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The State and Future of the Economy

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Abstract

This paper assesses the current state and future prospects of the Russian economy after the August 1998 financial crisis. The industrial growth visible since Autumn 1998 may well be unsustainable, as it is based on currency undervaluation and low real wages. Over a longer period, the characteristics of the economic system that has emerged in Russia cast a long shadow over the prospects of growth and prosperity. In fact, the whole country should be rebuilt.

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During the last fifteen years Russia has changed profoundly. It is now longer a dictatorship ruled by a single party. Neither has it an official ideology or censorship. The society has opened up to the rest of the world and a pluralism of views and ways of life prevails. All of this was unthinkable during Soviet socialism. The Russian economy has also changed. It has transited from central management to something that might be called a market economy. But this is a very peculiar market economy. The economic stagnation which became visible a quarter of a century ago had changed into s steep production decline which still continues. At the same time inequality has increased, and mass poverty has become a fact. Russia's economic decline is – if one abstracts from the other, even more unfortunate former Soviet republics – almost unprecedented in recent economic history. More surprisingly, it has taken place in the country which is best endowed with natural resources, and also has a relatively well-educated labour force and rich industrial and technological traditions. Russia's twentieth century is indeed crowded with unique developments: the collapse of an empire, revolution and civil war, famine, forced industrialisation, collectivisation, establishment of dictatorship and mass terror, another devastating war, collapse of the system and now economic decline. For Russia, it seems, it is entirely normal to be abnormal, and one should ask whether the future also has unexpected surprises in store.

This paper is divided into four parts. First, the state of the Russian economy after the August 1999 financial crisis is survived. Second, the sustainability of the current industrial upturn is analysed. Third, the characteristics and potential of the emerging Russian economic system is viewed, and finally, some policy proposals for Russia are discussed.

1 The Russian economy after August 1998

The economic development of Russia since abandoning Soviet socialism has differed dramatically from that in a typical Central European (inc. the Baltic states) transitional economy.[2] In Central Europe, the transitional recession connected with the shift in mechanisms for economic co-ordination from central management to markets usually lasted for a relatively short period of time only, so that the economy attained credible macroeconomic stabilisation within a year from the beginning of transition policies, growth – usually fuelled by domestic consumption and exports – followed within another year and investment picked up somewhat later. Countries like Poland or Estonia have consequently been the fastest growing in Europe for several years already, though it is a measure of the depth of the recession that by 1998 Poland remained the only transition economy that had surpassed the pre-recession GDP level – a comparison that is of limited value as national account conventions, relative prices, productive structures and the incentives of companies to report output had all changed. In any case, the contrast between Central Europe and Russia (and the rest of the former Soviet Union – FSU) is clear. In Russia, production decline has been steeper and has also continued almost monotonously for about ten years already, perhaps even longer.[3] More than forty per cent of GDP has been lost. In 1997, it seemed to the optimists that the situation was about to change. Russia recorded a GDP growth of 0.8 per cent, but 1998 destroyed any hopes of an surge into growth, as GDP again declined by 4.5 per cent. Slight decline is expected to continue through 1998, and at best very modest growth is forecast for 2000. Optimist predictions of a couple of years ago that even under the worst circumstances Russia would be growing by some four per cent annually by the end of the millennium (Layard and Parker, 1996) now seem ludicrous, as they always were.

Whatever happened on the road to "the coming Russian boom", prophesied by Layard and Parker only a couple of years ago? Answering demands some background. Simply put and abstracting from any asymmetric exogenous change ("surprises"), economic outcomes can be explained either by initial conditions or by policy differences. It was always understood – also by the representatives of the by-now disreputable "Washington Consensus" (see, for instance, The World Bank, 1993) — that Russia's initial conditions were in many respects worse than those in Central Europe. Russia's distance from a market economy was greater than in Central Europe: the socialist period was longer, structural deformations (e.g. the share of military and civilian heavy industries) greater, preceding socialist economic reforms almost absent, the economy and society more closed, and the share of the private sector almost nil, etc. Russia also lacked such civil society as the Polish catholic church or Hungarian independent intelligentsia. The introduction of transport costs, practically absent under Soviet planning, was to induce especially great relative price shifts in spatially huge Russia. The abolishing of the USSR implied the lack of several crucial institutions in Russia.

