Why the Russian Economy is Unlikely to Become a New "Asian Tiger"

Vladimir Popov
April 2000
PONARS Policy Memo 129
Academy of National Economy (Moscow)
and Carleton University (Ottawa)

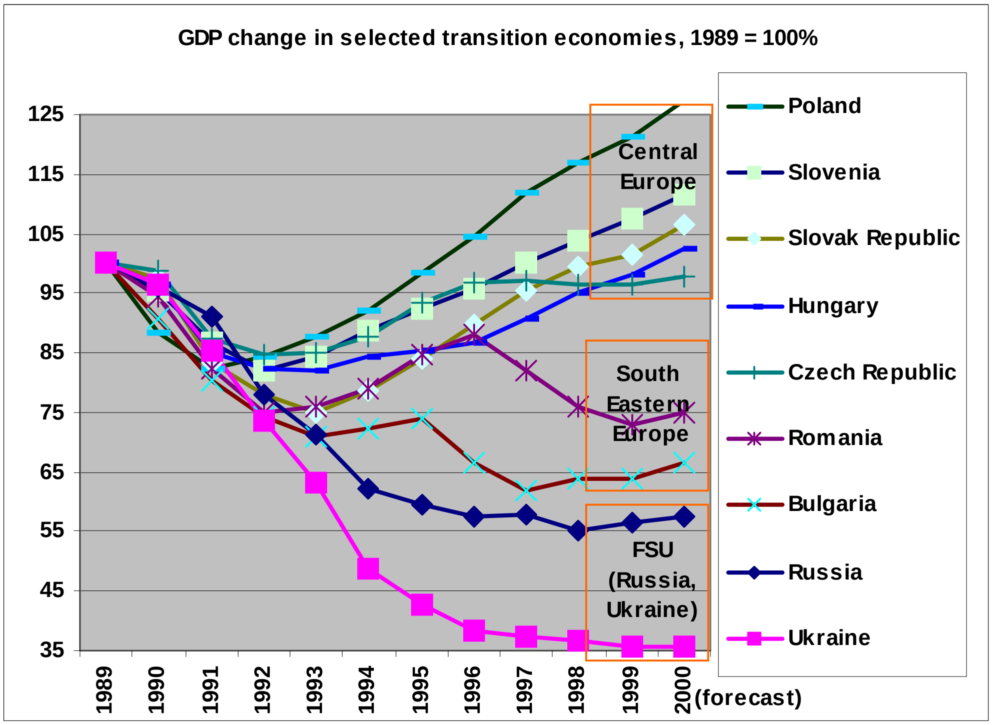
With the new president Vladimir Putin taking office in March 2000, there has been an array of predictions that acceleration of the economic reform process, accompanied by the strengthening of the state, would result in fast economic growth. In this memo I play the role of devil's advocate, with the aim to:

- identify the most important barriers to growth;
- provide evidence that these barriers are too serious to be quickly eliminated; and
- contribute to the discussion of how these barriers could eventually be overcome.

Growth Accounting

The trough of the decade-long transformational recession in Russia was (one hopes) reached in 1998, when the gross domestic product (GDP) shrank to nearly half of its pre-recession 1989 level. The 4.5% reduction of GDP in 1998 occurred before, not after, the August 1998 currency crisis and was the direct result of counterproductive and ultimately futile attempts to hold the exchange rate at an unsustainably high level. The resumption of growth after the crisis--in late 1998 and in 1999--occurred not because of, but despite government policies of keeping the ruble overvalued. However, even with the stimulating effect of the cheaper ruble, growth amounted to a modest 3.2% in 1999.

If the Russian economy begins to grow in 2000 at an average rate of 5% a year, it would take 15 years (until 2015) to achieve the pre-recession 1989 level of GDP (see the figure below). Russian GDP per capita on a purchasing power basis comparison is currently equivalent to approximately 15% of the US level, close to the level of China. Assuming 5% average annual growth in Russia and 3% annual growth in the US, Russia's GDP per capita will rise to 20% of the US level within 15 years.



But 5% annual growth may be quite an optimistic scenario, since most economies recovering from transformational recession do worse than that. The crucial prerequisite for steady growth--the solid flow of investment--is almost completely absent from the current Russian economic scene. Russian investment in 1999 was 4 times lower than in pre-recession 1989 and did not even compensate for the retirement of capital stock. In the second half of the 1990s, Russia's investment/GDP ratio fell even below that of many East European countries and the Baltic states, where it increased markedly during recovery and where the magnitude of the needed restructuring is somewhat less dramatic than in Russia.

