BOFIT Online
2005 No. 6

Pekka Sutela

Did Putin's reforms catapult Russia to durable growth?

Bank of Finland, BOFIT
Institute for Economies in Transition

Bank of Finland
BOFIT – Institute for Economies in Transition

PO Box 160
FIN-00101 Helsinki
Phone: +358 10 831 2268
Fax: +358 10 831 2294
bofit@bof.fi
www.bof.fi/bofit

BOFIT Online
Editor-in-Chief ***Jouko Rautava***

ISSN 1456-811X (online)
12.5.2005

Helsinki 2005

Contents

Pekka Sutela*

Did Putin's reforms catapult Russia to durable growth?

Abstract

Establishing connections between economic performance and policies, institutions and exogenous change is difficult under any circumstances. In the case of Russia, where relevant time series are short and structural and institutional change has occurred in the absence of a well-defined model of the economy, it becomes largely – if not entirely – a matter of art and taste. This paper considers the possible impacts of structural reform under President Putin on Russian economic performance. Judging the impact of Putin's reforms on recent Russian economic performance is confounded by the problem of overdetermination. That is, we can identify a number of contributing factors, but cannot say for sure if their absence would have a crucial effect on outcomes. On the other hand, there seem to be no grounds for denying the importance of reforms, even if their short-term impact might primarily be through expectations, a factor notoriously difficult to pinpoint. Further, it is a matter of some delight that, contrary to what is currently all too easily and often argued, Russia's structural reforms continue.

Key words: Russia, economic policy, reforms, growth

* Head of BOFIT (Bank of Finland's Institute for Economies in Transition): pekka.sutela@bof.fi. The opinions expressed are the author's and do not necessarily reflect the Bank's views. For their kind assistance, the author thanks his colleagues, especially Timo Harell, Tuomas Komulainen, Vesa Korhonen, Simon Ollus, Tiina Saajasto and Laura Solanko. An earlier version of this paper was presented in a conference at the University of Bremen. It will be published in German in a volume edited by Heiko Pleines and Hans-Henning Schröder.

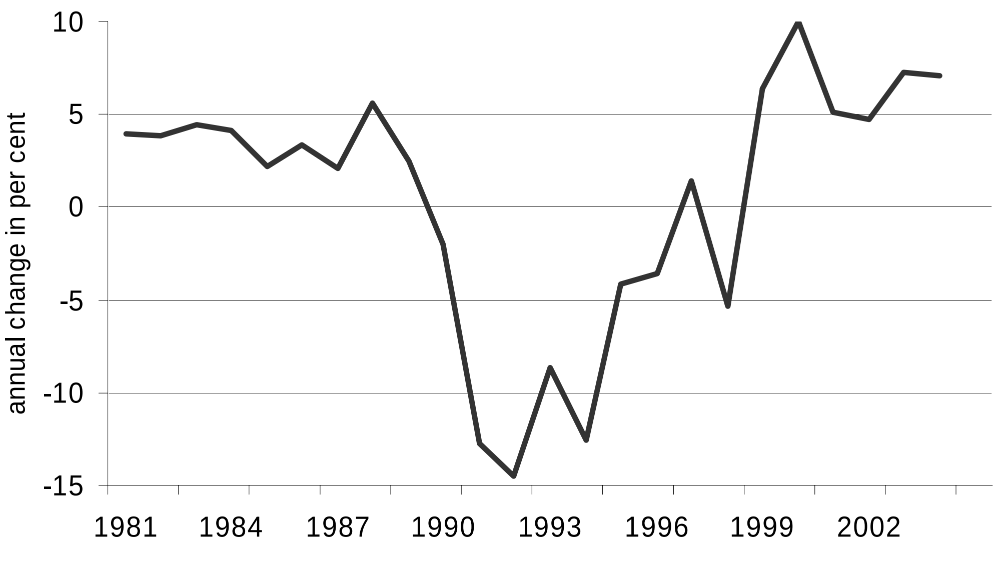
1 Introduction

Since 1999, when Vladimir Putin became Russia's prime minister, the Russian economy has recorded a statistically measured average growth rate of 6.5% a year. This places Russia – along with China, India, Kazakhstan and Ukraine – among the world's fastest growing large countries. The fact that none of these economies, according to received economic doctrine, can be considered an efficiently operating economy reminds us that growth is always measured relative to the preceding period.

Growth alone does not indicate a good performance. It simply means that the economy has functioned better than in the previous year. Ceteris paribus, the most efficient, i.e. richest, economies generally grow more slowly than others, partly because their wealth accumulation is already a fait accompli. Since such rich countries already operate at the cutting edge of technology, they have no opportunity to "catch up." Moreover, their wealth seems to be related to demographic change – populations ageing and then shrinking. This has been Japan's course, and many European countries are now following suit, albeit at varying speeds. Although Japan has not grown in the last 15 years, the Japanese are among the world's wealthiest people.

Though countries with lower income and efficiency levels have the potential to catch up, convergence is not guaranteed. Both willingness and capability are needed for this potential to be realised.

Figure 1. Russian GDP



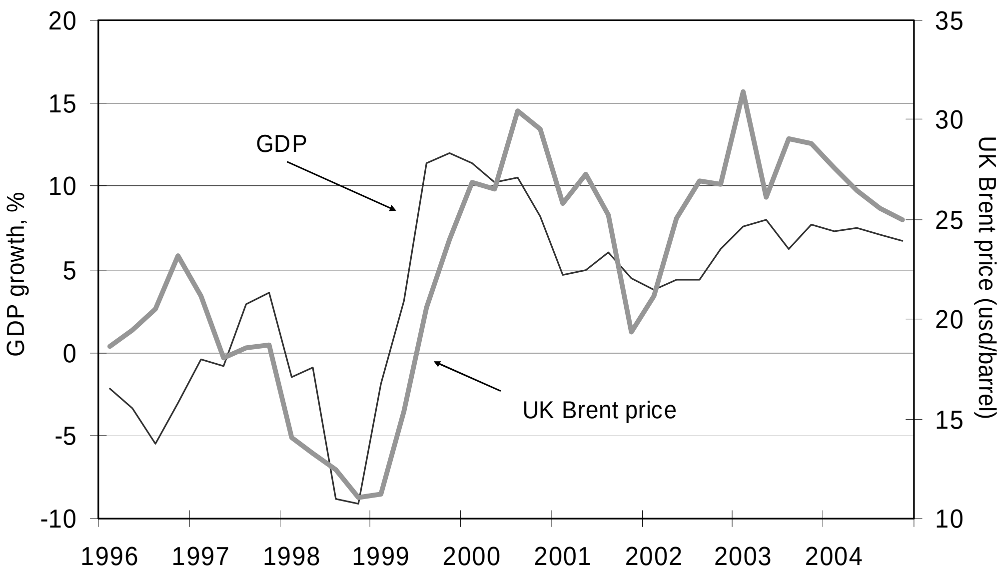
Source: Rosstat

Explanations of Russia's growth performance of recent years include a number of alternative, possibly complementary, scenarios. One view is that growth is solely or primarily a recovery from earlier crisis, a return to normalcy. Here, one might single out the financial crisis of 1998 or the crisis of the decade as a whole, during which time statistically-measured output declined by just over 40%.

Another possibility is that we are finally witnessing the results of an economic liberalisation that began in the latter part of the 1980s and became a transition from a centrally managed to market economy. A market economy is more efficient, and even though the Russian transition deviated (in many ways to its own disadvantage) from those of the eastern block of Central European countries (Sutela, 2003), its effects had to be felt eventually. The OECD (2004), for example, stresses that Russian output growth in recent years has been fastest in sectors that have been relatively free from state ownership and control. As regards oil production, where there are both privatised and state-owned companies, the former have proven more efficient and have increased their output fastest. On the other hand, it is also possible that the latter have invested more for the long term in the development of new oil fields.

A third suggested scenario focuses on external changes. In spring 1998, the world market price of oil – Russia's key export product – was struggling to break $10 a barrel. By late 2004, the oil price was up by a factor of four or five. This trend continued in early 2005. The price of natural gas, Russia's other key export product, follows the oil price with a lag. According to numerous evaluations, the energy sector currently generates about a fourth of Russia's GDP, 40% of its public sector revenue and well over half of its export income. Russia exports other raw materials besides energy, but only a small amount of processed commodities. The overall price level for raw materials tends to move in the same direction as energy prices, reflecting both world economic conditions and the strength of demand in major consumer countries such as China.

