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Tuomas Komulainen, Iikka Korhonen,
Vesa Korhonen, Jouko Rautava, Pekka Sutela

Russia: Growth prospects and policy debates

Bank of Finland
Institute for Economies in Transition, BOFIT

Bank of Finland
Institute for Economies in Transition (BOFIT)

PO Box 160
FIN-00101 Helsinki
Phone: +358 9 183 2268
Fax: +358 9 183 2294
bofit@bof.fi
www.bof.fi/bofit

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Abstract

This paper discusses Russia's growth potential in light of President Putin's target of eight per cent. The country has large investment needs, but low levels of financial intermediation. The economy is also highly dependent on raw material prices, which renders it prone to large economic fluctuations. However, there is no crisis similar to 1998 on the horizon and, most likely, no debt service problem this year. We conclude that Russia faces a huge challenge even in achieving a lower growth rate of about six per cent.

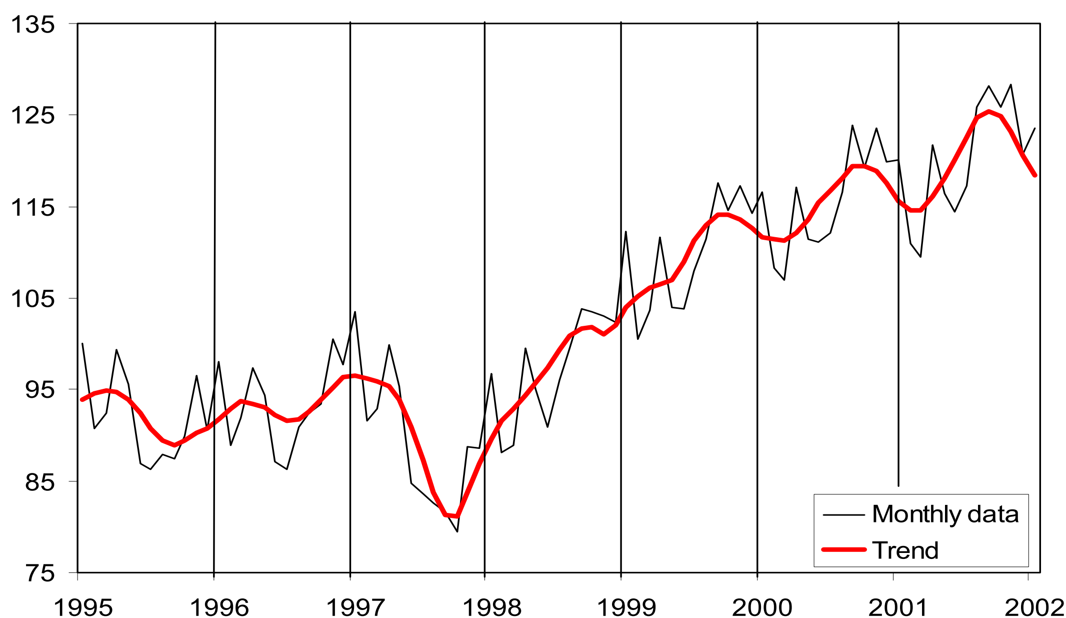
Key words: Russia, economic growth

1 Introduction

Since 1999, President Vladimir Putin has repeated the observation that Russia needs 8% annual growth for fifteen years just to catch up with a country like Portugal. Otherwise, he says, Russia will be unable to regain its position even as a regional power. *"Russia,"* Putin wrote just before coming to power, *"is experiencing one of the most difficult periods in its centuries-long history. Let's admit that for the first time in the last 200-300 years, it is facing a real danger of falling into the second – if not the third – echelon of states in the world. Our nation will have to exert tremendous intellectual, physical and moral efforts to avoid this fate. Coordinated creative work is called for. No one will do it for us. Everything now depends only on our ability to recognise the degree of danger, to rally together, and to dedicate ourselves to a long and difficult enterprise"* (Putin, 1999).

Russia's need for fast, sustainable economic growth, which it has achived since 1999, is today a subject of vigorous debate. Although Russia technically experienced a minor recession in early 2002, growth recovered to a point where last year's GDP growth was about 4%. Again this winter the by-now usual dip started this autumn (in December industrial growth was under 2%), but if earlier experience is to be counted on, this should again be a temporary matter. Some observers now argue Russia is entering an extended period of slower growth, and possibly recession, as its currency has become overvalued, investment stagnant, capacity utilisation high and progress in structural reforms insufficient to make the economy globally competitive. If these views are correct, Russia needs to implement major economic policy changes fairly soon.