The list of Russia's handicaps in initial conditions could be continued. One can counterweight the scales perhaps with only three factors: because of its size and continued military-political importance, Russia could count upon foreign understanding and assistance; because of her natural resource endowments Russia could expect to gain from a huge relative price shift vis-a-vis manufactures that had been relatively overprices in socialism; and the natural and other (education, technology) resources available might become a bonus for growth. On the first point, one should however underline that the relative ease with which Russia has received assistance – as evidenced by the repeated easing of IMF assistance conditionality – may well have been a burden in disguise, as Russia has been able and willing to substitute assistance for reforms. Tighter conditionality, as discussed below, would have been much preferable. On the second point, it is true that Russia has gained handsomely as a higher share of energy exports[4] has now been priced at world market level. Such a windfall may however have contributed to the further concentration of Russian exports on basic commodities. Even on the last point, experience advises caution: world-wide it is clear that bountiful natural resources are more often a handicap than a source for growth and prosperity (Sachs and Warner, 1995) – a point to which we shall return later.

A relatively large number of studies have been made on the respective roles of initial conditions and policies in explaining somehow measured success in transition, usually output performance (for a recent example see Berg et al, 1998). The clear consensus is that generally policies are much more important than initial conditions. One example that would seem to point in the same direction is a simple comparison between the Baltic countries and the FSU. Surely the initial conditions – say – in Latvia were in most respects worse than in Russia. Still Latvia outperforms Russia hugely.

What, then, explains differences in policies? This is clearly a complex question, but fortunately a simple and conclusive explanation is available. For the Central Europeans, the transition was always about "rejoining Europe". The simple argument is that historically these were "ordinary European nations" pushed aside from the natural path of development by an outside force, the Soviet army, which introduced socialism in Central Europe. As the political constraint of having to follow the Soviet model was abolished by the policies of Gorbachev's USSR, the almost unanimously shared goal in these countries was to become ordinary market-based, democratic and bourgeois European nations again. In practice, this implied the task of joining the European "alphabet soup" – the EU, NATO, OECD etc – as soon as possible. This has remained the overwhelming policy goal of the Central European countries ever since.

Joining the alphabet soup means joining a number of international organisations, clubs that demand the acceptance of their principles, rules and procedures as the condition of membership. Such conditionality, given the underlying societal consensus on the goal, is much wider, more detailed and hugely more binding than anything that – for instance – the international financial institutions (IFIs) can ever provide in their financing agreements. Therefore, whether the rules of the European alphabet soup are optimal for development or not, they do provide for such policy consistency that would otherwise be extremely difficult to ensure, given the various perceived and real tradeoffs in policy costs and benefits. Such consistency, it is easy to argue, is the basic reason for superior Central European performance, as only the much weaker IFI conditionality has been available to Russia. Even that, as mentioned above, has unfortunately been exceptionally weak in the Russian case, as Russia's perceived political importance has lead to repeated flouting of the accepted conditions.

The reason why the stronger, alphabet soup conditionality was not available to Russia is simple. Most Russians think that their country was never an ordinary European country. Many also think that she will never become one. But here the near-consensus breaks down: if Russia is different, what does that actually mean? If Russia's goal is not to join Europe, what is the goal? For all the talk of Russian specifics, no generally accepted view is available on what Russia should be like. And as Alice learned in Wonderland, if you do not know where to go, any road will take you there. In truth, Russia's policies have not been quite those of any road: almost nobody has wanted to return to the Soviet-type past, and as experience has been gained about – say – the consequences of very high and variable inflation, the avoidance of such policy outcomes have also become part of accepted thinking. But as Russia has been lacking a clear, operational goal state, policies have all too easily become the prisoner of the short-term interests of various elite groups. Therefrom, the lack of policy consistency; therefrom also – as the balance of power tends to be unstable – the very strong tendency to muddle through as an elite insurance policy.[5] Naturally, there are other reasons as well: the difficulty in abandoning the Soviet inheritance in toto – arguably the greatest achievement of Russia as an international power – and the lack of a proper political and administrative system, at least in the received sense of the word.