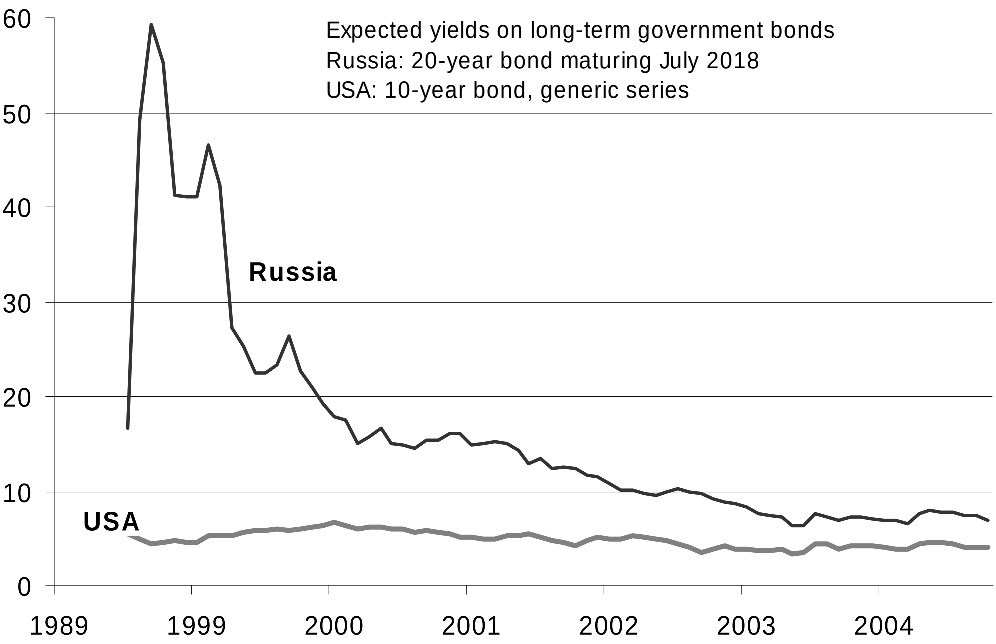
Figure 2. Russian GDP and oil prices



Sources: Rosstat, HWWA

The fourth scenario stresses the fact that the external environment, which had turned in Russia's favour, laid a firm foundation for better macroeconomic policy. In contrast to the 1990s, public finances have been in the black and monetary policy has been moderate. Thanks to a gigantic current account surplus, inflation has remained at a fairly high (but controllable) level, while the economy's monetisation and de-dollarisation have boosted demand for roubles. The exchange rate, tightly controlled by the central bank, has been eminently predictable, and interest rates have declined. All this has created a much more predictable environment for business than in the 1990s. Economic doctrine suggests that this should promote growth, productivity, investment and a rising standard of living. The same can also be said for the predictability of policy since autumn 1999. Figure 3 shows how the risk premium entailed in long-term interest rates has declined steeply, reflecting strengthened confidence in the predictability of Russian developments.

Figure 3. Russian and US long-term interest rates, 1998-2004



Source: Bloomberg, BOFIT

Fifth, it has been asked if Putin's first-term reform policies are not another major factor (Åslund, 2004). Particularly in 2001-2002, the economic legislation programme was broader, deeper and better aimed than many – surely most, including this author – Russia-watchers had thought possible. Of course, it is clearly too early to attempt a summary evaluation of the impact of that legislation. The harsh rule-of-thumb is that long-lasting change comes slowly, particularly where the purpose is to revamp institutions, structures and operational models. Nevertheless, the economics literature admits the possibility of more immediate effects. In the 1990s, economic agents' expectations pointed to economic and political instability. In fact, for the long run, one might well anticipate a continual shrinking of the economy. The short- run focus was on quick financial returns, often via price arbitrage or privileged legal rights. Now in the early years of the century, it is quite possible that economic agents' expectations have changed. Stabilisation of the macroeconomic environment has reduced the opportunities for arbitrage, while tighter governmental supervision has reduced the opportunities for major economic decision-makers to obtain political favours. High export prices have also made investment in the real economy highly lucrative. Thus, Russia could be entering a self-fulfilling cycle of meeting optimistic expectations. If such a change occurs in the balance of expectations, we could well see a jump in the rate of economic growth (Hausmann et al., 2004).

All of the above scenarios are credible with rationales informed by both economic theory and history. Yet even in the best of circumstances, a statistical sorting of their effects would be difficult. As regards Russia, what makes this impossible is the brevity of the time period involved and the exceptionally large number of changes that Russia has undergone in the last two decades. It would be rash to discount the relevance of any of the above five scenarios. Thus, as we probe the importance of specific reforms, it does not mean that other factors are pushed aside or dismissed. On the contrary, the argumentation presented here involves several simultaneous and parallel factors impacting the society. One certainly cannot credit all of the recent years' economic growth to the Putin era, since growth began earlier. Moreover, some of the factors clearly date from the period following the 1998 financial crisis.

2 Putin's first-term macroeconomic policy

When Vladimir Putin became Russia's prime minister in 1999, few expected him to last much longer than the three months his predecessor Sergei Stepashin had spent in the post. Even when Boris Yeltsin gave up the reins of power and named Putin his successor, little was known of Putin's views. Most analysts saw him as a mediocrity without convictions, a bureaucrat who had slogged his way up the hierarchy, better at listening than making decisions. This bland impression gained acceptance as Putin spent his first year in office solidifying his own position, while revealing little on how he intended to use power. In spring 2000, he accepted the "Gref programme" as a basis for economic policy. The plan seemed so grand in scope and so detailed that few considered it to have much practical significance. In retrospect, it is fairly clear that approval of the Gref programme, after other options had been considered, demonstrated that the economic liberals of the 1990s continued to play a key role in the formulation of economic policy.

From a macroeconomic perspective, the turning-point occurred on the cusp of 1998-1999. Political consensus on the need for balance in the economy was reached in the mid-1990s, but stabilisation was as yet impossible given the huge public sector deficit and the lack of incentive for boosting revenues or cutting expenditures. Primakov's government, which came to power in autumn 1998, was essentially forced to put Russia's macroeconomic house in order as all other policy options had been exhausted (Åslund, 2004).

The crisis of 1998 was an outcome of the swift ballooning of the government's short-term debt: instead of trending downward, the budget deficits fluctuated between 5% and 10% of GDP. Once Russia declared its inability to service debt, the situation became impossible. Borrowing to cover the deficit was no longer an option, nor was there enthusiasm for a return to note-issue finance after the experience of the early 1990s. With no escape, the ratio of public sector expenditures to GDP was pushed down by eleven percentage points in three years from 45% in 1997 to 34% in 2000 (Owen and Robinson, 2003, p. 101). It was also understood that the threat of post-devaluation high inflation had to be alleviated with tight monetary policy. The lessons of the 1990s, also in this regard, have not been forgotten. Thus, a huge post-devaluation loss of competitiveness was averted. At the same time, Russia avoided a spiral of instability of economic and political systems and society as a whole. Obviously, the default and currency depreciation of 1998 were hardly welcome, but once they took place, Russia earned respect internationally for not spoiling the improved competitiveness these events conferred.

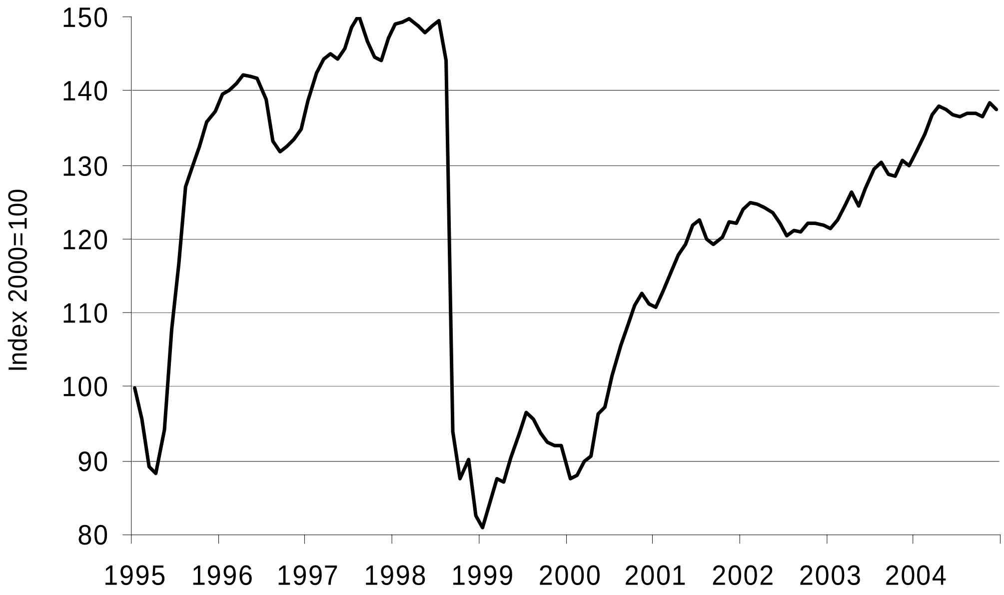
Although good policies were key to the improving state of affairs, Russia also enjoyed a healthy dose of good luck. Export earnings began to soar due to price developments in world markets. This eased the balancing of public expenditures and revenues. It also helped clear a mountain of payment arrears and reduce reliance on barter and monetary surrogates. The state no longer accepted anything but money in payment of taxes, while the current account surplus, and its attendant effects, enabled companies to pay. The value of barter transactions, which corresponded to the value of 54% of industrial production during the crisis, dropped to 13% in the autumn of 2001 (Russian Economic Barometer, 2004). Because the financial base and political influence of big investors (oligarchs) had faltered during the crisis, it was now possible to shift the tax burden to the export sector, especially the oil companies, at an earlier stage (Kwon, 2003). Although this exposed public finances to the risks of gyrating energy prices, oil prices in fact climbed steadily for several years.