Chart 1. Russian industrial production (index, Dec 1995 = 100)



Source: Goskomstat, BOFIT

If the Russian economy were to stagnate or grow slowly, the resources needed to reverse the long-term tendencies of decline and deterioration that have plagued the country for decades (Graham 2002) would simply not be available.[1] An inability to provide the necessary investment, infrastructure, social security, health services, education and environmental quality may have dramatic consequences with cross-boundary implications.

On the other hand, is Russia's high-growth goal even feasible? The government's current growth estimates appear rather pragmatic. For example, the government's "optimistic" growth scenario for 2003-2005 has only been raised from 3.5-4.5% to 4.4-5.9%. Indeed, any attempt to force the economy to grow at above-potential rates would be self-defeating and come with highly undesirable economic, social and political costs.

The commentary is divided into five sections. The second section presents a few simple calculations of Russia's growth potential. The third section argues that oil price and the real exchange rate are more important determinants of short-to-medium-term growth fluctuations than usually understood, which implies that, whatever the long-term growth potential, Russian growth will tend to be unstable. In the fourth section, we argue that the lack of financial intermediation in Russia is a major barrier to high growth. The fifth section looks at Russia's debt burden as a potential impediment to growth. The final section examines Russia's institutions and productive structure as foundations of growth, and ends with an outline of Russia's future role in the world economy. We conclude that Russia's growth potential is likely to undershoot President Putin's hoped-for 8% target, and, more significantly, perhaps, that the country faces a huge challenge even in achieving a lower growth rate of about 6%.

2 Russia's long-term growth prospects

A large body of literature deals with the long-term economic growth of countries.[2] Many variables correlate with a country's long-term growth. The most robust variables relate to accumulation of physical production capacity (investment), human capital (education), and the country's economic distance from richer countries (possibilities to catch up). Some studies have also emphasised the importance of financial intermediation for economic growth. However, the causalities between growth and its determinants often run in two directions.

A number of calculations find Russia has an annual growth potential of 5-6%. The IMF macroeconomic framework for Russia sees GDP growth strengthening to 5.0% in 2005 and averaging 5.6% in 2006-2015 (IMF 2002). The recent World Bank Russian Economic Report (World Bank 2002b) outlines four growth scenarios, each predicated on different assumptions as to reform implementation and natural resource prices. With no reform implementation and low export prices, the Russian economy hardly grows at all. With a healthy reform implementation and high commodity prices, Russia's growth averages about 5.5% until 2010.

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[1] Brainerd (2002) argues that, on basis of archival and anthropometric data, Soviet growth did not translate into higher living standards in the period 1955-1989. By some measures, the standard of living worsened significantly in the 1970s and 1980s.

[2] The standard reference is Barro and Sala-i-Martin (1995), which covers both theoretical and empirical issues. Both Levine and Renelt (1992) and Barro (1991) are routinely cited empirical works on long-term growth in a cross-country setting.

In this section, Russia's expected long-term per capita GDP growth rate is estimated using parameter values from Levine and Renelt (1992) and applied them to Russia. Levine and Renelt find that education is positively correlated with growth; that initially poorer countries tend to grow faster (ceteris paribus), i.e. there is conditional convergence; that investment also spurs growth; and that population growth reduces per capita growth. In another study, Fischer and Sahay (1998) conduct a similar exercise for the EU accession candidates of Central and Eastern Europe. They find that, in a benign scenario with investment ratios at 30% of GDP, the expected growth of per capita GDP for most countries is around 5%. In most of these countries, a high level of educational attainment increases expected growth.

Crafts and Kaiser (2002) conduct a similar exercise to Fischer and Sahay (1998) for Russia, taking into account more variables, including indicators for institutional quality. Excluding institutional indicators, Crafts and Kaiser calculate expected per capita GDP growth of 4.7% for Russia. When indicators of institutional quality (which are found to be significant in a cross-country estimation of growth) are included, the expected per capita GDP growth drops significantly. Depending on the specification, the expected growth rate is between 1.8% and 2.8%.[3] This implies that, in the absence of institutional improvement (e.g. in the rule of law), Russia would grow only slightly faster than, say, the EU.

Our calculations use three different assumptions for Russia's future investment ratio. The base scenario uses an investment ratio of 21%, i.e. the historical average between 1995 and 1999 (the ratio in recent years has been well below 20%). The optimistic scenario assumes an investment ratio of 30%, and the pessimistic assumption is 15%. Assumptions on the investment ratio further proxy progress in economic reforms, protection of property rights, political stability and attitudes to foreign investment (all factors that contribute to higher investment). We assume zero population growth, i.e. real GDP growth equals per capita growth. The results are presented in Table 1.

