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## Russia's Economic Revival: Past Recovery, Future Challenges

The Russian economy has gone through turmoil during the last two decades. In the 1980s the Soviet economy suffered from stagnation (although official statistics embellished the data), and in 1989–91, the Soviet economic system collapsed. Russia's GDP officially plummeted by 44 percent until 1998.<sup>1</sup> The real decline, however, was probably only half that, because an extensive unregistered economy developed after socialism.<sup>2</sup> From 1999 to 2007, the Russian economy grew rapidly by an average of 7 percent a year. But the global financial crisis has hit Russia hard. In 2008 growth slowed to 5.6 percent and even started falling in December. The question once again is, for how long and by how much will Russia's output fall?

Yet Russia today is vastly different from the country that was forced to devalue its currency and default on foreign obligations a decade ago. In 1998 the World Bank estimated that about 30 percent of Russia's population lived at or below the poverty line. By 2007 that number had fallen to less than 14 percent. Russians today are accustomed to traveling freely abroad and have a greater stake in an open, free market economy. Wealth has changed much, but many institutions remain unreformed.

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1. United Nations Economic Commission for Europe, *Economic Survey of Europe*, no. 2 (2004): 80.

2. Anders Åslund, *Building Capitalism: The Transformation of the Former Soviet Bloc* (New York: Cambridge University Press, 2001, chapter 4); Simon Johnson, Daniel Kaufmann, and Andrei Shleifer, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity* 27, no. 2 (1997): 183.

This chapter assesses Russia's recent economic achievements and the government's goals for 2020. The old sources of economic growth have faded. What are the sources of Russia's renewed economic growth? What are the current challenges? Is Russia prepared to face them? Will it respond with the necessary reforms to face the challenges of less advantageous economic conditions? What are the potential outcomes?

## Russia's Rising Economic Significance

In the past decade, Russia has emerged as one of the big, rising economies. Between 1999 and 2008, the Russian economy grew by an annual average rate of 7 percent, measured in constant rubles (figure 3.1). Because of the sharp real appreciation of the ruble, however, Russian GDP measured in current US dollars expanded by an amazing average of 27 percent a year over the same period, from \$196 billion in 1999 to \$1.75 trillion in 2008 (figure 3.2). According to the International Monetary Fund (IMF), Russia is now the eighth largest economy in the world, measured by GDP in current dollars, coming just before Spain and after Italy. If GDP is measured in purchasing power parity, Russia is already the sixth largest economy, after Germany but ahead of the United Kingdom and France.<sup>3</sup>

In a much-cited 2003 paper on the BRICs (Brazil, Russia, India, and China), Goldman Sachs projected that in less than 40 years these four economies together would likely be larger than the combined Group of Six (G-6) nations.<sup>4</sup> With a cautiously projected average annual growth of only 3.9 percent, Russia would overtake Italy in 2018, France in 2024, the United Kingdom in 2027, and Germany in 2028. By 2030, Russia would be the fifth largest economy in the world. Factors causing Russia's economic dynamism—in addition to abundant energy resources—are sound macroeconomic policies, an open economy, substantial investment, and high levels of education. Russia's weaknesses are institutions, governance, and the rule of law.

Among the BRICs, Russia has by far the highest GDP per capita in both current dollar and purchasing power parity terms: In 2008 these were \$12,000 (four times that of China) and approximately \$16,000, respectively—about one-third of those of the 15 old members of the European Union.<sup>5</sup> Goldman Sachs forecasts that Russia will be the only BRIC country to approach European per capita income levels by 2050.

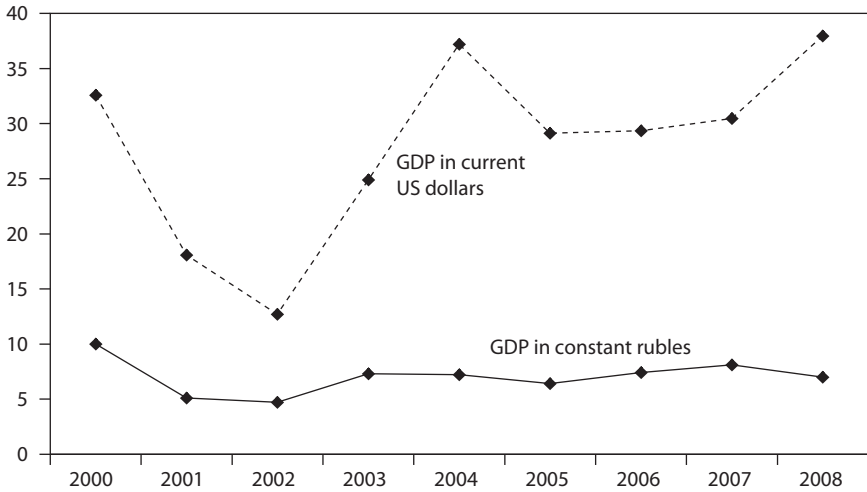
3. International Monetary Fund (IMF), *World Economic Outlook* database, April (Washington, 2008).

4. Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: The Path of 2050*, Goldman Sachs Global Economics Paper 99 (New York, 2003). The G-6 nations are France, Germany, Italy, Japan, the United Kingdom, and the United States.

