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The Russian Economy: Progress and Challenge

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President Putin's reform program is off to a good start. The surprising resumption of Russian economic growth has permitted him to reward soldiers, policemen, and pensioners. The strength of two principal barriers to reform–the independent governors and the oligarchs–has been substantially reduced. A balanced budget, with a surplus even after meeting foreign debt payments, is in the offing for 2001. Some capital that had fled the country is returning. Domestic and foreign investments should improve the economic climate over the next few years. The Russian bond market has been the world's best performer in 2000 in light of Russia's economic upturn and its reform program.

Nevertheless, a five percent growth rate will not achieve the overall reform objectives in less than decades. Russian industry is three times older than the OECD average. Machine tool production today is 11 percent of what it was in 1991. Russians will have to be content with gradual improvement. For his part, Putin will need to develop his political skills when the reforms drive up housing and utility costs and provide fodder for the opposition which is likely to consolidate over time.

The West, while not the major factor in this picture, can be helpful. The primary need is for the West, and especially the United States, to stay engaged with Russia, not to draw back from it. In strictly economic terms, one desirable Western move would be to reduce Russia's debt burden to a level that the Russian government can meet without crippling its ability to finance economic expansion.

Economic Growth Resumes

For most of its millennium-plus history, Russia has been a "rich country inhabited by poor people" in President Putin's words. It remains that today. The nadir was reached on August 17, 1998 when the Russian government defaulted on its bonds and ordinary Russians lost their savings one more time. However, the August 1998 default led to a major shift in the Russian economic situation, to the surprise of Russians and foreigners alike. At first the boomlet was ascribed to the surge in energy prices and the steep drop in imports as Russians could no longer afford the Western products that had been so prominently displayed throughout the country. More recently it became evident that these two factors alone could not account for the change. The Russian government is now collecting taxes more efficiently, and the big taxpayers, such as the major Russian corporations, are more willing to pay, given the new political situation within Russia. The reform program is on track with its opponents solidly on the defensive. Most of the $2 billion which has come to Russia as foreign direct investment in the first half of 2000 came from those same Cyprus banks which had been receiving much of the Russian capital flight. There is also evidence that worker productivity has increased as much as 20 percent, mostly due to retirements and layoffs at inefficient plants, which have nevertheless managed to retain their production levels.

In other words, high energy prices and lower imports do not account completely for the current rise in the Russian economy. The million or so small businesses in Russia seized the opportunity to profit from the 1998 devaluation and began to produce goods acceptable to the population at large even if they do not reach the quality of the far more expensive Western products. The rise in corporate profits, the better protection provided to investors, the sense that the new market economy for all its Russia-special distortions is changing in the right direction, have combined to make Russia a more attractive place to do business. Optimism is slowly replacing the sullen resignation of the last Yeltsin years. Moreover, oil prices have not dropped but increased.

The incomplete figures for 2000 are very positive. Russian GNP was up 7.3 percent in the first six months. Real incomes have risen 9.5 percent over 1999. Average wages have risen to $75 a month from $65 a year ago. Corporate profits are running 170 percent above the previous year and tax receipts from corporations are up 95.8 percent year to year. The share of state revenues as a percentage of GDP now hovers around 17 percent. The trade surplus should reach $50 billion in 2000.

A look at one of Russia's most promising regions, Leningrad (whose capital is the city of St. Petersburg), highlights the change from the dark days of late 1998 and the first six months of 1999. St. Petersburg's *Strela* magazine reported in August 1999 that consumer prices had risen two and one half times over the past year. Real incomes had dropped by 27 percent. Deaths exceeded births by a ratio of 2.5 to 1. Use of public transportation had risen sharply as auto trips declined by 5.4 percent–people could not afford the gasoline prices. Unemployment had reached 18 percent. Agricultural production had risen by 11 percent as Russia's second city began to consume local produce. St. Petersburgers bought 36 percent more apartments, those with cash taking advantage of the collapse in real estate prices. Vodka production doubled as people "drank and forgot" in the old Russian tradition.