Table 1. Estimated Russian per capita growth, three scenarios

	Per capita GDP growth
Pessimistic: low investment	2.0%
Baseline: status quo investment	3.0%
Optimistic: high investment	4.7%

Per capita growth rate (Δy) is calculated as follows: $\Delta y = -0.83 - 0.35*$(initial per capita GDP, USD PPP) $+3.17*$(secondary school enrolment rate) $+17.5*$(investment ratio); parameter values according to Levine and Renelt (1992).

The message of this simple calculation is a strong one: Russia can only achieve reasonably high growth if investment picks up considerably from its present level. Otherwise, there is relatively little prospect for catching up with developed countries.[4]

[3] Of course, many other factors may affect Russia's long-term growth. For example, the spread of HIV and AIDS may well reach epidemic proportions and severely affect the Russian labour force. Ruehl (2002) estimates that by 2020 GDP growth could be one percentage point lower than in the baseline due to the HIV epidemic.

[4] Alternatively, a McKinsey Global Institute (1999) study of Russian industries found that high growth with quite modest investment was possible through improvements in corporate governance and incentives in Russia. A recent restatement of this view suggests 8% as the potential growth rate (Palmeda and Lewis 2002).

For another element, any catching up with more developed countries will result in real rouble appreciation due to the Balassa-Samuelson effect. In other words, GDP in constant dollar terms will grow faster than reported real GDP. In Central and Eastern European countries, the estimated annual Balassa-Samuelson real appreciation has ranged from 0.5% to 2.5%. Here, we cautiously assume an annual real appreciation of 1%.

What do our results imply for the relative economic size of Russia? Under the optimistic scenario, Russia's per capita GDP, after adding the assumed Balassa-Samuelson real appreciation, grows at 5.7%. This means that Russian GDP would triple from $310 billion (€346 bn) in 2001 to $940 billion (in 2001 dollars) by 2022. In 2001, Russian GDP corresponded to 5.1% of euro-area GDP. If we assume conservatively that the current euro-area GDP grows at 2% pa in constant dollars, Russian GDP would reach 10.4% of euro-area GDP in 2022. While this would make Russia a more important trading partner for the euro area and the EU as a whole, even in the optimistic scenario Russia's aggregate economic weight remains modest.

In the pessimistic scenario, with no real appreciation, no catching up occurs. Almost the same result is obtained in the baseline case, particularly if euro-area growth is slightly higher than assumed above. Clearly, President Putin's 1999 worry remains very topical, but even optimistic assumptions are unable to deliver the growth that he says Russia needs.

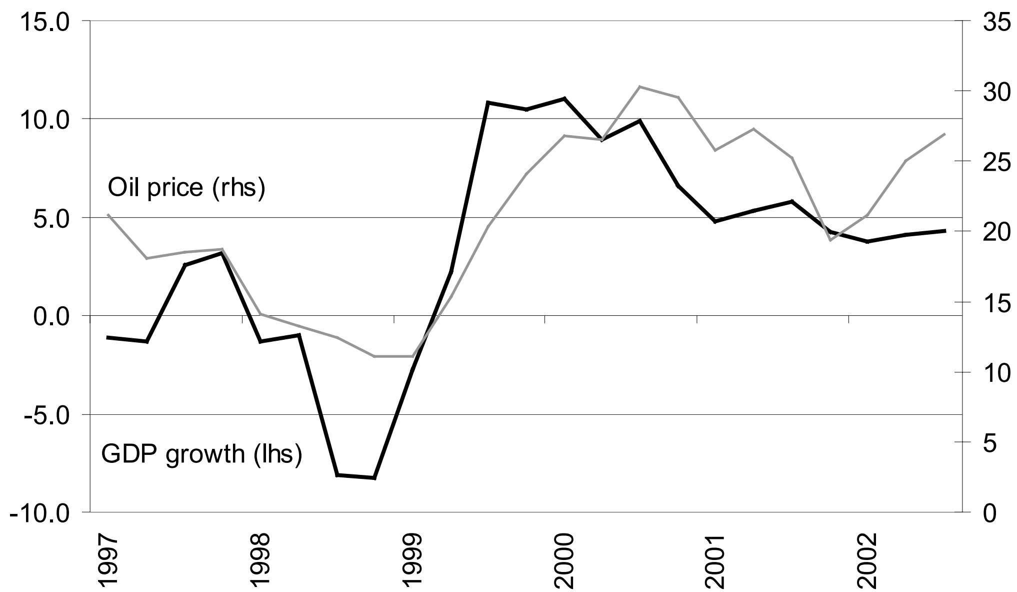
3 Oil prices and real exchange rate condition growth

If investment is the key to Russian long-run growth, what is the importance of oil dependence in the short-to-medium run? How stable can future growth be? Dramatic changes took place in the Russian economy in the 1990s. Today, Russia has become a market economy, many enterprises have adapted to the new circumstance and, unlike in the 1990s, economic policies contribute to stability and predictability. Important reform legislation has been passed, if not fully implemented. Even so, we now argue that export prices and the exchange rate remain crucial determinants of growth.