The federal share of tax revenues also increased substantially. There were many reasons for this, but above all it was a way to put fiscal management on a more rational footing. By 2004, public finances had been comfortably in the black for five years running and a big chunk of public debt had been repaid ahead of schedule. Russia is now a relatively low-debt country and its international reserves rank among the world's largest. The rapidly growing, albeit relatively small, stabilisation fund is slated to help in rapidly shrinking the country's external debt.

Nearly all of Russia's large banks ran aground during the 1998 crisis. This led to increased central bank powers in supervision of the money and foreign exchange markets, especially as the state-owned banks strengthened their position. Because the markets were small and underdeveloped, monetary policy was conducted largely via administrative edicts and other similar measures. Although the instruments were unsophisticated, monetary policy proved successful, as evidenced by a decline in inflation (albeit too slow for many), improved predictability of the exchange rate and a decline in interest rates. On the other hand, a crisis of confidence in the banking sector in summer 2004 revealed how fragile these successes were and how much work remains in normalising the financial system. Burned by the experiences of the 1990s, financial system participants remain unable to trust each other. Restoring confidence in the financial system, as well as in other institutions, will require carefully conceived, transparent, long-range policies.

Despite claims to the contrary, there is no solid evidence that the rouble was overvalued prior to the crisis. What it is clear, however, is that since the crisis the rouble has been undervalued. Using current exchange rates, the size of the Russian economy in 2004 was comparable with the Netherlands, or with Sweden and Finland combined. The rouble's real exchange rate has now returned almost to its pre-crisis level. Taking into account productivity growth, however, unit labour costs have not risen at all (Figure 4). Thus, the price-competitiveness of Russian companies, at least in the domestic market, remains excellent. Although appreciation of the rouble's real exchange rate appears to have come to a halt in 2004, further strengthening is probably inevitable in the longer term as long as Russia continues to liberalise its market economy.

Figure 4. Real effective real exchange rate



Source: IFS

Underlying its wide scope and detail, the fundamental message of the Gref programme was that "first-wave tasks" of economic transition – liberalisation, stabilisation and privatisation – have essentially been accomplished. The new programme shifted the focus to second-wave reforms such as taxation, banking institutions, social security, labour markets, education, judicial system and the public sector. Russia's new goal was WTO membership, and the literally hundreds of planned reforms were set to boost the growth rate to 8%. The role of small enterprises would expand as various requirements affecting them were eased.

Tax reform policy provides insight into Putin's first-term legislative programme. It is generally accepted that the taxation approaches Russia developed in the 1990s were complicated and arbitrary. Corporate and individual taxpayers, caught in a jungle of a couple hundred taxes with often high nominal rates, devoted themselves to tax avoidance as a matter of survival. The reforms of 1999-2002 reduced the number of taxes as well as rates. The tax base was broadened through the elimination of exemptions that had become the instruments of administrative arbitrariness and corruption. Russia adopted a flat income tax and corporate taxation shifted largely to turnover taxes en route to a more purely profit-based system (and eventually even reduced the turnover tax rate). Åslund (2004) observes that the design of Russia's tax system is now so reasonable it could serve as a model for some western countries.

In 2001, Russia dramatically lowered its highest tax rates on income and adopted a flat 13% marginal rate. The following year, income tax revenue jumped about 25%. Yet what was really behind this phenomenon has hardly been studied at all. Curiously, we have no evidence of strong supply-side incentive factors. Current speculation is that much of the credit should go to a concurrent transformation of the macroeconomic environment and improved tax collection.[1]

[1] Several studies relevant to this topic can be found at www.iet.ru. These conclusions are supported by a yet-to-be published IMF study.

A listing of Putin's first-term reforms would stretch over many pages (Åslund, 2004; Owen and Robinson, 2003; OECD, 2004), so we can only touch on a few of the most important in the next section. Even so, reform policy is understandable as long as we keep recall the government's primary goal – through establishing a normal market economy, diversifying the structure of production and promoting competitiveness at the international level – is doubling total economic output within a decade. These considerations are entailed in certain indicators used in the sections that follow to evaluate the practical effects of Russia's economic reforms.

3 Putin's first-term structural reforms

Since the 1980s, Russia has abandoned many precepts once deemed inviolable. Perhaps the most significant has been the taboo against private ownership of land. Russia never had a tradition of private ownership of land, so approval of land ownership in population centres in 2001 (after protracted discussion) represented a major policy shift. In the following year, the parliament extended private ownership rights to agricultural land. In fact, private ownership of land has yet to gain much practical significance, since ownership is generally limited to the enterprise sector. Regional administrations have decision-making power regarding land sales, so differences across regions are great. Regarding the much-discussed private ownership of forest lands, no decision was reached in Putin's first term. Instead, long-term leasing and utilisation rights were approved.

The establishment of a western-type judicial system was launched in 2001. A civil code and laws on arbitration courts, the status of judges and corporate activities were approved. The formerly strong position of prosecutor was downgraded and the courts were strengthened. While these reforms amount to a significant revamping of the Russian judicial system, it is still marred by serious defects. Close relations between officials, courts and companies, especially at the local level, often preclude impartial treatment. Low salaries also make the courts susceptible to bribery.

As mentioned in the previous section, the Russian tax system has been fundamentally revised, and further changes are in progress. During Putin's first term, company-specific tax benefits were dismantled and deductions for expenses were increased. Moreover, the tax rate on corporate income was reduced from 35% to 24% at the start of 2002. Income taxation was changed to a low flat tax at the start of 2001. The aim is to have the entire revised tax system implemented by 2006. The government foresees no further major changes in taxation thereafter. The planning and preparatory work on the tax system per se amount to a huge leap forward in stabilising the operating environment for businesses.

One structural change that would be important for business, but where Russia has been slow to make progress, is reform of the financial sector. Although the banking sector has recovered from 1998 financial crisis and failure of several big banks, banks have not managed to win back customer confidence. An important institutional problem of the banking sector is the lack of effective banking supervision. Russia still has about 1,200 smaller banks (including several hundred in Moscow) that are very difficult to supervise.

The banking sector is dominated by the savings bank Sberbank, which controls some 62% of household deposits. The central bank remains Sberbank's dominant shareholder. The bank's strong position as a deposit bank derives largely from complete deposit protection and an extensive regional network of branches. Last year, the parliament approved extension of deposit protection to other banks that meet the central bank's requirements. Following a transition period (not beyond 2007), Sberbank must share a level playing field with the other banks as regards deposit protection.

The vast majority of companies, especially small and medium-sized companies, have difficulty obtaining finance because their credit ratings are too risky for the banks. Companies lack long credit histories and lenders are not sufficiently secure to weather an insolvency. Thus, most company investments must be financed with retained earnings; bank loans account for only about 6% of corporate investment. Large, well-known companies have much better access to finance as they can borrow from abroad or from their own banks.

The Russian financial sector continues to develop as evidenced by steady growth of lending and bank balance sheets. Foreign banks can operate in Russia, albeit they are still not a major force in deposit-taking or credit extension. Looking ahead, however, they should assume greater importance as an upgrade to interbank competition and an addition to the overall level of banking activity.

The modest role of small companies in the Russian economy is recognised as a problem even at government level. One reason for this situation is well known: bureaucracy and excessive controls hinder small companies' operations and the birth of new businesses. Since 2002, company registration has been simplified and official inspections have been limited via legislation. Despite some improvement in the situation, the bureaucracy is still burdensome.

Russia also needs good corporate governance to provide direction for company management. In its absence, minority shareholders have suffered most from the trampling of their rights. This situation has improved in the past couple years thanks to new legislation on stock companies and bankruptcy. Guidelines on good company management issued by a commission on securities markets in 2002 provide detailed norms for company operations. Since the new legislation became effective, voluntary corporate bankruptcies have decreased and minority shareholders' rights have been upgraded. The change nonetheless affects mainly the larger companies, which depend on a good reputation, inter alia for purposes of exchange quoting and borrowing from abroad.

Reform of state-owned monopolies continues at varying effectiveness and speed. In 2003, a railway company for handling transport was split off from the Railways Ministry. The company is still state owned, although the plan is to partially privatise its operations. Energy producer EES has also been reorganised and regional production units are being sold as separate companies. Notably natural gas monopoly Gazprom has not been restructured despite several years of effort. It now appears Gazprom will remain in state ownership.