A year later, the Leningrad region reported a rise in local production of 25.6 percent during the first four months of 2000. Unemployment had dropped to 1.6 percent. Real estate prices had recovered. The city and region passed business-friendly legislation which produced quick results. Gillette, Ford, and a host of European companies prepared to invest in the region. Under consideration are two gigantic projects: a German consortium is looking at a $2 billion reconstruction of the St. Petersburg port while Russian oil companies are experimenting with transporting oil from the north of Russia via ship and pipeline to the Leningrad port of Primorsk for export to the West. The direct export of Russian oil and natural gas to Europe would do away with the huge charges that Russia now pays for transshipment, at least in the north.

Most Russian regions have not fared as well as the Leningrad region, although nearby Novgorod ranks among the most successful as well, while the northeast hinterland is receiving substantial investment from Finland. The economic rise has made possible a budget surplus, including foreign and domestic debt payments, despite additional expenditures resulting from the Chechnya conflict. The Russian government took in $18.3 billion during the first six months of 2000, two thirds of the anticipated revenues for the entire year. The 2001 budget now being considered by the Russian parliament envisages another surplus. Recent Russian commentaries suggest that the Russian government faces much the same problems as the United States: how to preserve at least part of the surplus for the inevitable future downturns. Foreign debt obligations will rise substantially in 2003 as the government well realizes. Putin's approval ratings continue at the 60-70 percent level despite Russia's continuing endemic social problems.

The Putin reform team downplays the current economic recovery knowing full well that prosperity could easily erode the will to introduce critical measures that over the short term will result in higher prices for many millions of Russians. The 2001 budget now under discussion assumes an oil price far below the September 2000 price, an inflation rate probably above what is reasonable to expect, and government receipts below what might be projected given the favorable surprises of the past year. Nevertheless, Putin has raised military and police pay by 20 percent starting in December, an essential step toward reducing the corruption and high level of hardship among Russia's uniformed servants.

The threat of inflation remains, however. The Russian Central Bank continues to inject huge amounts of rubles into the country as it buys up a substantial part of the foreign currency earned by its exporters. Given the moribund banking system along with the mistrust that burnt Russian investors have toward bond issues, the ruble overhang cannot be easily absorbed. Nevertheless, thus far–and thanks in part to a better than expected harvest–inflation in 2000 has remained at about 20 percent.

What is most important in this turn in Russia's economic fortunes is the effect it is having on the people of Russia. Paid-up pension and wage arrears, upgrading of Russia's credit rating, greater availability of credit, rises in some pensions with more to come and the aforementioned pay raises for the military and police are having their effect. Few Russians know the details of the reform program, and even less the manner in which Putin's team have put together old proposals into an interrelated package. But they sense forward movement at long last.

The Reform Program

Putin let it be known right from the start that he would press for economic reform within Russia. He asked a Moscow thinktank to draw up the program that resulted in the end in the program that the government approved on June 28. Some of the program drafters are now in the government: German Gref is minister of trade and economic development, Alexei Kudrin is a deputy prime minister and Andrei Illarionov is Putin's personal economic adviser. Prime Minister Mikhail Kasyanov also belongs to the group.

The program started with the warning that Russia was doomed to indefinite third world status if sustainable growth was not achieved. Growth had to exceed the anticipated 4 percent worldwide figure. Even 5 percent growth will not bring Russian incomes to the level of Spain and Portugal for decades. Illarionov projected that if Chinese growth rates stayed at 9.6 percent, the Russian economy twenty years hence would be smaller than not the largest but the second largest Chinese province.

Almost all elements of the program have been debated before, at least in academic circles. A reformed tax structure, a reasonable investment climate, protection of property rights were aims of previous reform projects for good reason. The new program emphasizes that the role of government in the economy should be reduced to that of a helping hand. This time the program is carefully meshed. More importantly, it has been approved at a time when growth has resumed, the Duma is no longer a hotbed of opposition, and the world is enjoying general prosperity.

Taxes and Duties

Most of the new tax legislation has now been passed by the parliament. Even before its passage, the Russian government had improved considerably its ability to collect taxes. In 2001 the flat tax of 13 percent on personal incomes will take hold, customs duties will be simplified considerably, and excise taxes reduced except for some luxury goods. A much larger share of government receipts will go to Moscow than was the case in the past, with some commentators expecting that the regions' share in the budget will fall below 40 percent in the next year.