The issue is a hot one. Sources close to President Putin repeatedly claim that lower oil prices will not affect GDP growth. It has been pointed out that the role of domestic factors has grown due to reforms, and, as oil and gas only account for 7% of GDP, they are unlikely to move the whole economy. It has been argued that, with the stabilisation of the macroeconomic climate, Russia has finally broken its reliance on oil, and that the country is no longer go governed by a cycle of boom and bust according to international oil price fluctuations.[5]

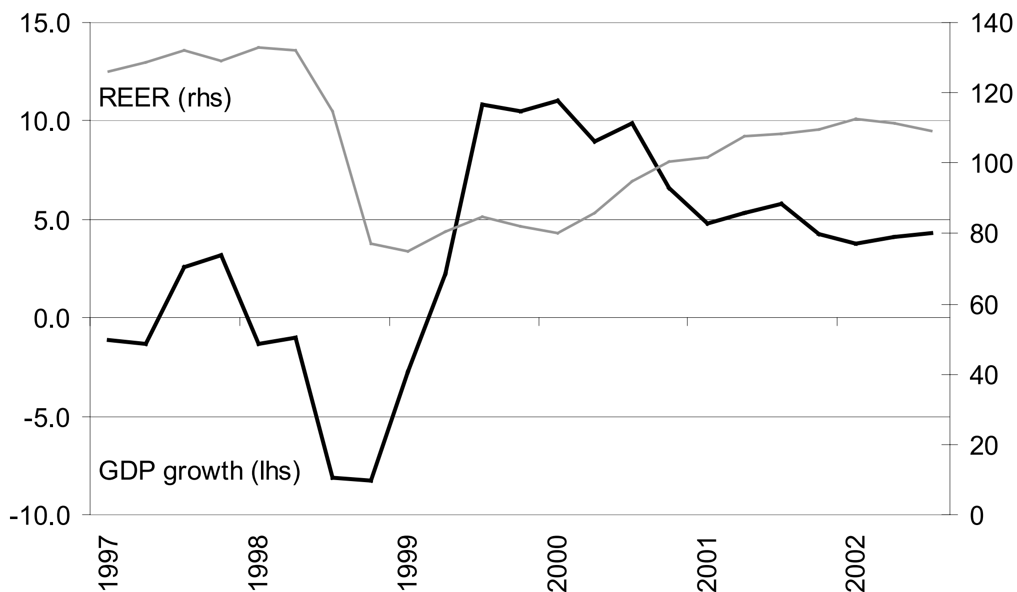
[5] See Ben Aris, "Weaning Off the Barrel", Moscow Times, June 3, 2002. Another view states that lower international oil prices are actually good for Russia as they force progress in reforms. Although it might be true, we forego discussion of this political economy argument here.

Chart 2. Russian GDP growth (% pa) and international oil price (Brent oil, US$/bbl)



Source: Goskomstat, IMF (IFS)

Chart 3. Russian annual GDP growth (%) and the real exchange rate of the rouble (1995=100)



Source: Goskomstat, IMF (IFS)

However, this view of stable growth remains a minority opinion. The prevailing view, i.e. that Russia's economy and fiscal situation are crucially tied to oil prices and the exchange rate, is bolstered by the several facts. First, Russia's exports corresponded to about one-third of GDP in 2001. As no major new export items have emerged, the structure of Russia's exports remains traditional, i.e. roughly half of export revenue comes from energy (mainly crude oil and gas). Second, the federal budget is heavily dependent on energy prices as revenues from the energy sector account for 30-40% of the central government's total revenue. Finally, the energy sector has accounted for about half of all industrial investments in recent years and, hence, it is unlikely that Russia's industrial structure will soon diversify significantly.

There is surprisingly little research on how oil prices affects Russian macroeconomic dynamics. Most arguments only examine the impact of crude oil price on exports or fiscal revenues. A shortcoming of most of these analyses is that they assume GDP development rather than estimate GDP in a model that explicitly accounts for output changes from a terms-of-trade shock.