For the purposes of this analysis it is appropriate to classify factors of economic growth into those that depend on the share of investment in GDP and those that depend on the efficiency of investment, or marginal capital productivity (MCP). The acceleration of growth can come only from two sources--either from increased capital productivity (qualitative sources of growth) or from an increase of the share of investment in GDP (quantitative sources of growth). Let us consider both.

Capital Productivity

The prospects for increased capital productivity are bleak. It is common knowledge that losses in allocative efficiency in centrally planned economies (CPE) as compared to market economies existed mostly in the form of low capital productivity: in particular, higher capital accumulation ratios in these countries were needed to achieve growth rates similar to that of market economies. In a sense, CPEs were compensating for the lack of quality (capital productivity) through an abundance of quantity (share of investment in GDP).

The expectations that the transition to a market economy would allow countries to reap a "marketization dividend" in the form of increased capital efficiency turned out to be correct for other post-communist countries. For example, Poland maintains reasonable growth rates with a lower share of investment in GDP than before the transition, whereas in China the increase in growth rates during the reform period was much more pronounced than the increase in investment/GDP ratio. These countries, however, are exactly the ones that managed to preserve strong institutions during the transition. The benefits of liberalization thus became noticeable only in economies with strong institutional capacities. On the contrary, in Russia (and the CIS and southeast Europe as well) the burden of weakened institutions proved to be more damaging for capital productivity than was central planning.

The greater magnitude of the Russian recession is associated with long-term structural factors, such as distortions in the industrial structure and trade patterns. Most important, Russia's recession is due to the collapse of state institutions, for which there is no quick fix in the short term. Overcoming disproportions inherited from the CPE (industrial restructuring) and creating strong institutions is a task that will obviously require decades rather than years. Hence the growth prospects in the medium term will depend largely on the ability to ensure the flow of savings and investment--that is, on the ability to compensate for and perhaps even to counter the poor quality of investment with greater quantity.

How to Increase the Share of Investment in GDP

With regards to the availability of savings for financing investment, the future does not look encouraging either. Business profits and depreciation funds are low; personal savings, though high, are made mostly through accumulating hard currency (financing capital flight, not investment), whereas ruble savings are low and falling. The government runs a sizeable budget deficit (dissaving), and the inflow of foreign direct investment is weak, so that Russia's substantial trade surplus and international borrowing are barely enough to cover debt service payments and capital flight.

The prospects for increasing savings and investment and for achieving high growth rates thus seem bleak as well, unless something is done to reverse existing trends. I offer below measures that are promising in this respect. Most of these measures involve the redistribution of national income in favor of savings (which should then be transformed into investment) at the expense of consumption, and hence are likely to face popular opposition. As in other areas, the feasibility of these measures depends largely on the ability to build a consensus to carry out politically difficult decisions.

The growth strategy should include at least four crucial policy changes.

- It is necessary to keep the exchange rate considerably undervalued to encourage exports, restructuring, and growth, while fighting inflation through tight fiscal and monetary policy (to offset increases in the money supply caused by the growth of foreign exchange reserves), not through highly priced national currency. Undervalued currency--the necessary component of export-led growth--was the strategy of Japan, Korea, Taiwan and Singapore some time ago, when those countries were still poor and were catching up with high-income states. This is currently the strategy of many new emerging market economies, especially that of China, which continues to keep the exchange rate at an extremely low level (5 times lower than the PPP, or purchasing power parity rate) by accumulating foreign exchange reserves at a record pace. It is by no means a coincidence that all the rapid growing economies are also famous for high and rapidly growing international reserves: China (including Hong Kong), Taiwan, Singapore, Malaysia, and Thailand account for a good 20% of total world reserves. Reserves to GDP ratio for these countries is normally above 20%, as compared to only 8% for the world as a whole and about 5% for Russia.

Unlike other measures to promote growth, this may be implemented relatively easily since it favors the interests of the all-powerful industrial groups (creating a stimulus for the export-oriented resource sector, as well as providing protection from import competition to secondary manufacturing and agriculture). Besides, a low exchange rate policy--unlike import protection or direct subsidies--is a non-selective policy instrument, and as such creates fewer opportunities for corruption.