5. IMF, *World Economic Outlook*.

**Figure 3.1 GDP growth rate, 2000–2008**

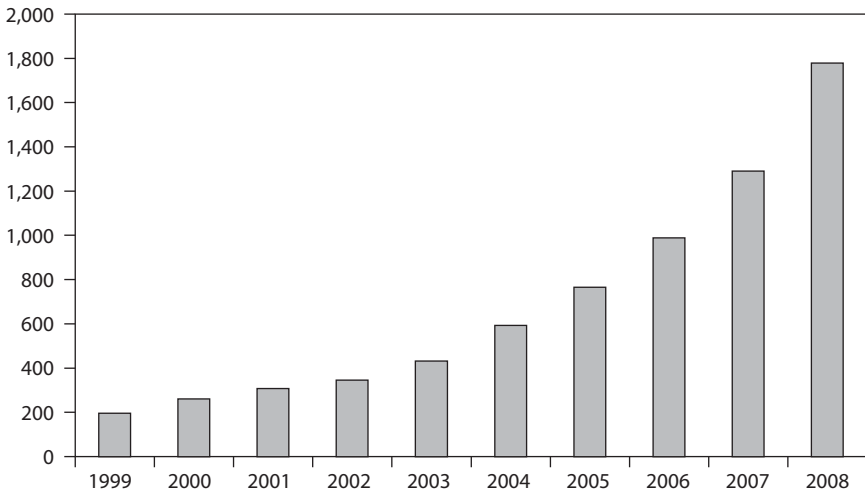
percent, year over year



Source: International Monetary Fund, *World Economic Outlook* database, October 2008 (accessed on November 22, 2008).

**Figure 3.2 GDP growth in current US dollars, 1999–2008**

billions of US dollars



Source: International Monetary Fund, *World Economic Outlook* database, October 2008 (accessed on December 23, 2008).

Russia's higher income level is also evident in superior social indicators. In most regards, Russia is slightly more advanced than Brazil and Mexico but head and shoulders above China and India. Most impressive, increasing numbers of young Russians are opting for higher education. According to UNICEF statistics, the share of Russian college-age youth who pursue higher education nearly doubled from 25 percent in 1989 to 47 percent in 2005; and with a broader definition of higher education UNESCO arrived at 73 percent for 2007, more than the average for the European Union.<sup>6</sup> Another indication of Russia's strength is its swiftly growing middle class. According to the Russian research institute Center for Strategic Research, over 30 percent of Russians can now be considered middle class. Russians have 14 times more cars per capita than the Chinese and three times more computers.

The sophistication of Russian consumers makes the country all the more attractive to US exporters of merchandise and services. Yet it also means that Russia is likely to run out of high catch-up growth earlier than the other BRICs.

## Russia's Goals for 2020

Russian politicians and economists are preoccupied with economic growth.<sup>7</sup> The nation is suffering from the trauma of its sudden demise as a superpower and is trying to come back through superior economic performance. The peer pressure from neighboring countries is also strong. This single-minded focus on economic growth permeates the Russian government, which has seized upon the Goldman Sachs vision of the BRICs as growth machines. In 2007–08, the Kremlin formulated a large number of goals for 2020; then-president Vladimir Putin laid out the program, Russia 2020, in a speech on February 8, 2008, and the Ministry of Economic Development and Trade presented a more detailed program in March with three alternative scenarios.<sup>8</sup>

The "innovation scenario" is the lead scenario of Russia 2020, with an average growth of 6.5 percent. It presupposes the development of a na-

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6. TransMONEE database (Florence: UNICEF Innocenti Research Center), [www.unicef-irc.org/databases/transmonee](http://www.unicef-irc.org/databases/transmonee) (accessed on December 8, 2008); UNESCO Institute for Statistics, *Public Report on Education*, <http://stats.uis.unesco.org/> (accessed on July 30, 2008).

7. The best example is Yegor T. Gaidar, *Dolgoe vremya [The Long Term]* (Moscow: Delo, 2005).

8. Vladimir V. Putin, speech at the Expanded Meeting of the State Council on Russia's Development Strategy through 2020, February 8, 2008, [www.kremlin.ru](http://www.kremlin.ru) (accessed on October 15, 2008); Ministry of Economic Development and Trade of the Russian Federation, *Rossiia 2020: Osnovnye zadachi strategicheskogo razvitiya Rossiiskoi Federatsii [The Basic Tasks of the Strategic Development of the Russian Federation]*, photocopy (Ministry of Economic Development and Trade, Moscow, March 2008).

tional innovation system, competitive human capital, and regional development centers. It requires a comprehensive reform and investment program, but it has only been laid out in general reasoning in public speeches.