All of this is immediately relevant for the August 1998 Russian crisis. Back in 1994-1995, a consensus arose in Russia that the preceding very high and variable inflation – up to 10-30 per cent monthly – was the prime reason for production decline, collapse of investment, huge emerging welfare differentials and the poverty problem. Inflation had been fed by monetary growth necessary for monetising public sector deficits (for an extended discussion see Sutela 1998, pp. 41-56). Lower monetary growth was thus needed, but at the same time the authorities were unable or unwilling to impose those hard budget constraints upon both the enterprises and the public sector that would have been necessary for balancing the budgets (see Commander and Mumssen, 1998). The square of not monetising the deficits that remained very large was circled by two means: financing the deficit by issuing short-term government debt paper, and quasi-financing it by running arrears, barter, quasi-monies and offsets. In the end, Russia both became dependent on foreign short-term capital flows, and the relative share of the ruble economy diminished. Though debt relative to GDP or export revenue remained seemingly manageable, debt relative to ruble M2 was soon unsustainable: "clearly, the present stance of fiscal policy … is unsustainable" (Korhonen, 1998, 11). The totally predictable outcome was the August 1998 crisis leading to steep ruble devaluation, partial default and debt moratorium. Production nosedived as the payment system almost ground to a halt, inflation surged, real incomes plummeted, imports shrunk, Russia's credit-worthiness collapsed and the state lost the ability to finance deficits.

The outcome could have been much worse. As the left-leaning Primakov government came to power in September 1998, its leading economic policy makers made a number of pronouncements that seemed to imply running huge deficits and a readiness to monetise them if necessary. It was widely forecast that by the end of 1998 the ruble exchange rate might well reach some hundreds to a dollar and the economy would be approaching hyperinflation. Various social disturbances were also feared. In fact, though the exchange rate dropped from 6.2 to a dollar to 20-25 within a month, this is the level that has been maintained by a mixture of quite stringent monetary policies and administrative restrictions until Summer 1999. If current policies are followed through, the exchange rate might be 30-35 rubles per dollar at end-1999. There was an inevitable inflation peak in Autumn 1998, but by Spring 1999 monthly inflation was down to 2-3 per cent. This is surely still excessive for growth and investment, but a far cry from the earlier fears of a hyperinflation. And industrial production has surged since October so that in January-May its level was 1.5 per cent up from a year earlier. Year-to-year growth in May was 6.1 per cent.[6]

A closer look gives some insight into the problematic character of the recent Russian industrial upturn. It should be seen against the background of ruble devaluation. During the first half of 1999 the ruble real exchange rate was still some 40 per cent lower than a year earlier. The price competitiveness of Russian producers has thus improved hugely. That is reflected in imports that were in January- April an astonishing 47 per cent lower than in January-April 1998. Russian companies have gained market shares in domestic markets, and there is also some improvement in traditional export branches. During the first quarter, the best performing branches were wood and paper, chemical and petrochemical, construction materials and non-ferrous metals. But on the other hand Russia has in spite of such improved price competitiveness been unable to introduce new export commodities. Overall, exports were in January-April down by ten per cent. This shows that the actual problem continues to be real, not price competitiveness. Russia seems simply unable to produce manufactures that foreigners might wish to buy – even at post-devaluation prices. A trade account surplus of some USD 20-25 bln is expected for 1999, but that is a consequence of imports that decline even more than exports.

The downside of a weaker real exchange rate is that statistical real wages are still 25-30 per cent lower than a year earlier. May retail trade turnover was 16 per cent lower than in 1998, and light industry output had collapsed by 17 per cent during the first quarter. As investment also continues to drop (by 11 per cent during the first quarter), surging industrial production was unable to translate into GDP growth. GDP was in first quarter still 4 per cent lower than in 1998.