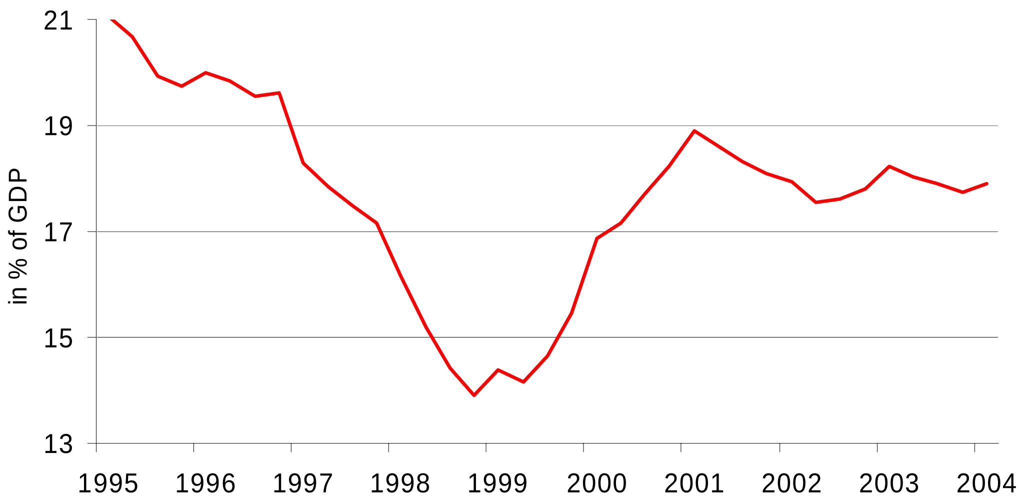
New laws on customs and foreign exchange could prove to be significant improvements for companies doing business with Russia. A new law on the customs system, which entered into force at the start of 2004, observes western customs standards and provides a basis for simpler procedures. The law requires customs officials to inform clearly on new rules and complete the clearance process within three days instead of ten. Only time will tell how successfully the new law has been implemented.

A new law on foreign exchange, which entered into force in summer 2004, virtually ends control of currency movements. The underlying principle is that the central bank will monitor currency operations but normally will not restrict them. A phase of step-by-step liberalisation of currency operations runs until end-2006. The law empowers the central bank to set restrictions in times of crisis. Starting in summer 2005, Russian companies will be free to open accounts in foreign banks. One consequence of the new law is that the bureaucracy associated with foreign trade-related payments should be reduced.

4 What do the numbers tell us?

Simple calculations show that for Russia, like other countries, long-term growth forecasts depend very much on assumptions about the investment ratio. If the investment-to-GDP ratio stays below 20%, as it has for Russia since the start of the 1990s, one can predict that growth will remain at 2-3% a year, assuming the absence of a continuing improvement in the external environment (Sutela, 2003). Such an improvement might be a continuing rise in the price of oil (Rautava, 2004). On the other hand, if the investment ratio climbs to around 30%, which is on par with many rapidly growing economies, the Russian economy could track an annual growth trend of 5%.

Figure 5. Investment ratio



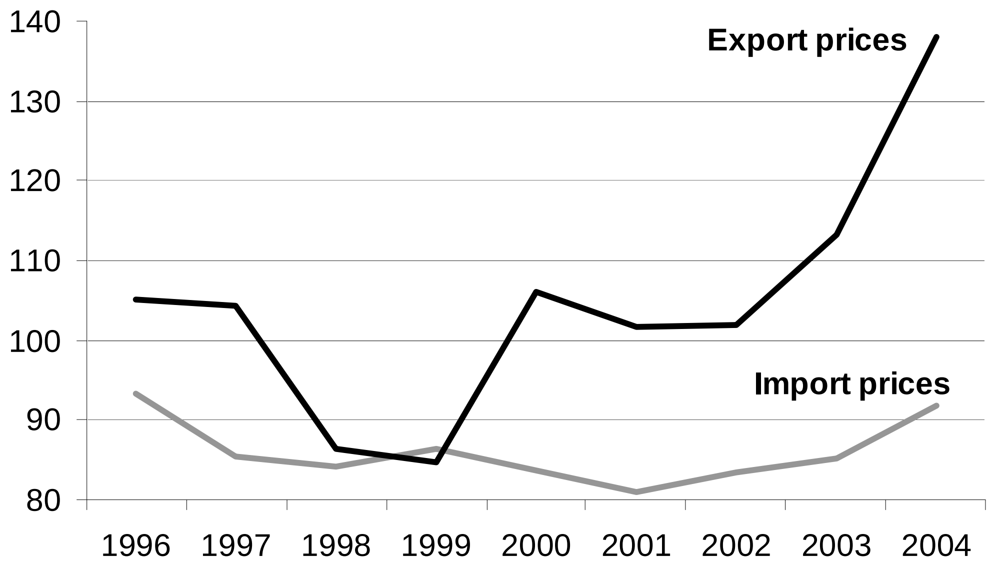
Source: Rosstat

These calculations assume nothing has altered Russia's potential growth trend since the 1998 crisis. The shortness of the period obviates the possibility of drawing specific conclusions. However, Figure 4 above shows that the productivity growth of the open sector would caution against writing off such an optimistic scenario.

It is possible that market prices of oil and raw materials will stay at a high level if world economic conditions improve, particularly if demand for raw materials remains strong in the major industrial economies. This situation could enable Russia to join the club of nations with persistently strong terms of trade (Figure 6). Such a policy result would obtain, however, only to the extent that the strong terms of trade derive from good monetary and fiscal policies that keep inflation low and the exchange rate stable. Another possibility is that the terms of trade would strengthen in the context of an increase in Russia's output of products that are more competitive and high in value added, and hence highly priced in world markets. For the most part, the terms of trade of Russian-type raw materials producers depend on factors that are exogenous to policy. By contrast, there is reason to assume that pressures for further reforms (that are in many ways technically demanding and often directly lower the standard of living) are diminished as Russia benefits from externally determined strengthening of its terms of trade. This applies above all to activities not directly benefiting from growth of export income.

But even here there could be difficulties. Several forecasts predict that Russia will have severe problems maintaining growth of energy production after about 2010 without massive investment in very near future to open new fields in difficult-to-access places like Eastern Siberia. In this respect, the recent focus on greater state control of the energy sector for strategic reasons is probably not conducive to foreign or private domestic capital inflows.

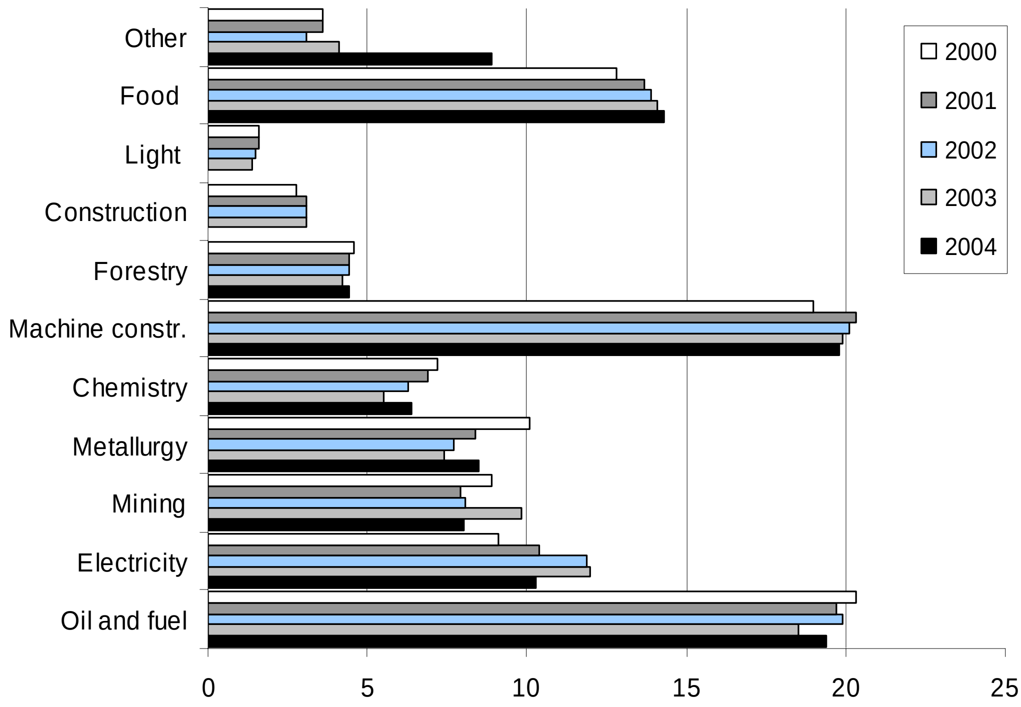
Figure 6. Terms of trade



Source: Central Bank of Russia

Besides boosting economic growth, another primary objective of Russian economic policy is to diversify the structure of production. The possibility of becoming an oil state is considered a huge threat. The available data indicate that essentially there was no change in the structure of industrial sectors during the period 1997-2003. Production of energy and raw materials has grown, but this has also happened in other industrial sectors. Only the light industry sector has recorded a clear downward trend in share of total industrial output. The textiles and clothing sectors have been pushed aside by strengthened foreign producers.