The Ministry of Economic Development and Trade also presented two less optimistic scenarios. The “energy and raw materials scenario” would result in 5.3 percent annual growth until 2020 based on faster development and modernization of the extractive sector. The “inertia scenario” assumes no significant improvement and forecasts an average growth of 3.9 percent a year.<sup>9</sup>

Russia 2020 conveys a vision of Russia as an innovation leader and a middle-class society. The key goal is to raise Russia’s GDP per capita from \$12,000 in 2008 to \$30,000 in 2020—from one-quarter of the US level to half—and make Russia the fifth largest economy in the world after the United States, China, India, and Japan. Russia’s GDP would increase on average 6.5 percent a year from 2008 to 2020, and its share of world GDP in current dollars from 2.5 to 4 percent. The share of the middle class would rise from 30 to 60–70 percent and the average life expectancy from 66.6 to 75 years. These are very ambitious goals but not impossible, with the exception of life expectancy. The question is whether Russia’s government will pursue an appropriate economic policy.

In order to achieve the program’s targets, labor productivity would have to increase by 2.5 times (slightly over 7 percent a year), the energy intensity of production decline by 55 to 60 percent, and spending on research and development increase from 1 percent of GDP in 2006 to 4 percent in 2020. At the same time, public expenditure on education and health care would rise significantly, and investment in infrastructure would skyrocket.

Energy is also a focus of Russia 2020. The energy windfall has facilitated Russia’s economic rise, but the government favors diversification. The Russian Ministry of Economic Development and Trade estimated that energy in all its forms contributed 18 percent of GDP in 2007—a substantial fraction but far less than in pure “petrostates”—and accounted for 50 percent of federal revenues and 61 percent of export revenues. President Putin explained:

So far we have only partially occupied ourselves with modernization of the economy. As a result, Russia has become increasingly dependent on imports of goods and technology, and our role as a raw material appendix to the world economy has been reinforced. In the longer term, this can lead to our lagging behind the leading economies of the world and our country being squeezed out from the world leaders.<sup>10</sup>

9. G.O. Kuranov, *Kontseptsiya dolgosrochnogo sotsial'no-ekonomicheskogo razvitiya Rossiiskoi Federatsii* [Concept of Long-Term Socioeconomic Development of the Russian Federation], photocopy (Ministry of Economic Development and Trade, Moscow, 2008).

10. Putin, speech at the Expanded Meeting of the State Council on Russia’s Development Strategy through 2020.

The Russian government has focused on the most optimistic scenario, which is natural given that the country's growth has persistently been at the upper end of all forecasts during the last decade. But as long as current policies persist, this does not seem very credible.

## Causes of Russia's Postcommunist Economic Recovery

To understand Russia's economic dilemma, it is necessary to comprehend the causes of its growth over the last two decades. They fall into three categories: capitalist transformation, the use of free capacity and structural change, and energy rents.

### Capitalist Transformation

The primary reason for growth has been European or capitalist convergence, which Russia has enjoyed thanks to the hard-fought introduction of a market economy in the 1990s. The transition to a market economy consisted of deregulation, privatization, and financial stabilization. The most important step was to liberalize prices and trade to create a market economy, allowing economic decisions to be freely made by individuals and independent firms. Prices and trade are predominantly free and subsidies are small. No state planning committee tells enterprises what to produce or to whom to sell. Transactions are overwhelmingly monetized. According to the transition index of the European Bank for Reconstruction and Development (EBRD), Russia was a full-fledged market economy by 1996.<sup>11</sup>

Another feature of a free market economy is the dominance of private enterprise. Russia undertook the largest privatization in world history from 1992 to 1997. According to the EBRD, the private sector contributed 70 percent of GDP from 1997 until 2004, although, contrary to the trend in other transition countries, that share fell to 65 percent in 2005. Because essentially all economic growth has come from private enterprise, a decline in the share of the private sector bodes ill for future growth prospects. One-third of the labor force works in the public sector, which has expanded in recent years, aggravating Russia's structural drawbacks.

The government's contribution has been to keep the budget in surplus and taxation moderate. Until 1998, a persistent budget deficit of some 9 percent of GDP held back Russia's growth. In August of that year, it caused a financial crash so severe that Russia switched to prudent macroeconomic policies for a decade. As a result, since 2000 Russia has enjoyed large budget surpluses of several percent of GDP, amounting to 5.4 percent of GDP in 2007. In May 2008 Russia's stock-market capitalization ap-

11. Anders Åslund, *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed* (Washington: Peterson Institute for International Economics, 2007, 278–80).

proximately equaled its GDP, as is common in Western Europe. Russia's foreign currency reserves peaked at \$598 billion in early August 2008, and its public foreign debt plunged from 100 percent of GDP in 1999 to 3 percent in 2008.<sup>12</sup>

From 1998 to 2002, Russia undertook a profound tax reform and adopted a liberal tax system, cutting the number of taxes sharply, reducing tax rates, and introducing a flat personal income tax of only 13 percent, while decriminalizing many tax violations. As a consequence, Russians started paying taxes, and public expenditures have hovered around a moderate 35 percent of GDP. The recovery was coupled with remonetization as Russia enjoyed a great credit boom.

Russia's structural reforms continued until 2002. Among the last important reforms were a comprehensive judicial reform—which means that businessmen sue both one another and the government on an increasing scale—and the adoption of a land code that legalized private ownership of agricultural land. New laws on licensing, certification, permits, and inspections eased restrictions on small enterprises, and a new customs code simplified the previously exceedingly difficult customs procedures.