2 Is industrial growth sustainable?

The character of these developments casts a long shadow on the sustainability of recent industrial growth. In brief, the following questions arise. (1) The left-leaning Primakov government was somewhat surprisingly both willing and able to preside over an impoverishment of the general population as shown in statistical real wages. Will the Stepashin government be able to do the same, especially as both the Duma and the presidential elections are forthcoming? (2) The recent growth has also been influenced by higher energy prices, as the oil price has come back from the about 10 USD of early 1999 to about 15 USD per barrel. Approximately, one USD in oil price changes Russian export revenue by one billion USD. As Russian export structure is even more dependent on energy and other basic commodities than earlier, the prospects of the economy are both in the short and in the long term very dependent on commodity prices. (3) The Primakov government was also able to cut budget expenditure and increase somewhat revenue so that the first quarter federal budget deficit was only 1.1 per cent of GDP. The actual stance and sustainability of this performance is open to some doubt, also but not only due to the forthcoming elections. (4) As investment continues to decline and new export commodities are not in evidence, the possibility of growth on the basis of increased capacity utilisation becomes the key issue.

The last point, indeed, has divided observers of the Russian economy for quite some time. The leading figures of the previous Russian government, Prime Minister Primakov and First Deputy Prime Minister Maslyukov in particular, often compared the economic predicament of Russia today with the Great Depression of the early 1930’s. Similarly to Roosevelt’s proto-Keynesian policies that draw the country and the world economy out of the crisis by pumping up aggregate demand, the Russian authorities should now rely on increased capacity utilisation. As income levels have dropped so that consumption-led growth is hardly feasible, there is no room for deficit finance to increase aggregate demand and an export-led growth seems utterly unrealistic, the alternative available is to shift demand towards domestic supply by maintaining an undervalued exchange rate. Though there is some disagreement whether the ruble exchange rate in mid-1998 was overvalued or not, there should be no uncertainty that currently the ruble is in deed clearly undervalued. Thus, one can well interpret recent economic policies as a consistent package of undervaluation, import substitution and low real wages. In the short run, the major threat to continued undervaluation is a rise in real wages. Over a longer period, the possibility of an upward pressure upon the ruble can not be excluded if ruble-denominated assets would again become interesting to investors. Though this possibility seems now distant, maintaining ruble undervaluation might in principle demand restrictions on convertibility.

But there is another view, which challenges the sustainability of this policy line. It argues (see, for instance, Sutela 1998) that over a medium-to-long term Russian economic growth must be investment-based. The capital stock inherited from the USSR, in this view, was smaller, older, less maintained, more inappropriate located and to a larger extent producing the wrong kinds of commodities than one might think. The transition to the Russian market economy, entailing opening up of the economy and the introduction of transport costs, together with a new political orientation making much of military industries unnecessary, had tended to make much of the inherited capital stock economically worthless. Therefore, growth on the basis of increased capacity utilisation only has very limited possibilities. Russian growth has to be investment-based. But unfortunately Russian domestic savings ratio is quite low, especially into rubles, and there is no efficient financial sector to intermediate existing savings into investment finance. In the 1990’s, ruble savings have been almost totally channelled via the state-owned Savings bank into budget finance. Dollar savings are greater in volume, but remain primarily outside the domestic financial circulation. The financial sector all but destroyed by the 1998 crisis still remains to be rehabilitated. If this view is accepted, Russia will have great problems in generating sustainable growth in the foreseeable future.

3 The emerging Russian economic system

The last point leads us to a further crucial consideration. During the last ten years, Russia's change has been immense. Russia is now, in practical terms for the first time ever, a country without an official ideology, without censorship and without dictatorship and politically mandated violence. It is no longer a centrally managed economy, though people will debate whether it is actually a market economy (compare, for instance, Åslund, 1995; Erickson, 1999; Sutela, 1998). It is also an open economy dependent on foreign finance and trade, an economy in the process of change from a unitary state into a federal state of some sort. There is no imaginable return into the ancien regime. There is also no intention – this is at least what the Primakov government experience seems to show – of returning to the high and variable inflation period of the 1990's'. This, at least, is within the confines of current economic policy consensus. Indeed the situation is basically stable to such a degree that one might ask if Russia actually already has transited to a new economic system. But if there is such a system with its own rules, internal logic and tendency of reproducing itself, this system clearly is not the textbook Anglo-American market economy. To assess the future potential of the Russian economy, one should look closely at the specific features of the economy. Here we distinguish four of them.