- Industrial policy should favor strong, competitive export-oriented industries, while subsidies to inefficient industries should be phased out and replaced by retraining and social programs. In the past, industrial policy was largely a failure. It took the most inefficient form of price subsidies--supplemented by quotas and export tariffs for fuel, energy and raw materials--supporting the highest energy intensity of production in the world. It also did not succeed in supporting investment in competitive resource industries, nor in allocating funds to those few high-tech industries (such as aerospace) that had good prospects for becoming competitive.

  The industrialization of the 1930s and beyond became a major isolationist import substitution experiment: from that time on the share of export in Soviet GDP did not increase until large-scale fuel sales abroad started in the 1970s. The huge perverted industrial structure created without any regard to costs and prices on the world market proved to be nonviable in 1992, when it finally faced foreign competition after over half a century of artificial isolation.

  Today Russia is choosing once again between export-oriented growth and autarky. On the one hand, there is the example of East Asian countries that managed to rely on export as an engine of economic growth. On the other hand, there are much less appealing examples of import-substitution strategy in Latin

America and India in the 1950s-1970s and of "champions of isolationism," such as North Korea.

The option of promoting export-oriented growth would require massive and rapid industrial restructuring--mostly in favor of resource-based industries, but also in favor of some competitive high-tech sectors, like the aerospace industry, and (perhaps) particular capital and labor-intensive industries at the expense of agriculture and most secondary manufacturing industries. The other option--continuing support to major non-competitive industries--is a slower and more costly way of restructuring, implying the preservation of subsidies to and protection for weak producers. Paradoxically, this option--despite the intentions of those who propagate it to stop the de-industrialization of the country--may lead to exactly the opposite effect: if the resource sector performs poorly it will not generate enough revenues to support all non-competitive industries. Even the few still competitive or potentially competitive secondary manufacturing industries will fail to get necessary support and will thus slowly disintegrate.

- Government commitments should be reevaluated and current government expenditures must be restructured so as to make them smaller, yet financially sustainable and efficient. The withdrawal of agricultural and housing subsidies and the reform of the pension system seem the most promising. Housing subsidies are even larger than agricultural subsidies: in 1996 they amounted to 4% of GDP (fees collected from residents were covering on average only 27% of housing and related municipal services). A May 1997 presidential decree called for the withdrawal of all price subsidies and their partial replacement by direct income subsidies to needy citizens by the year 2003. This measure, however, was extremely unpopular, and it was opposed by most regional authorities, including the powerful mayor of Moscow.

Pension reform may produce even greater savings, though politically it may be more difficult to carry out. Whether transition from the current pay-as-you-go system to the mandatory/voluntary fully funded pension plans can raise domestic savings or not is debatable (the evidence from cross-country comparisons seems to be mixed). Regardless of the debate, however, it is pretty obvious that the current Russian pay-as-you-go system is extremely inefficient and should be reformed. The existing system--based on mandatory contributions to the off-budget Pension Fund by employers (28% payroll tax)--is not working properly, yielding less than half of potential revenues due to employers' unwillingness to pay very high social security contributions. This is the fundamental reality of the Russian economic situation: there is no short-term solution to the tax evasion problem and hence, it is the pension system (and government spending in general) that has to be adjusted to the financial abilities of the state, not vice versa. Steps to reform the pension system have thus far been modest. In 1997 the government planned to start the transition (which would require 3 to 5 years) to so-called "individualized pension accounts," in which all contributions made by employers and employees would be allocated on an individual basis--but even these modest plans got stuck in bureaucratic red tape. More radical plans--such as transition to a Singapore-type fully funded pension system--were discussed, but not approved by the government in 1997. Given the limited ability of the government to collect taxes, it may well be that the pay-as-you-go system is an unaffordable but inescapable luxury for Russia for the foreseeable future.

- Finally, in the poor investment climate resulting from the uncertainty that was caused by institutional collapse, it makes sense to increase government investment and to promote foreign direct investment into resource projects. In recent years, Russia fared much worse in both areas than emerging market economies, and even worse than most transition economies.

