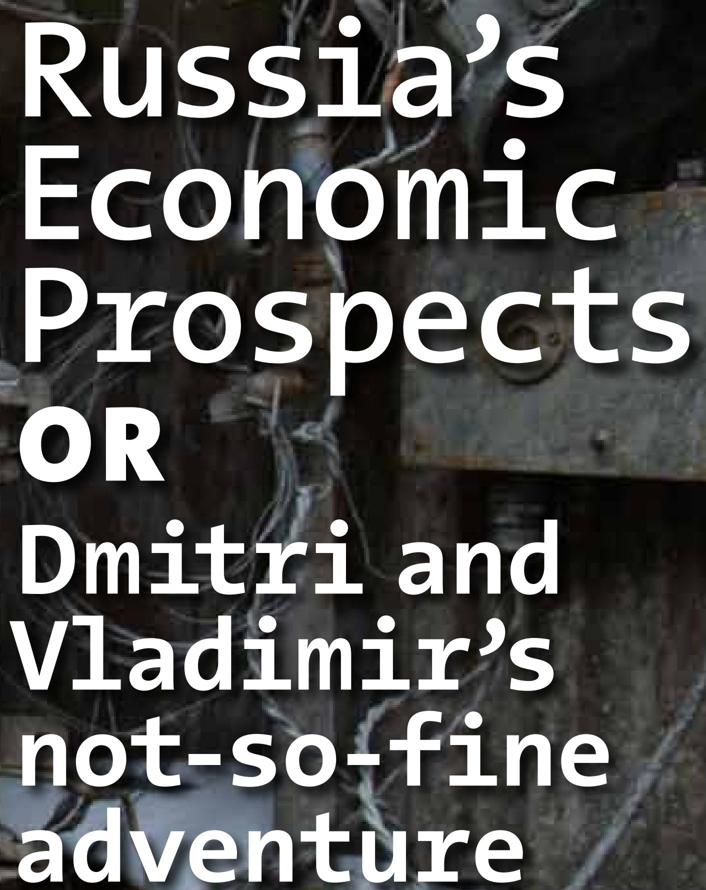

Russia's Economic Prospects **OR** Dmitri and Vladimir's not-so-fine adventure

BY ROBERT LOONEY

In the decade bookended by the collapse of the ruble in August 1998 and the global economic crisis in 2008, Russia enjoyed the fastest growth in its history. Real GDP doubled in just 10 years, and while this still left the country far behind the West in living standards, the growth spurt raised hopes that Russia was finally putting the Soviet past behind it. Declines in unemployment and poverty complemented rising productivity, near-Asian rates of investment and a balanced government budget. Meanwhile, years of current account surpluses permitted the accumulation of some $600 billion in foreign currency reserves to protect the economy from the sort of crisis that laid it low in 1998.

In the spring of 2008, the polity voted for continuity by naming Dmitri Medvedev, Vladimir Putin's chosen successor, as the new president. Medvedev promptly returned the favor by naming Putin prime minister. But the impression that Russia was over the hump was shattered in the fall of 2008. Few countries seemed as unprepared to cope with the global financial crisis. And in August 2009, Medvedev belatedly acknowledged that the path taken over the decade offered little hope of sustained growth – that business as usual would lead to an economic dead end.

Why so stunning a reversal of perceived fortunes? More important, what does the reversal say about the long-term prospects of this perplexing nation, which challenged the hegemony of the West for half a century and still remains a geopolitical player by virtue of its abundant natural resources, vast nuclear arsenal and imperial pretentions?

WOUNDED BEAR

With hindsight, it's plain that the sources of Russia's current economic woes go beyond the global crisis. Investors (domestic and foreign) proved to be far less willing to stick by Russia than might have been expected. In July 2008, Putin chose to attack Mechel, the giant metal and mining conglomerate, for alleged price gouging in domestic markets, suggesting that the company would soon feel the boot of state power for its errors. The value of Mechel's stock plummeted 38 percent overnight.

More significant, the price of oil peaked in July at $147 a barrel and headed south quickly, raising fears about Russia's ability to chart its own course. Then, in August, Russia and Georgia fought a brief war that ignited passions in the cause of an ethnic satellite group, worrying analysts that Putin had resorted to waving the bloody shirt in an effort to distract Russians from the economy's problems. The stock market imploded in slow motion, falling by three-quarters over the next six months. Even the value of Gazprom, Russia's high-profile natural gas monopoly and the largest company in the nation, dropped 74 percent.