Figure 7. Industrial production by sector, 1997-2003, % of total

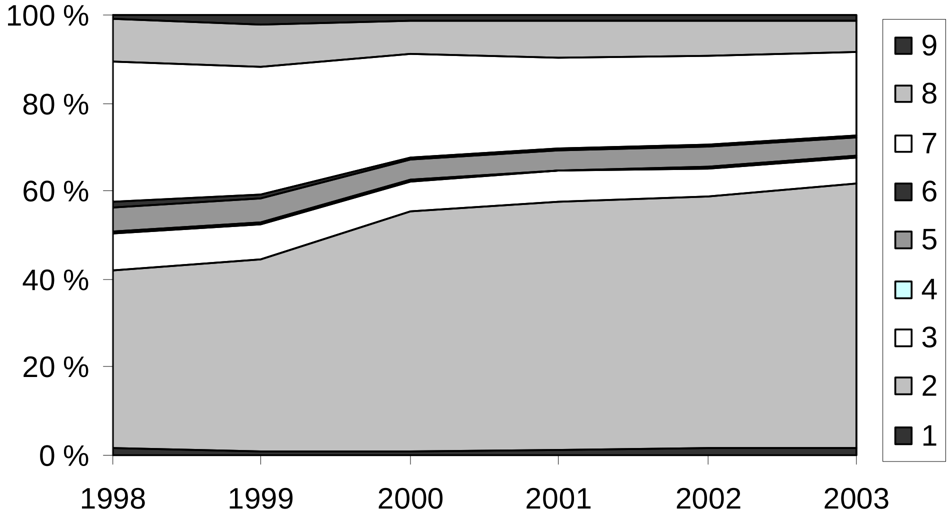


Source: Rosstat

In 2003-2004, the government raised taxation on the energy sector, especially to take advantage of the high price of oil, while easing taxation on the rest of the economy (e.g. VAT and social security taxes). On the other hand, direct subsidies are not being given for diversifying output as e.g. the proposed use of international reserves or the stabilisation fund for such public sector investments or for extending credit for related private sector investments. Apparently, the ideas of economic liberalism are still very important for the economic policies of Putin's government.

In an open economy, the success criterion for structural change is the ability to produce high-value-added industrial products or services that are internationally competitive. Such products have not come out of Russia, at least not in statistically significant amounts. Nor do foreign trade statistics indicate diversification of the export structure (Figure 8). Even Russia's military industry has not proven particularly competitive, especially outside its two major markets, China and India.

Figure 8. Structure of exports

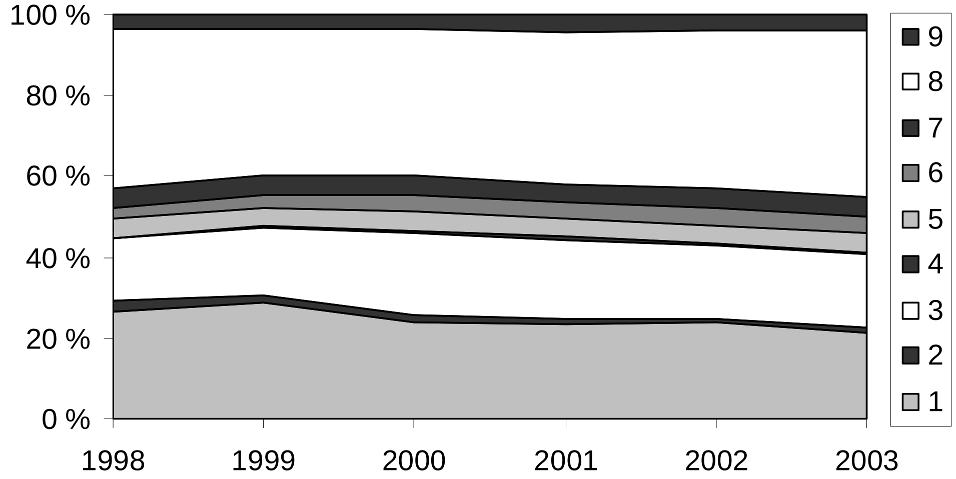


1 Foodstuffs and agricultural raw materials
2 Mineral products
3 Chemical products, rubber
4 Leather raw materials, fur and their articles
5 Wood, pulp-and-paper products
6 Textiles, textile articles and footwear
7 Metals, precious stones and their products
8 Machinery, equipment and transport means
9 Others

Source: Rosstat

One can also learn something from the structure of imports. If the country is in a phase of rapid development, one might expect to see an increasing share of investment goods in total imports. As the level of income rises, one should see growth in the share of durables in total imports of consumption goods. In the case of Russia, little of this can be detected in statistics, especially remembering that import statistics include items such as cars and mobile phones among investment goods.

Figure 9. Structure of imports



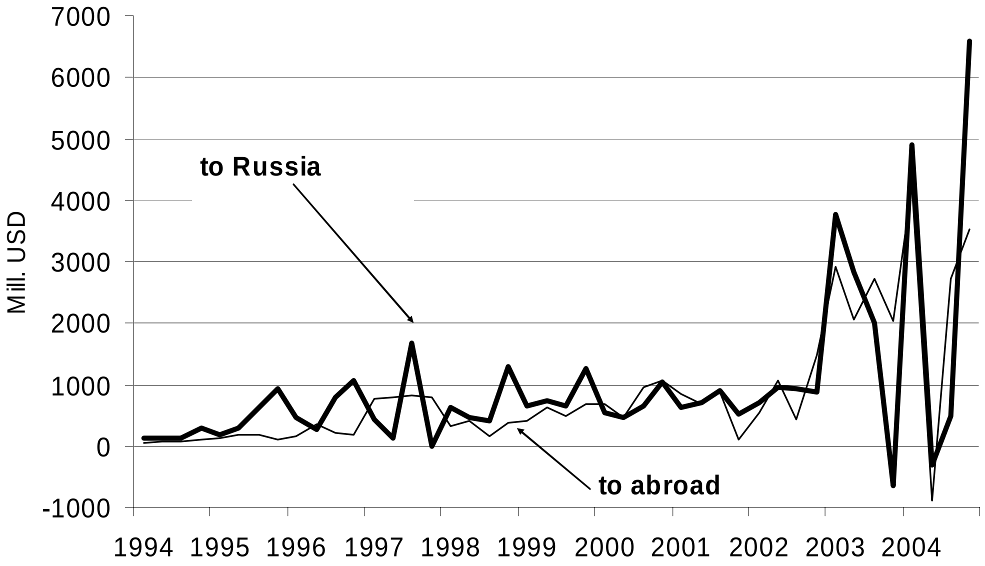
1 Foodstuffs and agricultural raw materials
2 Mineral products
3 Chemical products, rubber
4 Leather raw materials, fur and their articles
5 Wood, pulp-and-paper products
6 Textiles, textile articles and footwear
7 Metals, precious stones and their products
8 Machinery, equipment and transport means
9 Others

Source: Rosstat

The statistics classify Russia as a high-savings country. With domestic investment remaining at a very low level, the inevitable consequence is the export of capital. From another perspective, the deficit on the capital account is the result of the current account surplus. Hence, Russia does not need foreign investment as a source of financing. Nevertheless, foreign direct investment has often proven useful for lagging countries. FDI is associated with technology and other know-how, useful applications, readily marketed brand names and other means of gaining access to markets.

The bulk of FDI goes to industrial countries. Economies in transition have never been leading receivers of FDI. Although the latter may in the early stage offer advantageous privatisation targets, they generally are not able to offer more highly developed technology or permanently cheap labour. This is particularly true for Russia. The domestic market, while certainly large in terms of population, is so modest in terms of buying power that its needs can be met by foreign production. The matter is different e.g. in terms of its many difficult-to-transport food products, where domestic brands are strong. While foreign investors are clearly interested in Russia's non-energy natural resources, it has become quite clear during Putin's second term the state also intends to keep a tight rein on other natural resources.

Figure 10. Russia's inflows and outflows of direct investment

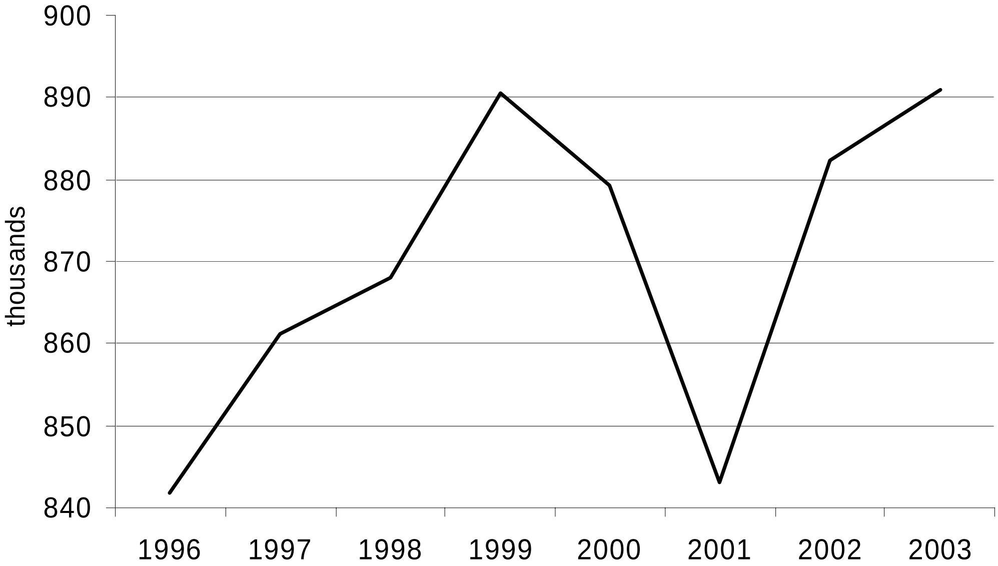


Source: Central Bank of Russia

Figure 10 suggests that, despite higher FDI amounts, the level is still quite modest. It is noteworthy that these data are not comprehensive. Russia's biggest foreign investment, the BP-TNK deal, is not even included in Russia's capital account because technically it involved two companies with foreign registration.