Overall in 1989-98 Russia received some $9 billion in foreign direct investment, which on a per capita basis is 4% of the Hungarian level, and only about 15% of the level of Kazakhstan and Azerbaijan, where political stability and the business climate are not much better than in Russia. It means that Russia obviously failed to use its "resource advantages" to bring in foreign capital. On the contrary, Russia in recent years has failed to prevent the reduction of investment and output even in competitive resource industries (oil and gas included), which should be viewed as a major failure of government policy.

One way to stimulate investment is to increase government investment in infrastructure--even at the expense of financing it through government borrowing. Available evidence suggests that public saving does not crowd out private saving on a dollar for dollar basis, but rather private sector saving offsets each dollar of public saving by dissaving only $0.25 to $0.50. The very fast growing economies of East Asia normally keep government investment high, despite relatively low ratios of total government expenditure to GDP, so that the share of capital expenditure in total government outlays is much higher than in other countries. To put it differently, even debt-financed government investment pays off by increasing national saving and investment rates. Unfortunately, Russia has not been able to increase government investment in recent years--in fact, it has fallen at the same rate as private investment.

The Political Economy of Reform: How Feasible is the First, Best Option?

The outlined measures are technically feasible. Moreover, the political situation seems to be favorable: the best time for "unpopular measures" is of course the beginning of a presidential term. However, the logic of the political economy of reforms does not give much reason for hope. The unfortunate combination of 1) Russia's weak state; and 2) the need for massive redistribution resulting from large income inequalities, gives rise to the macroeconomics of populism. Once there is a need (whether mythical or real) to redistribute income in favor of the poorest social groups and the weakest enterprises--coupled with the government's inability to raise enough taxes for this redistribution activity--the story unfolds pretty much in line with Latin American experience. Simultaneously constrained by the inability to raise tax receipts and the need to maintain redistribution in favor of particular social groups, governments are basically left with few options for indirect (disguised or hidden) financing of subsidies.

- The first one is to maintain control over particular prices. Controls over prices of non-resource goods do not solve the problem completely, since they require explicit subsidies from the budget to cover the losses of companies that produce those goods. In contrast, price controls for fuel, energy and other resource commodities effectively take away rent from the resource sector and redistribute it to consumers. Redistribution of rent in this case does not require counter-subsidization of the resource sector, especially if it is more efficient than the rest of the economy. This option is available to resource-rich countries, which may help explain why the resource endowment is found to have a positive effect on the shadow economy and corruption, and a negative effect on growth.

- The second option for maintaining subsidies under budget constraints is to resort to inflationary financing of the government budget. The government in this case compensates for the shortfall of tax revenues by imposing the ruinous-for-growth inflation tax on everyone.

- The third option is debt financing--either domestic or external borrowing. Debt financing makes sense when it buys some time for maintaining subsidies while conflicting parties are negotiating a way to get rid of them. If it continues for too long, however, it only makes things worse, since debt service payments impose an additional burden on the government budget.

- Finally, the fourth option is to maintain the overvalued exchange rate that favors consumers over producers and exporters over importers, and leads to an increase in consumption at the expense of savings. In this case, consumption increases due to an increase in imports financed through external borrowing and/or foreign exchange reserves, and obviously provides only a temporary solution, leading to a balance of payments crisis in the longer term.

Different countries in different periods have resorted to one or more of the above mechanisms for implicit redistribution. In Russia the government was initially (1992-94) relying on controlling commodity prices and inflationary financing. Since 1995, when exchange rate-based stabilization was carried out and the ruble reached 70% of its purchasing power parity value (i.e., Russian prices, including resource prices, approached 70% of US prices, which was the apparent overvaluation of the ruble), the government relied mostly on domestic and foreign debt financing and redistribution via the overvalued exchange rate. However, after the 1998 financial crisis--which led to the collapse of the overvalued rate and to the cessation of international and domestic debt financing--the government relies largely on price control (via export taxes and export restrictions) on major export commodities (such as oil, gas, and metals).

At the moment there are no indications that the new Russian government has the courage required to break this vicious circle of populist policies, and to embark on a new export-oriented growth strategy. Quick progress in adopting the outlined measures does not seem to be politically feasible, but some steps in this direction are more or less inevitable, especially in the longer term. One can be fairly certain, however, that rapid economic growth without major progress in most, if not in all of the above-mentioned policy areas is extremely unlikely.

This memo is based upon PONARS Working Paper No. 17, "The Political Economy of Growth in Russia," by Vladimir Popov (April 2000).