First, Russia has the makings of a dual economy. On one hand, the country has a dynamic export sector consisting of oil, gas, raw materials and some basic processed goods like chemicals. Exports generate about a fourth of Russian GDP: this is no longer a closed economy. But such exports provide only a relatively small amount of jobs, which are in the domestic branches of the economy. Russian industry and services mainly produce goods that are only competitive in the home markets, provided an undervaluation of the ruble and low real wages. A dual economy is sustainable and may well generate some growth, in particular when commodity prices are high. That has been proven by numerous examples, mainly from major third world commodity producers. But it also provides low welfare for most of the population and tends to generate very wide income differentials. A dual economy therefore politically tends to have an authoritarian tendency.

Though Russian officials like to talk about maintaining and developing the technological basis of the economy, it was noted above that recent Russian policies can easily be interpreted in the light of creating a dual economy. If such would be the outcome, Russia would continue to be Europe-oriented in her foreign economic policies. Both the markets, main supply, finance and technologies are available there. An economic interdependence that would be even stronger and more asymmetric than today would ensue. But this would be only one-sided integration with the world markets, as domestic jobs would need protection. Domestically, a crucial question would be the willingness and ability of the central authorities to tax some of the revenue received by the exporters and to use this revenue for infrastructure maintenance and redistribution, also between regions as the capability of earning export revenue is very unevenly distributed among Russian regions.

Second, Russia has a unique[7] distribution of property rights. As a consequence of the mass privatisation path chosen, most of Russian industry, agriculture and services are owned by company insiders. Employees are quite often majority owners, but managers are always the active owners. The position of the insiders was much strengthened by the 1998 crisis, as their potential challengers – domestic and foreign outside investors – lost their ability and/or appetite to invest in Russian firms.

There is no earlier experience of such property rights, and any speculation on their economic impact must therefore be quite tentative. But it seems both theoretically and in recent Russian practice that such inside owners (1) have little if any resources for investment other than the cash-flow generated; (2) often tend to see their position more as power than as an economic agency; (3) tend to concentrate more on job and social benefit provision than efficiency and structural change, undertaking more defensive than aggressive restructuring; and (4) often see their companies as a personal fiefdom to be exploited for private benefit. Insider ownership thus might be good for jobs but it is very probable bad for efficiency, competitiveness, welfare and growth (Blasi, 1997).

Third, Russia may be a market economy but it is not really a monetary economy. The ratio of ruble M2 (the wide money stock, consisting of cash and deposits) to GDP was never close to 20 per cent and is now below ten per cent. Ordinary market economies and transition economies usually have a M2/GDP ratio from 60 per cent upwards, depending on the characteristics of the financial system. In addition to roubles, dollars of a greater value are used, often as a store of value, and an unknown but presumably large amount of Russian-owned dollars are also abroad. Also, a variety of quasi-monies, usually IOU's issued by the authorities, banks and companies are used. Finally, about a half of industrial production is based on barter (for somewhat differing perspectives on barter see Commander and Mumssen, 1998; Gaddy and Ickes, 1998; Woodruff, 1999; Yakovlev, 1999).

As much as we might admire the ingenuity of complicated multilateral barter arrangements, there is no doubt that a non-monetary exchange-based economy has several handicaps: (1) barter arrangements are costly and cumbersome; (2) the acceptance of quasi-monies and offsets as tax revenue leads to lower revenue liquidity and therefore harms fiscal policy effectiveness; (3) the use of often regionally based quasi-monies tends to destroy the unity of Russia's economic space; (4) the wide use of non-monies lowers enterprise cash flow and contributes to tax and wage arrears; (5) an economy with several exchange systems may be unstable and difficult to regulate by economic policies; and (6) with little money in use, the possibilities of generating savings to be channelled into investment finance are modest at best. Therefore, these peculiarities of the Russian economic system go a long way in explaining why the economy continues to contract, why investment is still declining fast and why – therefore – the prospects of investment-based growth are slim.

Fourth, Russia, which used to be unitary state, is undergoing long overdue regionalisation, but with little design and consistency. Russia's regions – with an average of 1.9 million poor inhabitants – are also too small to be true economic agents. Often dependent on one or at most a few industrial enterprises for jobs, social services and tax income they are also hotbeds of cronyism, insider deals and corruption. In principle regional decision making might be closer to the population and easier to monitor. In practice, regional economic policies are often worse than the ones that the centre would like to pursue. But there is also a silver lining: there are already cases when good practices have spread from one region to others as an argument in competition for foreign and domestic investment.