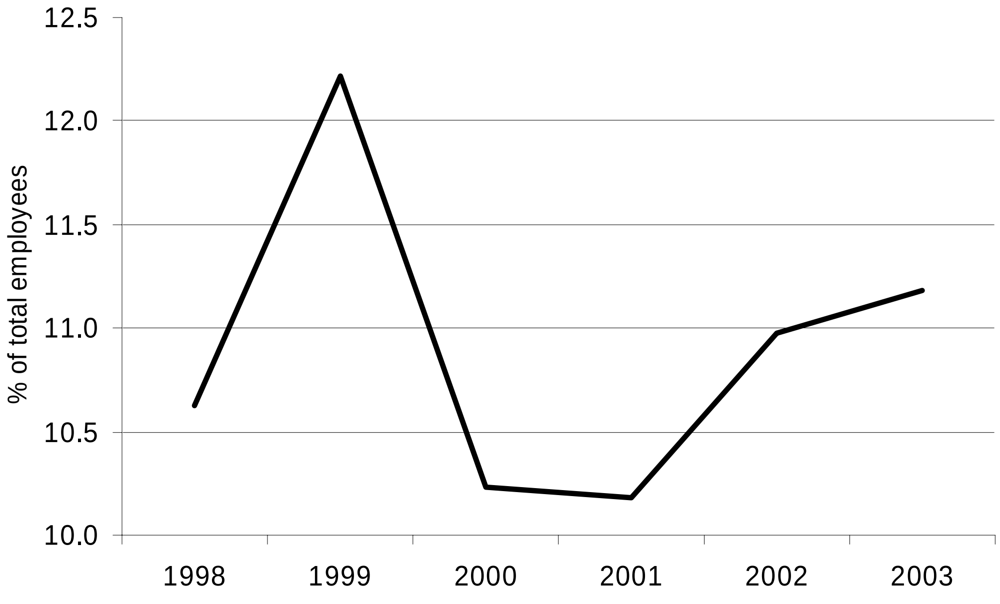
For many transition economies, growth has been driven by a rapidly growing small and medium-sized business sector. This is not the case for Russia. Liberalising reforms of the economy came only at the end of the Soviet Union, so Russia inherited a tiny sector of small and medium-sized businesses. Whether measured by workforce or share of output, the small and medium-sized enterprise (SME) sector has not gained in importance since the millennium change. While the statistics are neither comprehensive nor fully comparative with other countries, it seems clear that the SME sector's relative importance for Russia is only a fraction that both the old and new EU countries.

Figure 11. Numbers of small and medium-sized companies



Source: Rosstat

Figure 12. Numbers of employees in small and medium-sized companies



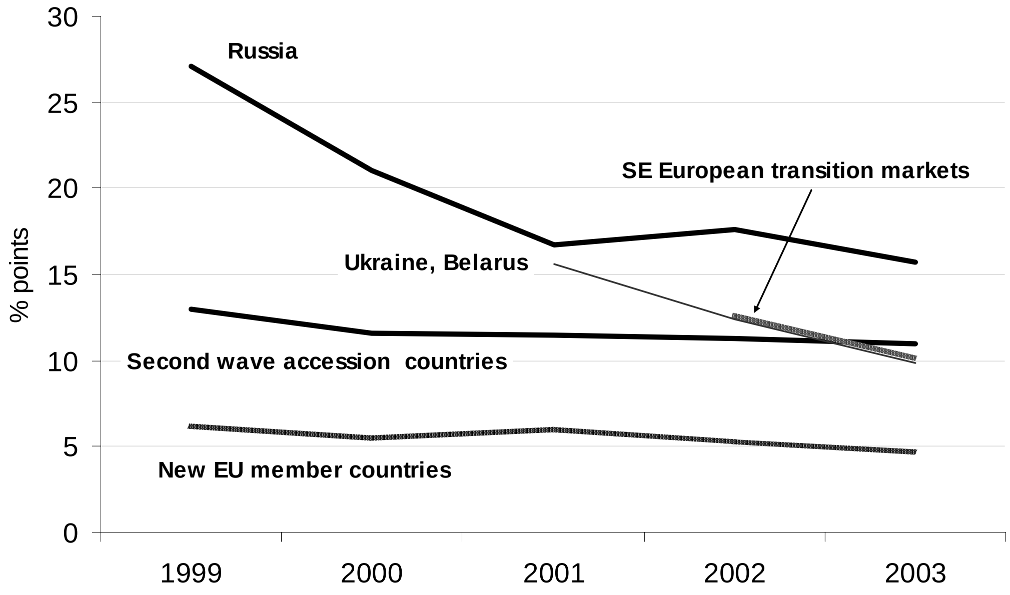
Source: Rosstat

In study after study, entrepreneurs recite the same obstacles to business success in Russia (see Table 1 below). The arbitrariness of public sector behaviour, high taxes, time and trouble in registering a company, the dearth of orders and financing, and tight competition continue to top the list. It is also clear that problems are also well known to the authorities.

Despite much legislation to create more business friendly conditions, the statistics have yet to reveal any noteworthy progress in this direction.

A major problem area is the financial system. A vast literature on development economics indicates that, for many reasons, a highly developed financial system promotes growth. The relationship, however, does not appear to hold for the transition economies, where rapid growth of the financial sector has typically led to a banking crisis that was very costly in terms of lost output (Koivu, 2002). Russia has gone through three serious banking crises (1991, 1994, 1998), as well as a loss of confidence by market participants in summer 2004. Thanks to numerous factors, Russia today has an undersized financial system and a small number of markets.

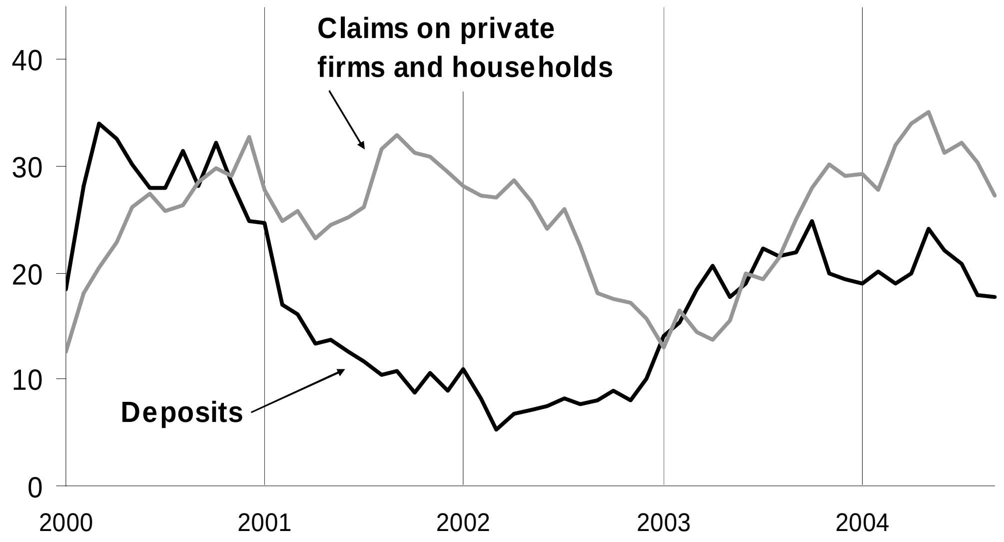
Figure 13. Interest rate margins, Russia and other countries
(average lending rate minus average deposit rate)



Source: Financial Times

There have been positive developments. While the margin between funding and lending rates (Figure 13) has narrowed, it remains considerably wider than in the countries compared. In recent years, bank deposits and lending (Figure 14) have also increased (indeed, so rapidly that the monetary authorities have become concerned about a possible expansion of problem loans). Another bright spot from Russia's perspective is the growth in rouble deposits, which reflects increased confidence in the rouble as the dollar has weakened.

Figure 14. Growth of funding and lending



Source: Central Bank of Russia

5 What do opinion surveys tell us?

The state of the economy and development possibilities cannot be measured by statistics alone, especially if one wants to assess the effects of very recent changes. These often impact the behaviour of economic agents via expectations. Hence, it makes sense to consider subjective evaluations as well.

The first standard question is about how Russian companies view their operating environment. A periodic extensive opinion survey of Russian companies is conducted by the World Bank and the CEFIR research institute in Moscow (www.cefir.ru). It covers 2,000 (most recently 1,600) small companies in 20 geographic areas and asks companies about the extent to which selected generally perceived deficiencies hinder their operations. Table 1 presents several of these business-inhibiting factors. It can be seen that small companies view of the seriousness of various problems differently than the media. Corruption and organised crime are not seen as serious problems, or at least companies have adjusted to them. On the other hand, the manner in which the public sector operates is seen as a problem. Taxes are considered high, as one might presume is the case for small companies in other countries.