Another important factor stimulating Russia's growth is the country's fast integration into the world economy: Total exports surged from \$42 billion in 1992 to \$472 billion in 2008 (roughly 30 percent of GDP) and the merchandise trade surplus to \$180 billion.<sup>13</sup> Russia has enjoyed huge steady current account surpluses since 2000; even in 2008 it was \$113 billion or 7.7 percent of GDP. Much of the increase has come from rising oil prices, but Russia's economy has been diversifying: The share of oil and gas in the country's exports has fallen to 60 percent from 90 percent in the late 1980s. With its exports now accounting for one-third of its GDP, Russia is quite an open economy.

## Free Capacity and Structural Changes

The second set of reasons for high growth has been the huge free capacity in production, infrastructure, and human capital as well as significant structural changes since the collapse of communism. With the rise of the new capitalist service sector, a large-scale structural change spurred growth. The service sector expanded from 33 percent of GDP in 1989 to 57 percent in 2007. Even so, Russia's industrial sector is still large by international standards, contributing 38 percent of GDP in 2006, compared with 27 percent in the euro area.<sup>14</sup> The sizable industrial sector partly re-

12. Bank of Finland, Russia Statistics Online, [www.bof.fi](http://www.bof.fi) (accessed on various dates).

13. Statistics are from the Central Bank of the Russian Federation, [www.cbr.ru](http://www.cbr.ru) (accessed on February 11, 2009).

14. World Bank, *World Development Indicators*, <http://devdata.worldbank.org> (accessed on various dates).

flects insufficient market adjustment (yet to come) and partly shows Russia's comparative advantage in raw material extraction.

Russia's structural changes are best illustrated with a quick review of its major industries. Economic growth took off with recovery in the privatized heavy export industries, oil and metals. In its wake, some related sectors recovered, notably mining, chemical industry, and partially heavy machine-building. With rising personal incomes, housing construction and retail trade expanded grandly, and their development is proliferating throughout the country.

A few industries that initially lagged are now evolving, and they will contribute to Russia's growth for years. Agriculture is reviving slowly but steadily. A very gradual redistribution of land is taking place from old state and collective farms, many of which have lain fallow, to huge agro-industries with a few hundred thousand hectares of land. But these companies are having serious trouble finding skilled management and labor. The agricultural revival started in grain production and other large-scale crop cultivation and is proceeding in poultry and pig farming, but Russia's cattle and dairy industry remains miserable. The country's burgeoning poultry industry has one of the strongest protectionist lobbies, whereas grain producers favor free exports. In the 1980s the Soviet Union imported an average of 38 million tons of grain each year, but in 2005–06 Russia exported 11 million to 12 million tons of grain a year.<sup>15</sup>

Another sector set to develop is the automotive industry. In 2010 Russia is forecasted to surpass Germany as the biggest car purchaser in Europe, with some 3.5 million cars. At present, Russia imports more cars than it produces because the old Soviet car producers have impeded the development of new domestic automotive companies. Yet most large car producers in the world either have or are about to establish production in Russia, and the country's automotive output will likely expand spectacularly. Similarly, Russia's forestry industry has been a laggard because of late reforms, but with huge resources and domestic demand it is set to develop fast.

One of the least noticed structural changes is the 7 percent a year rise in the number of registered enterprises. It is true that Russia remains dominated by big enterprises, but not to the extent commonly perceived. With 5 million registered enterprises and 3.4 million registered individual entrepreneurs, Russia has a total of 8.4 million firms<sup>16</sup>—one enterprise per 17 people, approximately as many as in Western European countries. Small and medium-sized enterprises contribute 45 percent of GDP, compared with about two-thirds in Western Europe.

15. Federal'naya Sluzhba Statistiki [Federal State Statistics Service] online database, [www.gks.ru](http://www.gks.ru) (accessed on September 11, 2008).

16. Federal'naya Sluzhba Statistiki [Federal State Statistics Service] online database, "Number of Individual Entrepreneurs," [www.gks.ru](http://www.gks.ru) (accessed on December 23, 2008).

A common feature of the postcommunist economies is a large pent-up need for investment and the remonetization of the economy. In 2006 Russia's M2 as a share of GDP was as little as 33.5 percent,<sup>17</sup> whereas 70 to 80 percent would be normal for a European market economy. As long as private property prevails, Russia has plenty of collateral for more than twice as large a credit volume without any apparent financial risks.

Together, Russia's systemic and structural changes represent the gigantic catch-up effect or capitalist convergence that all postcommunist reform countries have experienced. The average annual real growth in former Soviet states from 2000 to 2007 was 9 percent, but it reached only 7 percent in Russia, so Russia has actually been comparatively less dynamic than its cohort (the growth leaders are Azerbaijan, Armenia, Estonia, Kazakhstan, and Latvia).<sup>18</sup> Growth accounting shows that since 2000, about half of Russia's growth has been from capital and half from rising total factor productivity, while increased labor has contributed little.<sup>19</sup>

## Energy Rents

The third factor behind Russia's growth is the oil price windfall since 2004. As international oil prices took off, a dominant theme in the Russian economic debate became the danger of an "energy curse" for the Russian economy. The curse actually encompasses several problems, such as overvaluation of the currency, the government ignoring reforms, and rent seeking.