The Social Tax

The bureaucratic jungle that was Soviet Russia had any number of organizations distributing all manner of largesse to different groups of the population. Most of the system survived the fall of communism for there was no alternative to it; people had to live. But the system was manifestly unjust. Illarionov calculated that the really poor 40 percent of the population received only 36 percent of the state subsidies. The list of who gets what privileges in Russia runs to 266 pages.

The reform program calls for a single 7.6 percent federal "social" tax. Illarionov believes that in five years' time the really poor will be receiving 85 percent of this welfare money. The web of patronage that the old system conferred on all manner of committees throughout the country will be destroyed by the centralization of the system. Large numbers of people, including some of the relatively well-off, will find their incomes reduced. Russia's less than efficient government will have another monumental task on its hands as it distributes these entitlements. One element of the coordinated reform package has been suspended as of late 2000. Valentina Matveyenko of St. Petersburg, who as Deputy Prime Minister is Russia's ranking woman, successfully intervened to leave the current "pay as you go" retirement system in place for two years. Then, concepts familiar to Americans such as 401(k) plans and some measure of privatization may be introduced. In the meantime, pensions are to be raised by 35-40 percent in 2001.

Land

Boris Yeltsin constantly pressed for the privatization of land but to no avail. "Land is motherland and cannot be auctioned" said Communist Party leader Zyuganov and a blocking majority in the Duma. Years were lost and the government was deprived of untold billions of rubles as the "right to own, sell and mortgage land" was never implemented. The situation remains the same today as a decade ago. The agricultural economy continues to flounder as it did during the seventy-four years of Communist rule. Many non-communist Russians as well fear the possible results of land privatization. Land is sacred to them. The small dacha with its carefully-nurtured vegetable garden is part of most Russian hearts.

But until an independent farmer can obtain a loan for the purchase of farm machinery using land as collateral, the outlook will remain bleak for the critical, depressed agricultural sector. Moreover, foreign companies wishing to invest in Russia have difficulties obtaining financing when the land under their plants can only be leased, not owned. The Putin government has not yet moved on the issue save for a Putin hint that a national referendum may be needed. The probability, however, is that satisfactory legislation can be produced to balance the claims of the individual farmers and farm cooperatives against the power of big money. Many other countries have wrestled successfully with the issue. Russia should be able to do so as well.

Banking

Bank reform remains stalled, to the discomfiture of the reformists and the IMF. Russia's existing banks are an economically weak sector of the Russian economy. Prime Minister Kasyanov has promised priority action on banking reform. Rumors fly around Moscow to the effect that nothing can be done until Putin fires Viktor Gerashchenko, head of the Russian Central Bank. Banking reform will bring with it many complications, not least the question of whether to open up the sector to a much larger foreign presence. Only the Russian savings bank, Sberbank, now has its deposits guaranteed by the state. Under consideration is the idea of extending such guarantees to other banks and thus induce money out of the Russian mattresses. This is important, as everyone agrees that Russia's undercapitalized banks are a brake on economic growth.

Privatization

A new round of privatization among the 24,000 state companies in Russia has just begun. Many of these companies are Soviet-era white elephants which chalk up huge losses and do not have the cash to pay for electricity and supplies. But their directors are assured of good incomes through government subsidies, which are easier to obtain than profits.

According to Privatization Minister Farid Gazizullin the government intends to privatize 7000 companies annually over the next three years in keeping with the principle of supporting competition while reducing government influence. His ministry would create financial incentives for companies to opt for privatization. This time the rules will be clear, said Gazizullin, unlike the "voucher" and "shares for loans" privatizations of the Yeltsin era. The program is not intended to raise money for the government; rather it is an essential part of the restructuring of the Russian economy.

The sale of the Onako oil company for US $1.08 billion in September is an auspicious start to the program. A subsidiary of the Tyumen Oil Company won the bidding by paying several times more than the initial government offer. Foreign petroleum experts generally agree that the auction was carried out fairly and the final price is in line with what future Russian oil production is worth.