Rautava (2002) recently investigated the combined effects of exchange rate and oil prices. His findings indicate that both international oil prices and the real exchange rate not only continue to play major roles in the Russian economy, but that their impact may even be stronger than generally acknowledged. There is a relatively stable relationship between international oil prices, real exchange rate and GDP. A 10% permanent increase (decrease) in the level of oil prices causes the level of GDP to increase (decrease) by 2.2%. On the other hand, a permanent 10% real exchange rate appreciation (depreciation) is associated with a 2.4% decrease (increase) in GDP in the long run.

The impact of oil prices on government revenues is naturally stronger as oil prices affect revenues both directly and indirectly through output. And even stronger effects are achieved when oil prices are replaced with an index of commodity (including energy) prices.

Moreover, this study finds no evidence to support the view that the impact of oil prices on Russia's output and fiscal revenue has weakened in recent years. While the impact of oil prices on output might, in principle, be balanced by changes in the real exchange rate, this possibility does not depreciate Russia's vital interest in stable prices for oil and other raw materials. In particular, these results offer no evidence that Russia should somehow be content with its achieved level of reforms or current structure of its economy. Russia can still be characterised as a dual economy, so its export and fiscal revenue, real exchange rate and production remain inherently unstable.

4 Russian financial system does not support economic growth

Russian economy remains dependent on oil and other raw material production partly because of its underdeveloped financial system. There is no system to channel domestic and foreign savings into investment, no risk-management instruments and few ways for new private enterprises to raise capital. As a result, nearly all investment is financed from retained earnings. Only 3 - 4% of financing comes in the form of bank loans, and almost nothing from initial public offerings. Dependence on retained earnings is typical of

transition economies (Krkoska 2002), but the Russian case is extreme. Higher growth requires more investment, and investment requires financial intermediation.[6]

More telling, perhaps, is the relative scarcity of small and medium-size enterprises (SMEs). A major World Bank (2002a) study concludes that SMEs must reach a threshold of 40% of total employment to become the engine of national economic growth. In Russia, this share has stagnated at 20%. The expansion of new enterprises would benefit greatly if bank loans were available. Several empirical studies confirm that development of the financial system (efficient banking sector and liquid financial markets) promotes economic growth.[7] The recent crises in emerging markets further indicate how an underdeveloped financial system may cause financial crises and deep economic recessions.

Given this situation, it is indeed strange that until very recently a strong block of Russian opinion held that post-1999 growth proved Russia does not really need financial intermediation, because investment financed from retained earnings or transfers inside major multi-industry conglomerates was sufficient. Of course, this view neatly ignores the corollary that most of Russia's industrial investment is either in, or adjunct to, the energy sector, and which tends, therefore, to freeze Russia's traditional production structure.

The Russian banking sector remains small and affords little potential for financial intermediation. Total sector assets amount to just $103 billion, or about 35% of GDP. Corresponding figures are over 100% for the Czech Republic, over 70% for Estonia and about 60% for Poland. Lending to the private sector is also very modest: about 15% of GDP. Moreover, the short maturities of most bank liabilities limits credit expansion.

Thus, while other economic reforms have moved ahead recently, there is a conspicuous absence of banking reform. Russian banks can still use accounting standards that do not accurately portray asset quality. Because of low minimum capital requirements, Russia still has over 1,300 banks, the sheer number of which hinders efficient banking supervision. In addition, the Central Bank of Russia (CBR) operates both as banking supervisor and owner of major banks. Sberbank holds more than 70% of household deposits. It is majority owned by the CBR, and deposits are state guaranteed. There is little foreign investment in the sector.

Most observers generally agree on the list of needed reforms. These include implementation of higher minimum capital requirement, use of internationally accepted accounting standards and practices, improvements in banking supervision, clarification of the role of state banks and introduction of a guarantee for retail deposits. Opinions differ on the possible speed of progress. The CBR has embraced banking reform, while emphasising that excessive speed might endanger financial stability. More stringent banking supervision, international accounting standards and higher minimum capital requirement should be in place by 2004, as well as a deposit guarantee by 2005. Meanwhile, markets will closely follow the handling of state banks' ownership.

[6] The recent growth in Russia has been based primarily on higher capacity utilisation ratios, but such growth can hardly continue. The average age of equipment in industry is reaching 20 years. Capacity utilisation ratios are already quite high in many industries (World Bank 2002b).

[7] There is some discussion of whether financial intermediary development accelerates economic growth via higher saving and investment rates or via higher total factor productivity. In transition countries the efficiency of the financial system, indicated by a narrow interest rate spread and low level of non-performing loans, would be particularly important for economic growth (Koivu 2002, Drakos 2002). Levine et al (2000) argue that legal and accounting reforms that strengthen creditor rights, contract enforcement and accounting praxis can boost financial intermediation and accelerate economic growth.