After the Russian financial crash of 1998, the authorities were greatly concerned with any overvaluation of the exchange rate that would price out other exports, the so-called Dutch disease. As a consequence, talent has been focused on making money in the energy sector, and the development of other industries has been neglected, not least because Russian labor has been uncompetitive with its high salaries.

A second energy curse is that the abundance of energy revenues that has boosted the country's budget surplus, current account balance, and currency reserves makes it difficult to motivate policymakers and the population to pursue and accept economic reforms that often entail hardship in the short term. As a consequence, Russia has made no economic or social reforms worth mentioning for the past six years, as the government focused on the distribution of oil rents rather than on the improvement of policy.

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17. EBRD, *Economic Statistics and Indicators*, 2008, [www.ebrd.com](http://www.ebrd.com) (accessed on December 10, 2008).

18. *Ibid.*

19. Garbis Iradian, "Rapid Growth in Transition Economies: Growth Accounting Approach," IMF Working Paper no. 164 (Washington: International Monetary Fund, 2007).

A third energy curse is that the concentrated energy revenues facilitate the concentration of both political power and rent seeking. This is the cause of the extreme and rising corruption in Russia. As a consequence, Russia's business environment is poor, and it is getting worse. The state bureaucracy impedes efficient economic activity and adds to the cost of doing business in the form of time spent dealing with arbitrary regulations and the payment of bribes. The World Bank's Doing Business index ranked Russia 96 among 175 countries in 2006, but in 2008 it fell to 120 out of 181. Russia receives its best rankings for enforcing contracts (18), registering property (49), and starting a business (65), all of which make it comparatively easy to establish a firm. But the regulatory environment is bad (figure 3.3); in 2008, filing for and receiving the necessary permits and licenses for the construction of a warehousing facility took 704 days in Russia compared with 161 in the countries of Organization for Economic Cooperation and Development. But although there have been some official complaints about the public sector, Russia 2020 does not reflect any awareness that Russia's main problem is its huge, inefficient, and corrupt public sector.

The Kremlin's current economic problem is that most of the old sources of growth will soon be exhausted. Undoubtedly, some capitalist convergence will continue, being the engine of inertia growth, but it is bound to slow down. The qualitative improvement of human capital will also continue as will remonetization and structural changes. Yet the free capacity in production and infrastructure is probably coming to a sudden end. The most problematic sectors are those dominated by the state—natural gas, roads, railways, pipelines, aircraft, armaments production, medical services, education, and law enforcement.

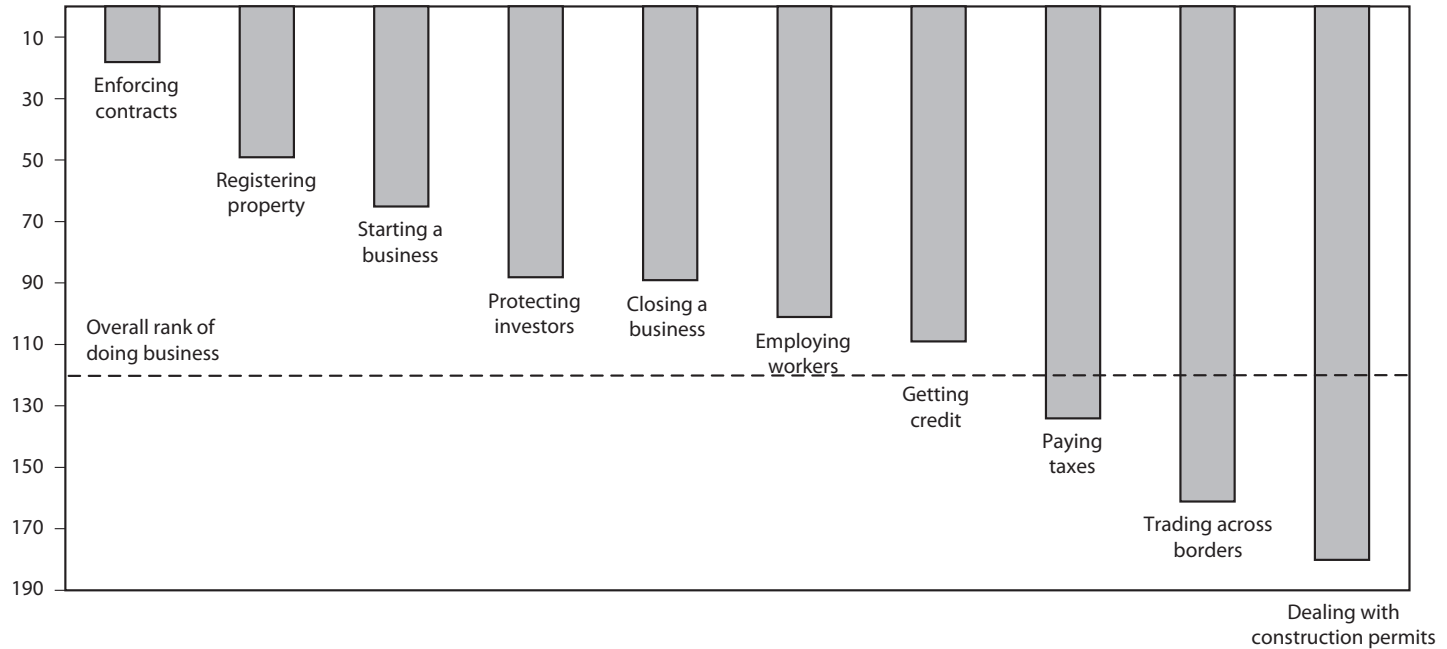
## **The Global Financial Crisis: A Perfect Storm Revealing Old Sins**

