arguments has been added in six appendices. It is one of few economic books in which the real world is not written away in abstract prepositions to make the economic model work. They include many real life examples to illustrate their arguments. This book should be compulsory reading for every economist (and many other a student) studying the Russian economy.