Russian banks have recently begun to show improved performance. Total banking assets, aggregate bank capital and lending to the private sector now exceed pre-crisis levels. Russian equity and bond markets have also shown clear signs of recovery. Between January 2001 and May 2002, equity markets rose 180% (then declined somewhat). During the post-crisis period (specifically, since December 2000), 14 large enterprises and banks, the city of Moscow and Yamalo-Nenetsk region successfully issued new international bonds (Troika Dialog 2002). Although these developments do not represent large-scale capital inflows, they demonstrate improvements in investor sentiment and greater functionality of Russian financial markets.

Financial markets not only enable enterprises to acquire capital, they also create possibilities to diversify ownership of Russian enterprises. This is particularly important since many Russian enterprises are still owned by their managers and employees, i.e. no participation of outside capital or know-how. Access to financial markets is no longer limited to the very largest raw materials and energy companies. The next echelon of enterprises can now get access, as shown by the NYSE listing of a foodstuff enterprise, Wimm Bill Dann, in February 2002, which resulted in 23% of the enterprise being sold to foreign investors. This represents a continuation of a trend of listing and selling partial stakes in Russian enterprises to outside investors that began in 1996-1997, but was interrupted by the 1998 crisis.

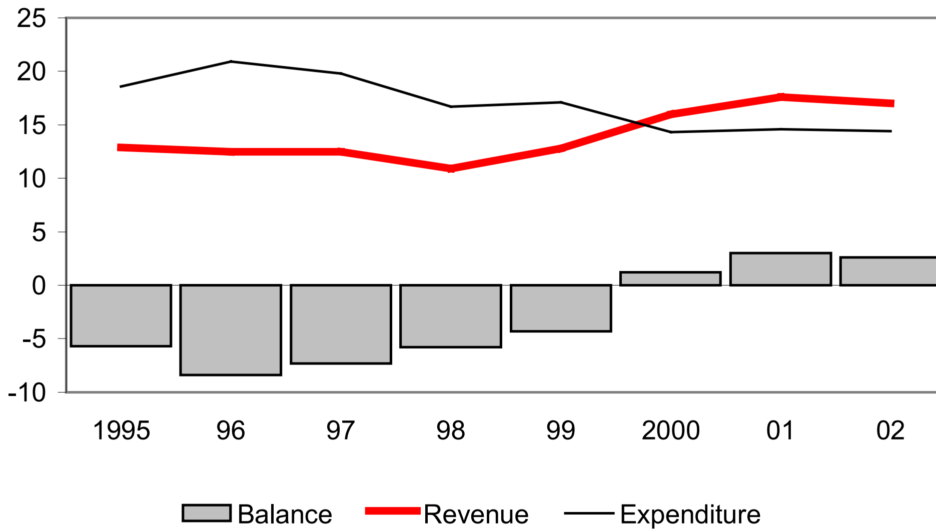
In the end, growth is generated by enterprises, where corporate control plays a key role. How keen Russian managers and owners really are to opening up enterprise ownership remains to be seen. Russia has experienced several instances of abuse of minority shareholder rights. If continued, such practices will threaten both efficient corporate control and development of financial markets. Here, the Russian authorities have a role in strengthening laws, supervision and the court system.

5 Constrained by a debt burden?

The bottoming out of decline and return to growth in 1997 was cut short by the 1998 financial crisis. This crisis was caused by persistent fiscal deficits financed by short-term government debt (GKOs), which rendered the country vulnerable to crisis. In the wake of the Asian crisis, interest rates increased to the point where it was clear Russian indebtedness was unsustainable (Korhonen 1998, Komulainen 1999). Moreover, many banks had large, essentially uncovered, currency risks. No similar crisis is presently on the horizon, as there is a budget surplus (Chart 4), public debt has decreased and banks have become more risk-averse.

Servicing foreign debt obligations has shadowed Russia's economic transition. Although rising, conventional debt indicators of external vulnerability were quite modest before the 1998 crisis. The federal-debt-to-GDP ratio stood at about 50% and the federal-foreign-currency-debt-to-exports ratio at around 120% (Chart 5). With federal-debt-to-budget revenues lodged at around 400%, debt serving became impossible (Chart 6). Russia has consistently serviced its new debt (apart from the 1998 moratorium), while its inherited Soviet-era debt has been repeatedly rescheduled.