In July 2008 top Russian officials presumed that Russia would escape the international financial crisis and even be a safe haven. Instead, this hazard has served as rude a shock to Russia as to most other countries. This first became evident when the Russian stock market plummeted by 80 percent from its peak in May 2008 to its nadir (so far) in January 2009. The international oil price plunged from an all-time high of \$147 per barrel in July to a low of \$34 in December.

The particular Russian causes of concern are mainly structural and long term. It is easy to criticize Russia 2020. Its author, the Ministry of Economic Development and Trade, used to be Gosplan, the State Planning Committee, and its style is reminiscent of the Soviet 15-year perspective plans, which had no operative implication. As in the days of Nikita Khrushchev and Leonid Brezhnev, the new plan specifies how fast Russia is to catch up with the United States. After nine successful years the authorities just presumed

**Figure 3.3 Ease of doing business in Russia, 2008**

rank out of 181 countries



Source: World Bank, *Doing Business 2009*, www.doingbusiness.org (accessed on December 23, 2008).

that the same trend would continue for the next decade, but if the sources of growth are not maintained but undermined, it would be unrealistic to expect further improvement. Some of the goals—for example, to raise life expectancy from 67 to 75 years within 12 years—appear downright utopian.

The main problem with Russia's economic strategy is that it requires substantial and comprehensive economic reforms, but no such reforms have been planned. Russia 2020 ignores deregulation and improvement of the enterprise environment, instead vaguely emphasizing innovation and high technology; but catch-up growth is usually a matter of imitation, pragmatism, and opportunism rather than originality. The program seems to rely on the strength of growth momentum. But because it is predominantly a commodity exporter, Russia is liable to be particularly sensitive to the vagaries of the global business cycle, and currently the whole world is facing a vicious financial crisis.<sup>20</sup>

Problems abound. As its energy production stagnates, Russia's external account is bound to dwindle quickly with crumbling prices. Industrial production fell by 10 percent in December 2008, and GDP growth forecasts for 2009 have been revised from 7 percent growth to moderate decline. Russia's official international currency reserves sank from \$598 billion in early August 2008 by more than one-third to \$381 billion in early March 2009. Although the whole world was severely hit by the global financial crisis, Russia seemed to suffer more than other countries in spite of its vast reserves. For too long, the government denied the crisis and pursued other ambitions.

The greatest social shock is that the real disposable incomes of the population, which had been increasing by an average of 13 percent a year for several years, suddenly plummeted by 12 percent in December 2008. Surprisingly, the budget surplus of 4 percent of GDP in 2008 is expected to become a deficit of at least 8 percent of GDP in 2009. The current account surplus actually peaked at \$99 billion, or 5.9 percent of GDP, because of the record commodity prices and contracting imports at the end of 2008. But the current account will possibly be balanced in 2009, though the size is highly dependent on the unpredictable oil price. A couple of these problems—the falling commodity prices and the global liquidity squeeze—are of external origin, but most are domestic.

The labor force is shrinking. Like most of Europe, Russia is facing a demographic problem as its native population is declining (as discussed in chapter 6); at best its population will increase only insignificantly until 2020. The labor force is set to decline from 90 million in 2007 to 78 million in 2020, according to the Ministry of Economic Development and Trade (or, at a minimum, 1 percent a year).<sup>21</sup> It may be possible to compensate

20. Two of the postcommunist star performers, Estonia and Latvia, have swiftly gone from 10 percent growth to decline.

21. Kuranov, "Kontseptsiya dolgosrochnogo."

for this decline with a more liberal housing market and a reduction in reliance on the public sector, but those will require substantial reforms.

Russia's investment ratio never reached more than 23 percent of GDP in 2007, and it is falling sharply in the current business environment, while the most successful transition countries have investment ratios exceeding 30 percent of GDP, as in East Asia. If Russia is to achieve high future growth, it needs to boost investment.

Infrastructure, especially roads, has become an extraordinary bottleneck, as any visitor to Moscow may notice in its horrendous traffic jams. The 2020 plans are full of grand infrastructure projects, but Russia seems to be unable to carry out major infrastructure projects. In 2000 the country had 754,000 kilometers of paved roads, according to official statistics; incredibly, by 2006 this figure had increased by only 0.1 percent, to 755,000 kilometers. The trunk (*magistral'nye*) oil pipelines were 47,000 kilometers in 2006, exactly the same as in 1995. The trunk gas pipelines increased from 213,000 kilometers in 2000 by 5 percent in 2006.<sup>22</sup> In all major infrastructure projects, the little that is built costs at least three times as much per kilometer as in the West. Russia's public administration has proven itself too incompetent and corrupt to undertake major projects. Unless that changes, none of the many large planned infrastructure projects will progress.