With the cost of capital soaring, the real economy slipped into free fall. From January to July 2009, industrial output declined at an annualized rate of 14 percent, and GNP fell at a 10 percent rate. Officially measured unemployment reached 8.3 percent by mid-2009, up from 5.6 percent before the crisis.

THERE'S NO THERE THERE

For some time after the crisis hit, Putin maintained that Russia's economic fundamentals remained sound and that its problems were simply the consequence of the greater global malaise. But analysts pointed to what now seems obvious: Growth built on a commodity price boom is a house of cards. During the decade, oil and gas had accounted for 40 percent of budget revenues and two-thirds of export earnings. Once energy prices returned to earth, the Russian economy's daunting structural deficiencies were exposed for all to see.

The private financial system was woefully inefficient and laced with corruption. Much of the capital for investment was coming from foreigners rather than Russia's immensely wealthy elite – and one-third of that investment was plowed into oil and gas ventures. By no coincidence, Russian banks and industrial corporations were excessively leveraged, doing business almost entirely with other people's money.

A variety of missteps by the central bank exacerbated the economy's immediate problems. The decision to slow the growth of the money supply in the name of fighting inflation reduced the liquidity of both the financial and industrial sectors on the eve of the crisis. Moreover, the government central bank

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had allowed energy export revenues to increase the effective exchange rate of the ruble by 145 percent since 2001, undermining efforts to build markets for Russian exports other than oil and gas.

But the deepest, most troubling problems revealed by the crisis – the problems that resist straightforward solutions – are related to Russia's political and economic cultures.

The Bad Old Ways

Even as the economy was triumphantly recovering from the 1998 crisis, Russia was brushing aside nascent democratic institutions and increasing state control over the economy. The World Bank's Governance Index measures these trends by tracking six factors. And few countries that fare badly on the index manage sustained growth.

In *voice and accountability*, a broad measure of democratic attainment, Russia scored in the 35th percentile among all countries in 1998 and slipped to the 22nd percentile in 2009. In contrast, Brazil, China and India (which with Russia make up the up-and-coming bloc of large developing countries known as BRIC) managed scores in the 40s. Russia tallied a 24th percentile ranking in *political stability*; by comparison, the non-Russian BRICs were all in the mid-30s.

Although Russia posted a respectable 51st percentile in *government effectiveness* in 2003, it was plainly heading the wrong way: the figure was down to the 45th percentile in 2008. (The other BRICs maintained scores in the high 50s.) Similarly, nascent reforms in *regulatory quality* pushed Russia from the 19th percentile in 2000 when Putin took the reins of government from Boris Yeltsin, to the 47th percentile in 2003. But by the time Putin left the presidency, the figure had retreated to the 31st percentile.

Russia's performance in *rule of law* has been a particular embarrassment: the country scored a miserable 20th percentile in 2008, compared with a 49th percentile average for the other BRICs. By the same token, Russia is lagging miserably in *control of corruption*, ending up in the 15th percentile, versus 48th for the other BRICs.

Lack of progress in the quality of governance has had the expected consequences. The Heritage House Index of Economic Freedom – an ideologically charged source to be sure, but one that offers insights into the efficiency of economies – is indicative. By Heritage's reckoning, Russia ranked 146 out of 179 countries in 2009, trailing such stalwarts of economic freedom as Vietnam, Ethiopia and Burkina Faso. Likewise, Russia ranked a mere 58th out of 122 countries on the Milken Institute Capital Access Index in 2008, behind Peru, Egypt and Belarus.

Why did the development of Russian institutions lag so badly behind the growth numbers? Two reasons:

- The oil and gas boom, which ironically undercut incentives to improve governance and reduce corruption, undermined balanced economic development.
- Vladimir Putin's willingness to sacrifice medium-term growth prospects to bolster his own power and to increase Russia's resilience to short-term currency shocks.

The Curse of Oil

Study after study has found that economies underpinned by energy exports are unlikely to sustain growth once prices decline. One reason is that a surfeit of cash during the boom reduces the government's will to exact taxes – and thus the need to earn citizen sup-

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port by providing valued services and effective economic management. Instead, oil-based wealth tends to create an implicit social contract in which state-provided welfare is substituted for political rights. By the same token, all that easy money is an invitation to corruption (public and private), further undermining incentives to deliver good government at minimum cost.

Dependence on resource exports, it's worth noting, damages economies in more direct ways, through a mechanism that economists call "Dutch disease" after the experience of the Netherlands during its natural gas boom in the early 1960s. Bountiful earnings from energy (at least during periods of high commodity prices) tend to increase the exchange value of a nation's currency, making it more difficult for exporters of other goods and services to compete both at home and abroad. And Russia certainly fits the description: The world's largest exporter of natural gas and second largest exporter of oil has failed miserably to build world-class manufacturing and service sectors.