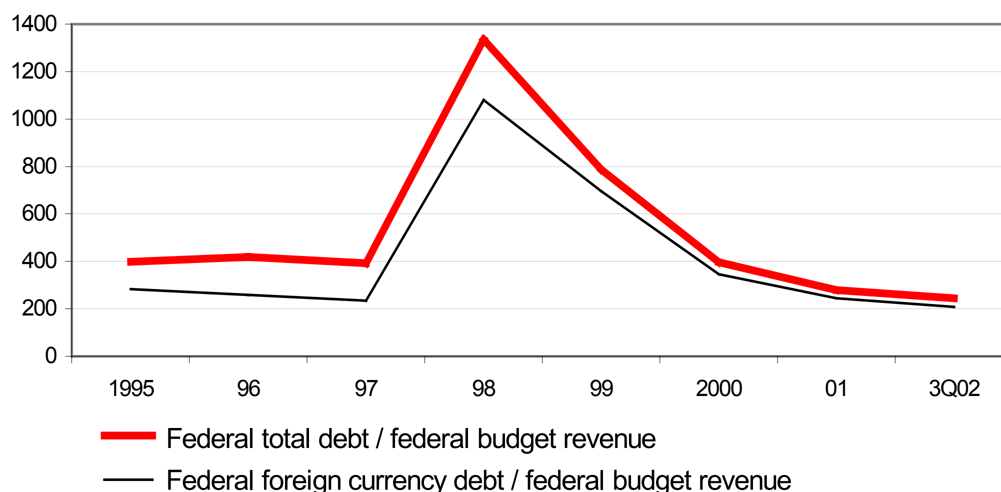
Chart 4. Federal government budget, % of GDP



Source: IMF and Economic Expert Group

Chart 5. Russian federal government debts, % of GDP and export revenue

Chart 6. Federal government debt, % of budget revenue



Source: Russian government, CBR, BOFIT

After the crisis, debt ratios began to decline along with the rapid revival of the economy, appreciation of the real exchange rate, improved budget revenue performance, absence of government borrowing, debt repayments and, in 2000, the partial write-off of Soviet-era debt by the London Club of creditor banks. Since the government made its unsuccessful attempt in early 2001 at a rescheduling of Soviet-era debt owed to the Paris Club of official creditors, debt servicing has been on track.[8]

Russia's basic debt ratios are now lower than before the 1998 crisis, with the federal-debt-to-GDP ratio at 43% (October 1, 2002). Moreover, the federal foreign currency debt has declined from about $150 billion two years ago to below $120 billion (36% of GDP), including the less than $110 billion owed to non-residents. The government foresees a further decrease of its foreign currency debt to about $110 billion (around 30% of GDP) by end-2003. Federal debt to budget revenues still exceeds 230%, but during the 1998 crisis it was around 1,300 – 1,400% (Chart 6). In contrast to 1997-1998, the amount of short-term debt, which could potentially flee if the situation turned sour, is currently small in Russia.

Concern has been expressed as to the government's capacity to service its foreign debt at its peak in 2003. The projected peak was lowered slightly last winter as government-controlled banks reportedly repurchased debt. The government currently calculates that its foreign debt servicing payments will rise from $14 billion in 2001 and 2002 to $17 billion this year, which implies that the ratio of debt repayments and interest payments to budget revenue will (on a comparable revenue basis) increase from 24-25% to an expected 28%.

Will there be a debt-servicing problem this year? In 2002 Russia started to gather a financial reserves fund, partly for these debt payments. When revenues from large privatisation deals made at the end of 2002 are received, the size of the reserves will reach over $8 billion. The 2003 budget also assumes a quite cautious average oil price of $21.50 per barrel (Urals) and economic growth of 4%, while ca. $18.50 per barrel would balance

[8] Russia and some Paris Club members recently agreed on rearranging the debt and payment of part of the debt in kind.

budget revenue and expenditure.[9] At a lower oil price the government is likely to follow its 2002 budget practice of making some expenditure conditional on the oil price. To fill the possible financing gap the government is in principle ready to increase borrowing on the domestic market from the amounts laid down in the 2003 budget. Unless Russia and the international financial markets were sufficiently drawn to one another at even lower levels of the oil price, this would imply turning to other sources for extra financing, like CBR (which now has sufficient foreign reserves to cover seven months worth of imports and 80% of rouble M2) and IMF. Thus, most analysts do not expect Russia will have a debt-servicing problem this year.

6 Conclusion: Russia in the world of the future

Russia's growth since 1999 has been based on undervaluation of its currency and high export prices, as well as reasonable macroeconomic stability and enterprise adaptation to the market economy. To tip the balance in favour of sustainable growth, Russian authorities have pursued reform legislation that is wider, more ambitious and more relevant than most observers thought possible two years ago. Highly relevant legislation has ranged from property rights via taxation to enterprise entry and exit – and the reform program continues. Among the issues currently on deck are further property right reforms (for land and forests), public sector reform, financial sector reform and various aspects of the enterprise environment.