Russia's economic growth has also been driven by international economic integration. The World Bank and Russia's Economic Development Ministry estimated that World Trade Organization (WTO) membership would increase the country's economic growth by 0.5 to 1 percentage point a year for the next five years, primarily from finance, foreign direct investment, and services. If Russia's leaders abandon their attempts to join the WTO and aggravate protectionism, especially in agriculture and finance, a corresponding economic deterioration is likely.

Russia merits praise for its conservative fiscal policy, its accumulation of large currency reserves, and its limited domestic leverage, but it suffers from minimal domestic financial intermediation because inept state banks dominate the domestic financial market. Almost half of Russia's banking system is owned by five state banks: Sberbank, VTB, Gazprombank, Vneshekonombank (VEB), and Bank Moskvyy. Because these banks are politicized, the banking system is inefficient and unreliable, and the national costs of a poor banking system rise over time. In effect, the Russian banking system works like this: The state takes money out of the country, while big Russian corporations are forced to borrow abroad, maximizing their currency risk.

Most of Russia's many private banks are quite small, while the Russian economy is dominated by large companies, leading to a mismatch be-

22. Federal'naya Sluzhba Statistiki [Federal State Statistics Service], *Russian Statistical Yearbook 2007*, www.gks.ru (accessed on October 16, 2008).

tween small banks and large creditors, which have to turn to international banks. Many small banks have failed or been merged with larger banks, but bank restructuring has only started. Moreover, large nonperforming loans need to be written off. If Russia had privatized its banking system like most other post-Soviet countries, its companies would suffer less from currency risks. Furthermore, if foreign banks owned a large share of the Russian banking system, Russia's access to international finance would be much better.

Russia's economic recovery has been generated by private enterprise, but since 2005 renationalization has prevailed, reducing economic efficiency and thus future growth. The renationalization of major companies such as Yukos, Sibneft, Vankor, United Heavy Machineries, VSMPO-Avisma, Sakhalin Energy, and Rusia (Kovykta) has aggravated corporate governance and political risk. The state now accounts for 83 percent of gas production and 45 percent of oil production, and the Kremlin is utilizing the financial crisis to promote renationalization that is economically unfounded and harmful. Strangely, in the midst of the financial crisis, the Russian government is preoccupied with further nationalization. A couple of companies, the mining and steel company Mechel and the potash producer Uralkali, seem to have been singled out for expropriation through major penalties, while the state corporations are buying up one distressed company after another with money from the state budget.

Yet Russia has not espoused a socialist ideology, and its big state corporations are moving toward 51 percent state ownership—Rosneft and VTB made limited initial public offerings in 2006 and 2007, respectively—exposing themselves to assessment by the stock market. Investors have reacted negatively, slashing Gazprom's market capitalization from \$350 billion in May 2008 to \$70 billion in October.

A major policy flaw has been the managed exchange rate, which caused annual inflation to peak at 15 percent in the summer of 2008. Global inflation rose with increasing food and energy prices, but Russia's inflation rate was about twice that of other emerging markets because its macroeconomic policy relied too much on fiscal policy and too little on monetary and exchange rate policy. The inflation was caused by the large current account surplus, which was monetized in rubles because the central bank purchased hard currency to defend the fixed ruble exchange rate (Russia's exchange rate was loosely pegged to a basket of \$0.55 and €0.45). For years Russia had a negative real interest rate that boosted monetary expansion and inflation, as the central bank stated, but did not act on, its intention to move to inflation targeting within three years.

The Russian government has repeated its mistake from 1998, maintaining an untenable pegged exchange rate in the face of falling commodity prices. Until the summer of 2008, the pegged policy provoked speculative capital inflows that boosted the money supply and inflation. Since then the

rate has left the ruble overvalued, promoting speculative capital outflows and rapidly reducing the currency reserves. At the end of 2008, Russia started to devalue, but rather than letting the exchange rate float, Russia devalued the ruble in many small steps. Repeated mini devaluations only convinced the market that a major devaluation was inevitable. All who could exchange their rubles for dollars or euro did so. Even so, Russia has not succeeded in letting the exchange rate float, though it has raised interest rates so that they correspond to inflation. The combination of loose fiscal policy, negative real interest rates, current and capital account deficits, and an overvalued ruble is unsustainable, clearly provoking capital flight: Russia's international currency reserves declined by over \$210 billion from \$598 billion in early August 2008 to \$381 billion in early March 2009—more than one-third in half a year, though large amounts of the hard currency are held by Russian banks in Russia.

Russia should let the ruble float freely, move to inflation targeting, and boost interest rates to achieve positive real interest rates. A commodity-exporting country needs to let its exchange rate float up and down with international raw material prices to balance its foreign payments. As in 1998, speculators now sensibly bet on a ruble devaluation, which quickly depletes Russia's currency reserves and becomes a necessity. When the ruble is allowed to float, nobody knows whether it will rise or fall, which will reduce speculation and losses of currency reserves.

