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Can Putin Jump-Start Russia's Stalled Economy?

JAMES R. MILLAR

Nikolai Petrakov, a former economic adviser to Soviet President Mikhail Gorbachev, summed up the sentiments of many Russians in the preface to his new book, *Russian Roulette*: "For an entire century Russia has served as a gigantic laboratory. Only the experimenters have changed."

Russian and Soviet leaders alike have favored large-scale, dramatic reforms designed to revolutionize or reverse the entire social system. Each has failed at its objective, with great human cost.

The effects of the most recent experiment, "shock therapy," or the attempt by Russian President Boris Yeltsin and his advisers to rapidly transform the Soviet command economy into a market economy, have been described by political critic Boris Kagarlitsky in *Novaya gazeta* as similar to those of a nuclear attack: "According to the experts of the 1960s and 1970s, a limited nuclear conflict would mean the loss of three to five million people, about 40 percent of industry, and more than half of agriculture. After the nuclear strike the country would only recover production after two years.

"Fortunately, nuclear war did not happen. Instead, in the '90s economic reform took place, 'shock therapy' to be exact. The result of this wonderful experiment on us precisely matched the consequences expected from a medium-scale nuclear attack."

Regardless of whether one agrees with Kagarlitsky's specific analysis, the attempt to transform the Soviet economy into a market-oriented one open to the global economic system has proved costly. This is the Russia Vladimir Putin has been selected to rule as the country's new president.

The etiology of Russia's current economic ill-health is not in question. The main causes are 70 years of Soviet comprehensive command planning and the largely successful extirpation of all market institutions and private property; the loss of the Soviet empire in Eastern Europe in 1989 and the breakup of the Soviet Union in 1991, with the concomitant break in economic links and the exposure of systematic and ingrained inefficiencies relative to the global economy; the absence of a real commitment to economic reform since 1992 by both the Russian people and a large segment of the Russian elite, which became distracted by the possibilities for personal enrichment through rent-seeking behavior; a general reluctance to view the loss of empire realistically and a consequent high degree of empire envy, which has resulted in the fever of the second Chechen war and much expensive posturing in the so-called near abroad. There is also another cause, the "schizophrenia of the Russian political class," which Andrei Piontkovsky has vividly captured. "As was the case 300, 200, or 20 years ago, we understand that we need Western technology and investments, and that autarky and an iron curtain would bring economic and geopolitical disaster to Russia. We understand that Russian culture is a part of European culture.

"But, nonetheless, the West, it seems, annoys us through its very existence. We perceive it as throwing down before us an economic, information, and spiritual challenge. We're constantly convincing ourselves of the West's imminent hostility and ill intentions toward Russia because it flatters

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our ego and makes it easier to explain our errors and failures."[1]

RUSSIA'S DEVELOPMENTAL DESCENT

Just before his appointment as acting president on January 1, 2000, Prime Minister Vladimir Putin posted a diagnosis of the Russian economy—"Russia at the Turn of the New Millennium"—on the web page of the Russian Federation (http://pravitelstvo.gov.ru). Putin described a country in which GDP had fallen by 45 percent during the 1990s and was currently approximately one-tenth that of the United States; per capita GDP was about one-fifth the average level of the Group of Seven industrial nations; labor productivity was generally only about 25 percent that of the United States; 70 percent of plant and equipment was more than 10 years old; gross domestic investment, the lifeblood of the future, was at only 20 percent of 1989 levels; and foreign direct investment was minuscule.

The quality of life of Russian citizens had fallen "catastrophically," Putin noted. "For the first time in the past 200–300 years, [Russia] is facing a real threat of sliding to the second, and possibly even the third, echelon of world states." He added: "It would be a mistake . . . to deny the unquestionable achievements [of communism in Russia]. But it would be an even bigger mistake not to realize the outrageous price our country and its people had to pay for that Bolshevik experiment."

The vital signs of the economy are reasonably positive, mainly because of external factors. The question is whether the recovery can be sustained and accelerated.

Putin pointed out also that it would take 15 years of an 8 percent growth rate for Russia to attain the per capita GDP of today's Portugal or Spain. To attain the per capita GDP that Britain and France enjoy today would require a 10 percent growth rate over 15 years.

"Who's to blame?" Putin asked. "We could have avoided certain problems. . . . They are the result of our own mistakes, miscalculations, and lack of experience." However, he saw "no alternative to reform."

Although Putin's July 8 state-of-the-nation address reinforced this bleak evaluation, one can understand why many observers are optimistic about the future of economic reform under the new president's leadership. The first and essential step toward a correct prescription is a realistic diagnosis, and Putin certainly provided that. The new president has also been fortunate because the economy has rebounded nicely since the August 17, 1998 financial crisis that saw Russia devalue the ruble and default on both domestic and foreign financial obligations. The vital signs of the economy are reasonably positive, mainly because of external factors. The question is whether the recovery can be sustained and accelerated.

ECONOMIC RECOVERY

The most general and important index of economic activity, gross domestic product, turned up significantly in 1999 to 3.2 percent for the first time since 1989, and indications are that it will show positive growth in 2000 as well. However, because GDP fell by 4.6 percent in 1998, Russia will not regain the 1997 level until some time in 2000.

Exports have been steady and have been the main stabilizer of the economy. Oil export revenue is up sharply, thanks to the success of the Organization of Petroleum Exporting Countries in restricting oil production. Oil prices, of course, are not under Russia's control. The current band set by OPEC, $24 to $28 per barrel, will likely be honored by its members, which means that additional windfalls from oil price increases are unlikely. Moreover, prices for other exports are down or stagnant. These include fertilizer, timber, ferrous metals, and paper products, which offset a portion of the gain from oil exports. Exports are unlikely, therefore, to be a major source of growth in GDP in the near future.