Table 1. Business environment perception of Russian small enterprises

Round:	1		2		3		4
Problem:	2001-II	Change 1 → 2	2002-I	Change 2 → 3	2002-II	Change 3 → 4	2003
Level of taxation	3.52	↓***	3.30	↓***	3.06	↓***	2.80
Macro instability	3.28	↓***	3.00	↓***	2.78	↓***	2.60
Competition	2.63	↑***	2.73		2.69	↑***	2.78
Tax administration	3.11	↓***	2.82	↓***	2.67	↓**	2.58
Regulations	2.91	↓***	2.64	↓***	2.51		2.52
Problems in access to capital	2.65	↓***	2.40		2.39		2.33
Problems in market access	2.27	↓***	2.17	↓*	2.09	↑**	2.19
Corruption	2.10	↓***	1.87		1.87		1.93
Extortion	1.34	↓***	1.27	↓***	1.20	↑**	1.25

1 – No problem
2 – A small problem
3 – A difficult problem
4 – A very difficult problem
5 – Threatens the existence of the company

* refers to statistical significance of the results.

The survey results also show how the business climate has changed over time. In almost all included aspects, the situation has improved over the course of the first three surveys, albeit the pace of improvement has clearly slowed. The fourth survey shows that the improvement of perceived business environment has continued at least until the end of 2003, though possibly at a declining rate.

Since 1999, the Central Chamber of Commerce of Finland has conducted annual surveys of CEOs of companies in northwest Russia (Central Chamber of Commerce of Finland, 2004), the latest in September 2004. The answer-options are qualitative, but numerical balances can be calculated for these. Interestingly, the survey asks directly for the responder's opinion of how President Putin's policies have affected both their operating possibilities in the last twelve months and foreign companies' investment possibilities.

In all surveys, the majority of responders saw Putin's policies as positive, i.e. a positive balance. Between 2000 and 2003, the balance for both questions became more positive, and then dropped abruptly in 2004. On the question of foreign companies' investment possibilities, the drop was the most precipitous in the short history of the barometer. At the same time, responder uncertainty increased. In September 2004, a full 36% left unanswered the question about the effect of Putin's policies on foreign companies' investment possibilities.

Corruption is widely seen as a big problem in Russia. Transparency International has for several years collected information on how businessmen view corruption in different countries. Since 1999, Russia's ranking has deteriorated among a growing group of countries, but according to the present evaluation, corruption has actually receded somewhat. This is somewhat contrary to a widely-shared sentiment that corruption may actually have increased during the Putin years. It is argued that the demand for corruption has strengthened, as there is more liquidity in the economy. At the same time, the corruption supply may have increased as a stronger state apparatus potentially has more corrupt practices to offer.

6 Market economy under the Putin system

For any rapidly changing society such as Russia, trying to reduce things to a few basic elements is risky, if not doomed to fail. But if one is to at least attempt to sort out the permanent elements from the random bubbles, it is necessary to simplify. Indeed, if one is willing to simplify shamelessly, close one's mind to possible counter-arguments and refuse to listen to a conscience that would speak of the actual complexity involved, it may be possible to get a glimpse of what is called, for want of a better name, the Putin system. Admittedly, this is a poor name because the system is not a creation of Vladimir Putin, but rather an appellation that merely acknowledges the stamp his name will bear on this decade in Russia's history. Indeed, Mr. Putin himself may not like the system, and may even try to junk it, whether he can do much about it is another matter entirely. Even the liberals are split; some see the system as a danger, others as a lesser of evils.

The Putin system combines two elements – two reactions to the 1990s – and only in this light can one come to grips with it. The first element is the attempt to build an authoritarian state. It is only an attempt, not an accomplished fact, nor is Russia about to become a totally authoritarian state. During the Yeltsin years, policy-making was in many ways chaotic and unpredictable, but it was based at least in part on competition among politicians, regions, enterprises and even political parties. Russian society evolved. The mass media, freed of state control, became instruments of private interests. Income differences and other economic inequalities increased sharply. Russia's international reputation and influence diminished at least as fast as its statistical GDP. The country acquired a serious poverty problem, and a host of other potentially grave social problems surfaced, from a deteriorating educational system to the decaying health of the populace.

In a recurring theme of the history of Russia and other countries, the pendulum shifted. The building of an authoritarian state became based on stability, identified with a yearning for predictability. Power had to be vertically organised. As the lower, i.e. regional, level could not appear to excessively influence the central power in deliberations and decision-making, a special arrangement was needed to ensure that decisions were actually implemented and power allocation based on a division of tasks. Moreover, businessmen were not to interfere in political decision-making, yet it was desired that they represent the state's political interests domestically and abroad. The judicial system has its own tasks, not the least of which is promoting the interests of the state. Democracy per se is not the goal; rather it is the restoration of the might and repute of the state. But might and repute could be at odds with each other.

Striving for an authoritarian state is not an attempt to return to the past. Even though such nostalgia might be commonplace, there is no real yearning for an official ideology, state ownership, one-party politics and a closed society. The country's leadership is sincere in considering Russia a part of Europe (and a disaffirmation of the belief in a mythical

Eurasia). Becoming part of Europe is the only means of achieving modernisation, a more competitive economy, and hence might. Moreover, the leadership wants the country to be a valued and respected member of the international community. The elite want to be free to travel and do business (including the purchase of foreign football teams). The youth prefer broadband Internet access and Interrail passes over the opportunity to attend a youth camp in Kazakhstan.

In order to be accorded equal status by the international community, it is necessary to hold elections that meet the minimal requirements of democracy: a choice of candidates and reasonably accurate vote counting. The courts must also be independent at least to the extent that defence lawyers can have their say. Nor can freedom of the press be stifled. Free speech must apply at least to the media of the elite – those that we too follow. For these and other reasons, the authoritarianism of the Putin system can never be total.

In fact, the Putin system's goal of building a partially authoritarian state is unsustainable. Elections can be held, but the results must be "right." In this regard, there is a readiness to resort to means of influencing politics that are considered off-limits in a democracy. A businessman, who strives for independence, should – and can – be ousted, but it must be done through the judicial system. Which implies that world's best defence lawyers must be given a seat at the table. The Khodorkovsky case speaks volumes about this paradox. Clearly, the process is not under anyone's control.

The manner in which the 2008 presidential election is conducted will set a precedent. The Putin system calls for a guarantee of its own survival via the choice of a suitable successor. And yet elections are mandatory. Therein lies the need for adequate preparations, which have already been in progress for about a year.

The system's unstable political base stays upright only as long as presidential popularity remains high. This is fortified by a number of factors: firm support of the common people and the elite, oversight of the politically important media, a controlled parliament, tamed regional leaders, and – not to be downplayed – control of the forces of violence. If these fortifications do not suffice, the Putin system will either disintegrate into an attempt at total authoritarianism or move toward a fully fledged democracy.

The pillar of a president-centred system is also its weakness. When the goals of the state become the choices of a single individual, he is also needed in the realisation effort. The people's interests become identified with the character of that individual. Anyone who criticises or opposes him may be labelled an opponent of the best interests of the people, which is almost the same as enemy of the society in this context. Such were the fates of Khodorkovsky and Glaziev.

Another weakness of such a system is that the leader's entourage is often made up of unoriginal implementers. This quickly makes the burden on the person in power overwhelming; few things are more troublesome to a yes-man than not knowing what to say "yes" to. The actual output of the system does not measure up to proclamations that expound essential and well-intended ideas, but stay on the level of lofty generalities.

Besides the president's position, another political pillar of the Putin system is a history of inertia. Many institutions, operating habits and modes of thinking hark back to the era of Soviet socialism, which was, after all, the time of Russia's greatest accomplishments. So it is no wonder that a yearning for those times remains and is difficult to break away from it completely. The Soviet system left valuable legacies such as a fairly well educated populace. On the other hand, the inherited burdens have also been tremendous. These include an oversized military industry, geographically misallocated (à la economics) activities and people, a variety of security systems and a plethora of outmoded thinking.

Another element of the Putin system is the striving for a normal market economy. I have elsewhere labelled Russia's economy as a "peculiar" market economy (Sutela, 2003). It is in many ways normal by international standards: a typical (especially for large developing countries) and familiar dual economy. It is divided into an energy and raw materials sector tightly linked to world markets, and a sector serving the domestic market comprising domestic industry and service providers. Russia's energy sector produces a fifth of the GDP (and possibly more by some estimates). In 2003, that fifth accounted for 55% of export income, about 40% of budget revenue and about a half of total investment in the industrial sector. The weapons industry, in contrast, accounted for only a few per cent of export income. There are no signs of any diminishment of the economy's dependency on energy and raw materials. Fluctuations in GDP continue to closely track energy prices and production. According to an official estimate, energy accounted for about five percentage points of the nearly 7% growth in 2003.

The export sector, however, is characteristically not a great provider of employment. Most jobs are in mature industries, where productivity is low and job preservation requires quantitative restrictions, state subsidies or an undervalued currency.

This dual economy can never be totally integrated with the international economy. For this reason, the establishment of free trade between the EU and Russia is necessarily a long-term goal.