4 Could something be done?

Overall, the August 1998 crisis has tended to strengthen many of the negative characteristics that were visible in the Russian economy already long before. Though the recent upsurge in industrial production is an undeniable fact, the existing fundamentals give little ground for optimism. Neither does the political situation. The probability of consistent reform policies before the presidential elections due July 2000 is very low. Neither should the post-elections time be seen with pink spectacles, given what is known about the main candidates. Probability is high that Russia will continue to muddle down. Where the optimists and the pessimists differ, is that the former think that muddling down will continue to be a feasible alternative. In the pessimists' view that is impossible over a longer period of time. At some point, the basic functions of the society will become overstretched. As a worst case scenario, Russia may join the sad and potentially very dangerous company of failed states.

But surely something could be done, even if it is clear that no quick fixes are available. It is a measure of outside frustration that prominent observers and actors propose remedies that are little short of a deus ex machina. Thus the chief economist of the World Bank argues (Stiglitz,1999) that Russia should first renationalise and then reprivatise the main wealth generating assets that were privatised in the 1990's. This wish to go back in history forgets (a) that reprivatisation may not be politically feasible at all; (b) that the probability of the Russian authorities being able to manage and prepare assets for privatisation must be very low indeed; and (c) the probability of "better" new owners being available is negligible. Michel Camdessus, Managing Director of the IMF, contributed recently by arguing that Russia needs a social contract that would revolutionise the character of the Russian political process and the state to further private enterprise, openness and competition; to delink enterprises from the authorities; to move back to a monetised economy and root our corruption; and to establish a commitment to equity in society.

Lofty as Camdessus sounds, he is actually on the right track. The Russian political process is the root cause on many of the huge problems that the country is facing. The body politic is also the place where improvement should take place. Coming somewhat closer to practicalities than Camdessus, one can argue that there are three first priorities that the Russian authorities should adopt.

First, Russia should recognise that she is at most a medium-sized European economy, with a USD 370 bln GDP in 1998 (i.e., about 2.5 times the size of Finland) and with a weight in the world economy that is smaller than, for instance, Sweden. All official expenditure commitments should be reassessed with this fact in mind, and only such commitments should be maintained that can be financed from available resources.

Second, the authorities should also contribute to the abolishing of the non-monetary economy by declining to accept anything but money as tax revenue.

Third, the authorities should turn their state from a "grabbing hand" to a "helping hand" (Shleifer, 1995). Russia needs a huge amount of new private economic activities. So far, the public sector – licensing, taxation, inspections, legislation and its implementation — has been the major barrier to its emergence. This must change if Russia is ever to become what she so rightly deserves to become, a wealthy and stable society. But in the end reaching that goal demands that the country be rebuilt: its state, institutions, the economy, capital stock, infrastructure, the civil society and the values of the people – almost everything.

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Notes

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[2] This abstracts from the South Eastern European countries, whose performance is somewhere in between.

[3] What proved to be the beginning of the terminal decline of the Soviet Union should probably be timed at the mid-1970's, when the oil price hikes gave artificial breathing time to Soviet leaders, all plans for economic reforms were shelved, the USSR rather recklessly increased her global political and military commitments, real investment into new productive capital stagnated and the Brezhnev leadership ossified. Official statistics continued to show some, though declining growth, but it is not clear what the actual output change was. Many observers would argue that the actual share of the second economy has increased, for instance from one fifth to almost a half. If true, taking this into account might make true production decline smaller than showed by official statistics (which do include an estimate of current second economy of about a fourth of GDP).

[4] But not all: Russia has continued to subsidise some of the former Soviet republics by accepting major payment arrears.

[5] Elite groups understand that today's winners may well be tomorrow's losers and therefore tend to avoid policies that might place them at an excessive risk of becoming tomorrow's outcasts. Muddling through therefore becomes the preferred strategy on the basis of minimising maximal expected loss.

[6] Current Russian economic statistics are published and analysed in The Russian Economy: The Month in Review, available at www.bof.fi/bofit.

[7] With the exception of some other FSU.