Russian big businessmen and their corporations have turned out to be much more leveraged than anybody had thought—total Russian corporate foreign debt was \$488 billion in October 2008. Many of these big businesses have pledged their strategic holdings of Russian stocks against foreign bank loans, forcing the Russian state to bail them out (the government has made clear that it will refinance their foreign loans to secure “strategic” ownership). Initially, \$50 billion was allocated to VEB for this purpose, but the government reduced this amount to \$13 billion, directing the support to the banks instead.

For long the government persistently denied that anything was wrong with Russia's economic policy. Domestic and foreign businessmen realized that this did not tally with reality, and this incongruity undermined their confidence in the Russian market. Without free public debate, rational policy decisions are unlikely.

Short-term statistics from the winter of 2008–09 indicate how severe the situation is. In the spring of 2008, capital investment rose by some 20 percent over the corresponding month the preceding year. By December 2008, it fell by 2 percent. Similarly, in December 2008, industrial production plummeted by 10 percent, and gas production by about as much. These dramatic falls in output tally with the statistics of many other countries in the midst of the financial crisis, but the shocker is that in Russia, real disposable income dropped by no less than 12 percent, while the pop-

ulation had enjoyed a rise of an average of 13 percent a year during the six preceding years.<sup>23</sup>

Until 2009, the Russian government denied the crisis and treated it as a foreign phenomenon. Rather than trying to minimize the cost of adjustment, the government tried to minimize the adjustment itself. Its primary ambition seemed to be to promote renationalization, which deterred both domestic and foreign businessmen. It is too early to predict the overall decline in Russia's GDP, but it is likely to be a few percent, as large as or somewhat larger than in the Western world.

Russia has also alienated itself from the outside world just when it most needs worldwide support. At the Group of Eight (G-8) summit in Japan in July 2008, Russia promised not to block UN sanctions against Zimbabwe, after which it immediately vetoed them in the UN Security Council. Through its recognition of Abkhazia and South Ossetia, Russia violated multiple treaties guaranteeing the sovereignty and territorial integrity of former Soviet republics. At the G-20 meeting in Washington on November 15, 2008 Russia committed itself not to undertake new protectionist measures but immediately raised import tariffs on cars. Such blatant violations of top-level promises have boosted Russia's risk premium.

It is difficult to assess the impact of all these actions, but they are all potent and negative. How will the Russian people and leaders react? The positive scenario is that the rulers face reality and return to the progressive market reforms they pursued until 2002. The alternative is that they dig in and refuse to undertake necessary reforms.

## A Time of Economic Challenge

After a decade of solid economic growth, Russia is now facing numerous acute challenges. A temporary economic slowdown is inevitable because of the global recession and falling prices of commodity exports. Russia's very high real estate prices are already rapidly declining, which will hurt the weak banking system, and domestic demand will be constrained. The big question is how Russia will respond to the economic slowdown. Three scenarios appear plausible over the next 12 years: an inertia scenario, a reform (or innovation) scenario, or a crisis scenario.

The inertia scenario presumes no major new reforms and average annual growth of 3.5 to 4 percent. The only growth drivers would be capitalist convergence, improved development and better allocation of human capital, continued economic restructuring, and some remonetization. Russia's resource wealth is so substantial that such a strategy can de-

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23. Federal'naya Sluzhba Statistiki [Federal State Statistics Service] online database, [www.gks.ru](http://www.gks.ru) (accessed on January 29, 2009).

liver moderate growth for a long time to come, and the higher world energy prices will be, the more likely such a choice.

The reform scenario implies that the Russian government faces its main challenges and carries out the required reforms. This scenario requires the swift implementation of several critical measures. First, Russia should accede to the WTO to secure its successful international integration and an improvement of its legal standards. Second, to ease infrastructure bottlenecks, the Kremlin needs to introduce transparent procurement procedures for major investments. Third, property rights must be reinforced and renationalization stopped to ease the problems in banking and energy production. With this scenario, an average growth of 6.5 percent a year is feasible, but it is very far from Russia's current economic policy.

Finally, a crisis scenario not foreseen by the Russian government is possible. Russian officials do not discuss the possibility of outright systemic crisis, but the grounds for such a scenario are substantial. Russia is extremely sensitive to commodity prices, as commodities accounted for about 85 percent of Russia's exports in 2007; in the second half of 2008 international commodity prices fell sharply, and in 2009 they may very well be less than half of their average 2008 level. Such a drop would reduce Russia's exports by 40 percent, or some \$180 billion. A political system whose legitimacy is based almost entirely on economic growth can easily collapse in such a situation and thus prompt a change of political regime.

So far, the Russian government has managed the financial crisis poorly. First, it denied the crisis. Second, it maximized capital outflows through an inadequate exchange rate policy. Third, its main endeavor has not been to deal with the crisis but to pursue other objectives, such as renationalization of major corporations. Clearly, this policy cannot continue because the results would be politically and socially untenable. When and how will Russia's government alter its economic policy?

Russia has gone through two impressive waves of structural reform, in 1991–93 and 1998–2002. In the interim, hardly any reforms were undertaken. The question today is whether Russia, facing a great need for a new wave of reform, can mobilize the political will to achieve it. This is, of course, a matter of political leadership, but the farther commodity prices fall—and with them economic growth—the more likely the leadership is to implement new reforms.