Russia is thus not under any great pressure to join the WTO anytime soon. Consumers, who would benefit most from WTO membership, have no voice in Russia's decision-making. Domestic producers, on the other hand, doubt they could keep up with international competitors in selling advanced industry- and service-based products. Thus, the greatest pressure to delay joining the WTO comes from traditional Soviet-backbone industries such as cars and aircraft, where there is a fear of being toppled in open competition. If Russia makes a speedy entry into the trade organisation, as it now seems poised to do, it will only be because of a decision at the top to join the international community.

Another unique characteristic of the Russian market economy concerns ownership rights. Most of the key exporters are included in conglomerates known as the oligarchy groups. These are controlled by tiny cliques in which ownership is often cloudy and the companies represent a wide range of economic activities. The majority of jobs are in domestically oriented companies that are shrinking in size and are owned by managers and sometimes workers as well. Although some oligarchy groups may have displayed dynamic, even internationally oriented, thought processes, a common characteristic of domestically oriented companies is defensiveness. In Russia, the modern, small and medium-sized companies comprise a small sector of the business community; they have shown few signs of expanding fast, at least not until very recently.

We already mentioned the small, underdeveloped financial sector and a dearth of authentic foreign ownership that characterise the Russian market economy. At this point, it may help to also comment on certain other special features of Russia.

The central position of the state means that companies often find it more profitable to focus on accumulating connections-capital vis-à-vis political decision-makers than to try to improve their competitiveness via product development and productivity. This is especially the case for regions. The average Russian region has fewer than two million inhabitants and a single company can often dominate a local economy. There is no real difference between a region's political and economic decision-making. Just as in the Soviet Union, too many economic decisions are made on political grounds, albeit to a diminishing extent.

Too often political and economic power rests with the same person or is associated with promoting shared interests.

Repeatedly in surveys, small Russian companies have said that the prime obstacle to economically efficient operations is the arbitrary and discriminatory manner in which the public sector operates. The subjects of complaint are well-known: taxation, licensing, inspections, shifting interpretation of the law, etc. On the other hand, companies noted an improvement in the operating environment in 2001-2002. Only competition, they say, has gotten worse (i.e. tougher). These responses, detailed in Table 1 above, should be seen as very good news, yet their interpretation is problematic. Has the environment actually improved or are companies learning to operate better in the same old environment? If the latter is the case, the pressure for improvement in the business environment has actually diminished.

Russia is not merely an oil state. It inherited a fairly good educational system, some large-scale industry and high-level research capability from the Soviet Union. But Russia could be drifting in that direction. The educational system provides pupils with little capacity to solve problems, at least according to the OECD's PISA study. A significant part of industry produces uncompetitive products in locations that are not rational in terms of a market economy. R&D spending relative to GDP is a third of that in Finland and the share is rising quite sluggishly. Russian companies generally do not develop new products. It is somewhat ironic that even though the price-competitiveness of Russian output remains excellent, new internationally competitive industry- or service-based goods for export have not been forthcoming.

These risk factors are well-known to Russians. President Putin on numerous recent occasions has emphasised the importance of diversification of the structure of output and competitiveness. The prime minister has joined in, saying that the government will use all available resources to modernise the economy, ease the tax burden and promote competitiveness.

7 Conclusions

Establishing connections between economic performance and policies, institutions and exogenous change is difficult under any circumstances. In the case of Russia, where relevant time series are short and structural and institutional change has occurred in the absence of a well-defined model of the economy, it becomes largely – if not entirely – a matter of art and taste. This paper considered the possible impacts of structural reform under President Putin on Russian economic performance. Judging the impact of Putin's reforms on recent Russian economic performance is confounded by the problem of overdetermination. That is, we can identify a number of contributing factors, but cannot say for sure if their absence would have had a crucial effect on outcomes. On the other hand, there seem to be no grounds for denying the significance of Russia's reforms, even if their short-term impact might primarily be through expectations, a factor notoriously difficult to pinpoint. Further, it is a matter of some delight that, contrary to what is currently all too easily and often argued, Russia's structural reforms continue. To grasp this, it should be sufficient to have a look at the Russian government's recently issued work plan for relevant legislation (http://www.pravitelstvo.gov.ru/data/news_text.html?he_id=103&news_id=17052).

References

Åslund, Anders (2004), "Russia's Economic Transformation Under Putin," *Post-Soviet Economics and Geography* 6, 397-420.

Hausmann, Ricardo, Lant Pritchett and Dani Rodrik (2004),"Growth Accelerations," National Bureau of Economic Research Working Paper No. 10566, June.

Central Chamber of Commerce of Finland (2004), *Keskuskauppakamarin Luoteis-Venäjän Business-barometri 2005* (2004), www.keskuskauppakamari.fi, marraskuu.

Koivu, Tuuli (2002), Do efficient banking sectors accelerate economic growth in transition countries?, BOFIT Discussion Papers No 14/2002.

Kwon, Goohoon (2003), "Post-crisis Fiscal Revenue Developments in Russia: From an Oil Perspective," *Public Finance and Management* Vol. 3, No. 4.

OECD (2004), *Economic Surveys: Russian Federation*, OECD, Paris.

Owen, David and David O. Robinson (eds.) (2003), *Russia Rebounds*, International Monetary Fund, Washington, D.C.

Rautava, Jouko (2004): "The Role of Oil Prices and the Real Exchange Rate in Russia's Economy", *Journal of Comparative Economics* 32 (2004), 315-327.

Russian Economic Barometer (2004).

Sutela, Pekka (2003), *The Russian Market Economy*, Kikimora, Helsinki.

BOFIT Online

http://www.bof.fi/bofit

2002 *No 1* Juhani Laurila: Determinants of transit transports between the European Union and Russia
No 2 Tarja Kauppila: Polish Economic Review 1/2002
No 3 Tuomas Komulainen: Elokuun 1998 talouskriisi
No 4 Laura Solanko - Merja Tekoniemi: Fiskaalifederalismi Venäjällä
No 5 Jian-Guang Shen: China's Macroeconomic Development in 2001
No 6 Tuuli Koivu: Vuosi 2001 Baltiassa
No 7 BOFIT: Näkökulmia Venäjän talouteen - BOFIT-seminaari 13.5.2002
No 8 Pekka Sutela: Combining the incompatibles: fixed exchange rate, liberalisation and financial development in Estonia
No 9 Tarja Kauppila: Polish Economic Review 2/2002
No 10 Iikka Korhonen: Selected Aspects of Monetary Integration
No 11 Tuuli Koivu: Banking and Finance in the Baltic Countries
No 12 Filippo Ippolito: The Banking Sector Rescue in Russia
No 13 Antje Hildebrandt: What is Special about Enlarging theEuropean Union towards the East? A Comparison with the Southern Enlargement

2003 *No 1* Marco Fantini: An evaluation of draft legislation on Russian deposit insurance
No 2 Jian-Guang Shen: China's Economic Development in 2002
No 3 Komulainen, Korhonen I, Korhonen V, Rautava, Sutela: Russia: Growth prospects and policy debates
No 4 Tuomas Komulainen: Polish Economic Review 1/2003
No 5 Abdur Chowdhury: Banking reform in Russia: Winds of change?
No 6 Laura Solanko: Why favor large incumbents? A note on lobbying in transition
No 7 Tuuli Koivu: Suotuisa kehitys jatkui Baltian maissa vuonna 2002
No 8 BOFIT: Näkökulmia Venäjän talouteen - BOFIT-seminaari 22.5.2003
No 9 Merja Tekoniemi: Venäjän maatalous 2000-luvulla - Venäjästäkö viljanviejä?
No 10 Abdur Chowdhury: WTO accession: What's in it for Russia?
No 11 Tuomas Komulainen: Polish Economic Review 2/2003

2004 *No 1* Elena Smirnova: Impact of Cross-listing on Local Stock Returns: Case of Russian ADRs
No 2 Seija Lainela - Pekka Sutela: European Union, Russia, and TACIS
No 3 Seija Lainela: Investoinnit kasvussa Venäjällä
No 4 BOFIT: Venäjän talous Putinin aikana
No 5 Merja Tekoniemi: Venäjän Kaukoidän taloudellinen integraatio
No 6 Tuuli Koivu: The sustainability of Chinese growth
No 7 Tapio Korhonen: Venäjän rahoitusjärjestelmän nykytila ja näkymät
No 8 Tapio Korhonen ja Simon-Erik Ollus: Mikä pääomapako Venäjältä?
No 9 Simon-Erik Ollus: How much oil can Russia produce? - A study in the Russian oil sector
No 10 Tapio Korhonen: Kiinan rahoitusjärjestelmän nykytila ja näkymät
No 11 Simon-Erik Ollus: Miksi kesällä 2004 oli luottamuspula? – Katsaus Venäjän pankkisektorin rakenteeseen ja nykytilaan

2005 *No 1* Tuuli Koivu: The challenge of choosing an optimal exchange rate regime for China
No 2 Jouko Rautava: Is India emerging as a global economic powerhouse equal to China?
No 3 Pekka Sutela: EU, Russia, and Common Economic Space
No 4 Barbara Bils: What determines regional inequality in China? – A survey of the literature and official data
No 5 Laura Solanko and Merja Tekoniemi: To recentralise or decentralise – some recent trends in Russian fiscal federalism
No 6 Pekka Sutela: Did Putin's reforms catapult Russia into durable growth?