Foreign investors are sure to fall over themselves to underwrite the 4.5 percent of the oil giant Lukoil that the government plans to sell. More problematic will be the privatization of deficit-ridden companies without profit prospects in the coal and agricultural sectors.

Foreign Direct Investment

Russia cannot begin to generate internally the investment capital necessary to restructure and modernize its economy. Many billions of dollars are needed over a lengthy period for those purposes. The only possible source of such sums is the world capital market. Thus far investors have been reluctant for good reason to plunge into Russia. Russia received in 1999 a pitiful $2 billion of the $827 billion that is estimated to have been invested worldwide in cross-border transactions. Investors have favored China over Russia by a twenty-to-one margin.

The picture is changing today. Some capital flight money is returning as its Russian owners begin to consider investment in their own country to be a reasonable risk. Dozens of joint ventures and production-sharing agreements are being bruited about. The long list includes ventures between General Motors and Fiat with Russian automobile producers, the "Blue Stream" project between Italy's ENI and Russia's natural gas giant Gazprom, the Finnish buildup of the paper industry in neighboring Karelia, and the start of oil production led by Japan in Sakhalin. If the Russian government succeeds in its effort to ensure that foreign property rights are respected, the next few years should see foreign investment rise closer to what might be normally expected in a country of 145 million educated people living with so much natural wealth.

Of far reaching importance to long-term Russian economic prospects is the "Prodi Plan," which calls for increasing and perhaps even doubling Russian natural gas exports to the European Union. Russia has the gas reserves but neither the money nor the productive capacity to boost production. Europe needs the gas and can supply both the financing and the modern technology. This mammoth deal is now at the working group stage. If implemented, Russia will see a substantial and secure increase in its annual revenues.

The Debt Burden

If the Russian Federation were forced to pay back the entire $150 billion of Soviet and Russian Federation debt, there would be no money left for economic expansion. Russia's London Club creditors agreed last spring to reduce Russia's debt to them by 36.5 percent. Russia is now issuing eurobonds for the remaining $31 billion of the London Club payment. Some forgiveness also appears in the cards for the $42 billion of Soviet-era debt that Russia agreed to assume. Prime Minister Kasyanov has made the case for lenient terms in the *Financial Times*. He noted that the West, including Japan, should remember that the Marshall Plan's infusion of $88 billion in current dollars into a prostrate postwar Western Europe achieved its purpose. Western Europe became the stable democratic region that was the purpose of the Marshall Plan. Then Kasyanov cited the $70 billion that West Germany has transferred to East Germany annually since reunification. He pointed out that, if it has proven so difficult to jumpstart economically a part of Germany which was communist for only four decades, then how much more will be required for the transformation of huge Russia with seventy years of a more extreme version of the planned economy behind it.

Germany, historically and currently Russia's largest trading partner, appears willing to grant Russia relief on the Paris Club debt. It has already agreed to stretch out the $8 billion that Russia failed to pay during the 1998-2000 period. It has reinstated its Hermes insurance scheme guaranteeing German investments in Russia. In December, Chancellor Schroeder proposed that the debt be repaid through the issuance of shares in Russian companies. That imaginative scheme is likely to founder, whether because of the views of the other seventeen Paris Club members or opposition within Russia. It nevertheless underlines the willingness of Russia's largest creditor to provide debt relief and hence enhance Russia's ability to finance its internal growth.

For 2000 and 2001, Russia can meet its debt payments. But the debt repayment schedule rises substantially in 2003, by which time oil prices could well have dropped. The West, including the United States, should at least consider reducing the Paris Club debt to a level that Russia can pay.

The Russian Military

A final important element in the Russian economic picture is its military establishment. Putin has favored a smaller but better paid, equipped and trained force. He has been caustic about the expense involved in maintaining a bloated establishment, top heavy with rank but incapable of efficient military action. Yet the Russian military has almost always been Russia's most powerful internal force. In taking them on, Putin may meet his match. The military remember all too well the shabby treatment accorded the officers dismissed during the Yeltsin downsizing of Russia's ground forces. Reducing the Russian military while adapting its mission to Russia's current situation may not happen.

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