Putinism

A casual observer might assume that Putin is working from Deng Xiaoping's template, attempting to build an advanced free-market economy without giving up his monopoly on political authority. But while the Russian leader no doubt envies China's success, he is hardly managing the economy on the Chinese model. Indeed, Putinomics seems based on an unusual strategy (in recent decades, anyway)

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of keeping a largely privatized economy on a short leash, offering little prospect of better governance or high productivity, which typically evolves organically from decentralized markets and open economic competition.

Putin's strategy is, in part, a reaction to the currency crisis of 1998, in which Russia found itself at the mercy of foreign creditors. To avoid such dependence in the future, private enterprise must defer in choosing between profit maximization in risky global markets and the broad interests of the motherland – as interpreted by the Kremlin.

Like the CEO of a large corporation, Putin apparently sees himself free to change the operations of subsidiaries and to fire operating managers who fail to meet his expectations.

An obvious question here is why Putin bothers with the facade of capitalism. Why not just go back to government ownership and Soviet-style planning? Clifford Gaddy, an economist at the Brookings Institution, argues that Putin sees himself as a corporatist rather than a socialist – that he is the chief executive of Russia Inc., not the chief functionary of a centrally planned economy. The goal is to keep the economy on a course broadly mapped by the government, but to leave the operations to the private sector in order to avoid the wretched inefficiency characteristic of state ownership.

Like the CEO of a large corporation, Putin apparently sees himself free to change the operations of subsidiaries and to fire operating managers who fail to meet his expectations. So while Russia remains a nation of laws on paper, control of the private sector is based less on formal regulation than on extralegal threats – as in, "we can dismantle your company just as we did Yukos," the giant oil company that was buried under a blizzard of tax claims and criminal prosecutions in 2004 to 2006.

In an environment of minimal economic freedom, no real protection under the law and immense oil revenues, the owners of large enterprises were presented with a unique ultimatum: You can keep your properties if you make them productive. Of course, you must also be prepared to share your wealth with the government and with other private parties favored by the government. Last but hardly least, you must defer on strategic decisions that could affect Putin's power or Russia's interests as interpreted by the Kremlin.

Once Putin consolidated authority, the way the strategy would work in practice became clearer. The government took advantage of the oil boom to pay off its foreign debts. And it consolidated its grip over business, demanding an increased share of the earnings of raw material exporters, which were reaping the fruits of the broader global commodity boom. The government thereby accumulated a vast war chest, with $200 billion set aside to support domestic investment and to sustain the Kremlin's power to reward compliant businesses. Most of the accumulated reserves, it should be noted, were held as the short-term debt of Western governments – an effort, presumably, to give the government clout in central banking circles and to contain the ravages of currency appreciation (i.e., Dutch disease). This, ironically, opened up a large market for Western investors to supply capital to Russian businesses suffering from a shortage of domestic credit.

The Kremlin judged Western financial institutions to be better at finding productive

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uses for capital than their inefficient Russian counterparts. The government's apparent intent was to use foreign banks to provide financial intermediation services on the basis of free-market principles rather than have the country's wealth frittered away through corruption and ineptitude.

For a time, the result was rapid growth, reduced unemployment and fiscal stability as envisioned in Putin's Russia Inc. model. However, when oil revenues dropped and private capital inflows atrophied, the consequences of this odd hybrid economic strategy became all too apparent.

Russia had, in effect, wasted a decade in which reform might have made the domestic financial system more efficient and resilient to external shocks. With the loss of access to private credit, domestic or foreign, during the global crisis, only the state had the resources to support demand. And while the government possessed humongous financial resources and wielded unchecked authority, it lacked the competence to implement an effective stabilization plan. As a result, the country's economic contraction has been much greater than that of most countries.

The effect on Russia's growth prospects became increasingly apparent once the oil-price declines of late 2008 stripped away the facade of success. The government had focused disproportionate wealth and attention on the big conglomerates that it could and did control. In the process, it had neglected small- and medium-sized enterprises – or, more to the point, it had neglected the reforms of private capital markets and the legal system that were needed to fertilize the ground for their growth. This reality is particularly ominous, since smaller firms have played a leading role in the transition of the more successful former Soviet economies of Central and Eastern Europe.

WHAT NEXT?