Impressive as reform legislation has been, however, it has not occurred as rapidly as originally planned, and there is still little evidence of implementation.[10] Analysts already detect the first signs of reform fatigue in the run-up to Duma and presidential elections in 2003 – 2004. Many of the remaining reforms would hurt the immediate interests of large numbers of voters.

Although countries with favourable initial conditions benefited during the early years of transition, current research concludes (World Bank 2002a) that over time good policies have become increasingly important in explaining differences in growth performance in post-socialist economies. One explanation as to why some countries pursued better policies than others is the presence or absence of an external anchor. While Central European and Baltic countries saw that the essence of change was "a return to Europe," post-Soviet states had no such generally shared goal. Therefore, policies tended to be inconsistent and focused on short-term considerations. The remaining issue in assessing Russia's growth prospects is whether the newly strengthened intent to join the international community, politically and possibly economically, will provide such an anchor.

The programs of international financial institutions were surprisingly weak in the case of such a politically important client as Russia (for an insider account, see Talbott 2002; for analysis, see Stone, 2002). Currently, Russia does not need IMF finance and is intent to cut back on participation in World Bank programs. The Partnership and Co-

[9] The world market price of oil has a major impact on budget revenue. A one-dollar-per-barrel change in oil price results in a budget revenue change of roughly a billion dollars, i.e. almost 2% of the budget. Uncertainties also relate to other items below the budget balance line: privatisation revenue, possible sale of state metals reserves, and financing from domestic and international financial markets.

[10] It is unclear whether the 2001 introduction of a flat income tax really led to realisation of the Laffer Curve ideal or whether establishing new enterprises has become easier.

operation Agreement (PCA) with the EU, signed in 1994 and inaugurated in 1997, created an institutional framework for cooperation and opened up the prospect of free trade, but could never act as a policy anchor for Russia. President Putin has repeatedly announced that Russia should unilaterally choose to approximate (appropriate) *acquis communautaire*, but whether there are sufficient incentives for that to become an overriding policy goal remains to be seen. Russia and the EU have outlined an idea of a Common European Economic Space; presumably combining the prospect of free trade with the aim of unilateral approximation of *acquis*, but this idea remains an abstraction. For China, WTO accession was an important policy anchor. Russian accession negotiations are also underway, but there seems to be little willingness to look for workable compromises on key issues. There has been progress in negotiations recently, but if the deadline of autumn 2003 WTO meeting is missed, accession may be postponed for several years.

A lesson of the 1990s was that the impact of the international community on Russian developments is weak at best. Therefore, regardless of whether one sees Putin's foreign and security policy as searching for external stability or seeking to join the international community, the correct policy remains to strengthen the Russians' confidence in the future of their society through an approach of "trust and verify" (Vogel 2002). This means trust in Russia's willingness to integrate fully with the global economy, and verification by not allowing a lowering of standards and requirements.

The factors limiting Russia's ability to integrate into the European economy are largely the same as the ones limiting its growth potential. Some of these were noted above. Russia has a productive structure skewed towards basic commodities. It is unable to produce competitive manufactures and services. Export and fiscal revenue, as well as the real exchange rate and production, remain unstable. There is also an organisational structure weighted towards a small number of multi-branch conglomerates and a few small enterprises. This tends to create an oligarchic and unequal social structure and distribution of welfare.

Badly needed financial intermediation is improving only slowly. Russia inherited a number of potentially extremely serious long-term economic, social, technological and other trends of deterioration and decline, which, in most cases, worsened in the 1990s. The country also has a political structure in which a very thin reform- and internationally minded leadership is imposing change through an often slovenly bureaucracy upon a population where the willingness to change is quite unevenly distributed.

Rapid long-term growth will not be possible in Russia, because the investment ratio and financial intermediation will remain low. Moreover, an economy heavily dependent on raw material prices is prone to large economic fluctuations. Thus, Russia could well remain a relatively poor economy facing a plethora of challenges. Assuming slow growth relative to its needs, Russia's challenge will be that of trying to make the best use of slowly increasing resources in an environment where changes in international oil prices may bring about major policy problems. However, there is no crisis similar to 1998 on the horizon and no debt service problem this year.

There will be a slowing of reform legislation and implementation as the twin elections of 2003 - 2004 draw closer, but Russia's fiscal and balance-of-payments position is strong enough to carry it through these years, at least until change will hopefully accelerate again.

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