Winston Churchill's characterization in 1939 of Russia as "a riddle, wrapped in a mystery,

inside an enigma" may not quite apply today. Still, the economy's future remains exceptionally difficult to predict. It continues to be tied to the vagaries of the global market for oil, natural gas and other raw materials – but not in straightforward ways. On the one hand, high commodity prices would provide the revenue needed for fiscal and social stability in the near term, as well as the means to invest in long-delayed infrastructure and industrial modernization. On the other, it would sustain Putin's vision of Russia Inc. – a vision that most economists (and perhaps Russia's current president) believe will inhibit the evolution of the sorts of institutions needed for balanced long-term growth.

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The Russian government began to lay out a course for the country in the summer of 2006, when it put forth the preliminary designs of its Strategy 2020 program. The plan, formally adopted in November 2008, acknowledged the adverse consequences of living on the oil-price roller coaster and the need for greater economic diversity nurtured by market-friendly institutions. But it was more a wish list than a practical plan for economic development.

Strategy 2020 imagined a handful of situations. The favored "innovation scenario" anticipated growth rates in the 6 to 7 percent range. This course presupposed far-reaching market and governance reforms and human capital initiatives – developments that would require high oil prices that recent history suggests are inconsistent with the painful process of subjecting business to competitive pressures, rooting out corruption and delivering government services efficiently. Similarly, the government's "inertia scenario" assumes that 3.9 percent growth would be possible without significant reforms – a prospect few neutral observers think is plausible without oil prices above $75 per barrel.

Equally problematic, the model was based on unrealistic demographic assumptions. The country is rapidly aging thanks to exceptionally low birth rates, and the total population is actually declining because death rates are very high for a middle-income country. Fewer young people are entering the labor market, while widespread health problems make it difficult to extend the productive life of workers. Nonetheless, the model assumes a stable population and work force – rosy projections for an economy that almost certainly faces a future of both chronic labor shortages and high dependency rates that will overwhelm the pension system.

So, what future is consistent with reality? The country's reserves of oil and gas represent

a huge patrimony, albeit one that complicates economic development. But many of its oil and gas fields are quite mature, implying that sustaining very high levels of production will require enormous investments along with the application of sophisticated Western technology. Meanwhile, the Kremlin's lack of respect for the rule of law and willingness to use natural gas exports for geopolitical leverage has alienated foreign investors and led Europe to rethink its dependence on Russian energy.

On the liability side of the growth equation, Russia has inherited an industrial black hole from the Soviet era: hopelessly inefficient manufacturing and distribution systems, an environmental toxin load that threatens public health, and a managerial culture out of touch with modern business practices. More generally, it lacks many of the intangible cultural assets found in rapidly developing economies, not least of which is confidence that hard work and investment in human capital will lead to a better world for the next generation.

In this context, one might imagine a variety of plausible futures. The most ominous for Russia (and the rest of the world) would be a retreat to ultranationalism along with a drive for autarky that insulates the ruling interests from economic failure and manages internal discontent with a mix of authoritarianism and the distractions of a pugnacious foreign policy. Arguably, a more likely scenario, at least in the medium run, is another try at Putin's Russia Inc. model. In its most optimistic incarnation, the state would enhance its role in social protection, prop up compliant enterprises and invest heavily in modernizing industrial capacity while keeping the lid on corruption and the grossest abuses of state power that alienate foreign partners. Perhaps this would allow Russia to muddle through, provided energy prices behave.

There is a more optimistic third possibility, though, one associated with Medvedev's asserting his own technocratic instincts. The president has called for more political competition, tougher measures to combat corruption and limits on the centralization of economic power, while openly acknowledging that "we haven't done anything in the last 10 years because oil kept rushing higher and higher." A cynic might conclude that Medvedev is simply playing the good cop to Putin's bad cop, giving the Kremlin a convenient way to tack toward liberalism when foreign investors or unhappy domestic interests must be pacified. But cynical or not, it suggests a pragmatic flexibility, offering hope that when Russia Inc. fails, the ruling elite will shift toward decentralized markets and political pluralism rather than retreating toward Russia's familiar authoritarianism.

It now seems naïve that we ever expected Russia to erase centuries of misrule and decades of economic stagnation so easily.

After the collapse of the Soviet Union, it was widely hoped that "shock therapy" in the form of the overnight adoption of the trappings of pluralism and capitalism – free elections, wholesale privatization – would quickly yield fruit. With hindsight, it now seems naïve that we ever expected Russia to erase centuries of misrule and decades of economic stagnation so easily. But, by the same token, the fact that the dream was largely unfulfilled doesn't imply that incremental progress is impossible.

In short, the game is not over.