The devaluation of the ruble that resulted from the August 1998 financial crisis caused a sharp rise in the cost of imported goods. Consequently, imports were down by about $3 billion in 1999, which of course represents an increase in aggregate demand and in GDP. Import substitution increased demand for domestic producers and stimulated industrial and agricultural production (8.1 percent and 2.4 percent, respectively). Stabilization of the ruble (currently about 28 rubles to the dollar) makes it unlikely that further import substitution will drive GDP growth in the immediate future.

Tax collections are up reportedly, thanks mainly to exports of oil and gas. Consequently, federal revenue rose to 13.7 percent of GDP in 1999 versus 11.3

[1]Andrei Piontkovsky, "Season of Discontent: The Russian Patient," *The Russian Journal*, May 22, 2000.

percent in 1998. This was offset by a rise in government expenditures. Much depends on the Putin government's ability to maintain and increase tax collections while holding expenditures down. The latter will be difficult as Putin seeks to consolidate his political position. Attempts to use strong-arm methods have proved counterproductive. It is now hoped that a reduced tax rate will induce better compliance.

Inflation fell from 85 percent annually in 1998 to 37 percent in 1999, and indications are that it will fall farther in 2000, which is obviously a healthy sign, especially since real average wages fell by 15 percent in 1999. A further decrease in inflation in 2001 is unlikely due to appreciation of the ruble as the economy grows.

Investment in plant and equipment grew by 1 percent in 1999, but this was still only about 20 percent of the level of investment in 1991, when reforms began. It is no wonder that the average age of the capital stock has increased sharply. Much of it is therefore obsolete or in poor working condition. Without a sustained increase in the rate and volume of investment, the recent growth rate in GDP cannot be maintained and exports are also likely to falter. The slight investment indicates the lack of confidence domestic producers, lenders, and borrowers have in the economy's future, and this view is confirmed by the very low volume of direct foreign investment. In 1999 Russia received about $2 billion in FDI out of a world total of over $800 billion.

Rather than investing in the Russian economy, individuals and firms continue to export capital. Capital flight is defined as the ab-normal conversion of national financial assets into a more stable currency—which in Russia is usually dollars. The best estimate is that about $150 billion has been exported since market reforms began in 1992. The Russian Central Bank estimates that the rate has been $1 billion a month on average. Unfortunately, this has apparently increased to $2 billion as economic growth has resumed, thus undercutting the long-run beneficial consequences of growth. As long as the security of fixed and financial investment is not assured by the Russian government and courts, and while personal property remains subject to the caprice of politics and clan rule, capital flight will continue.

Government debt represents an enormous drag on the economy; total sovereign debt outstanding at the beginning of 1999 was in excess of $150 billion. In 1999, internal GKOs (government short-term securities) amounted to approximately 25 percent of GDP; external debt acquired by the Russian government was about 40 percent of GDP; and external debt carried over from the Soviet period represented another 70 percent of GDP before restructuring in February 2000 by the private financial creditors that make up the London Club. Russia also is hoping to restructure debts with the government creditors of the Paris Club, but thus far no progress has been made. Germany holds the largest share of foreign sovereign debt ($23 billion), and has shown little interest in restructuring it.

Without the London Club restructuring, which wrote off one-third of the debt, service charges would have claimed 80 percent of all anticipated federal tax revenue. Clearly, the health of the Russian economy depends heavily on its success in restructuring or obtaining debt forgiveness. If no further relief is provided, Russia can probably avoid default only if the price of oil remains in the high $20s per barrel or increases. Since debt forgiveness by the Paris Club has been ruled out by both Germany and Japan, rescheduling is the only alternative, which offers short-term benefits but prolongs the burden of Soviet-era debt by stretching out interest and principal payments over time.

The fundamental problem is that the Russian government does not control or can little influence the more favorable economic indicators that have been noted, since they depend variously on OPEC, the Paris Club, the IMF, the World Bank, the German government (especially), and potential foreign investors and speculators. It is not just a case of Russia being on its best behavior. That will help with the international financial institutions, but OPEC and other determinants of the prices of Russia's exports of primary commodities are indifferent to Russia's plight. Yet Russia's recent behavior under President Putin has not been so benign, and this may complicate returning the economy to robust health.

RUSSIAN BOOTSTRAPS

The August 1998 financial crash has, paradoxically, proved to have been a favorable condition for continued economic recovery. The Russian economy hit bottom as the government was forced to devalue the ruble and default (or delay) payments on outstanding domestic and foreign debt. An inability to collect sufficient taxes and to restrict government expenditures produced a cumulative deficit that the government could no longer finance. The crisis seems to have finally persuaded the government that it could not borrow its way to prosperity, nor could it depend on the rest of the world and the various international financial institutions to bail it out.

The IMF has also learned a lesson. It and the other international financial institutions are no longer enabling Russian fiscal improprieties. Russia can expect no new net money from the IMF, but it will not be abandoned by the fund either. The IMF wants its money and reputation back and can be expected to develop ways to allow Russia to repay its debt, keeping the IMF from realizing the financial loss that would otherwise occur. The IMF remains important, however, because its approval is the gateway through which funds may flow from other institutions and from private sources.

Bankruptcy provided a necessary dose of reality, but it also made skeptics of even the most durable optimists in the West, including especially the Clinton administration and the IMF. It is now obvious to all parties both inside and outside Russia that Russia will have to pull itself up by its own bootstraps. The alternative is Russia's continued descent into the third world.

The Chechen war represents perhaps the most serious unfavorable condition with respect to economic recovery. This is partly because the treasury is continuously drained by the tasks of keeping a sizable army in the field and restoring and reconstructing the Chechen republic. More important, the war is symptomatic of Russia's continuing empire envy, of the unwillingness of the power elite to accept the loss of the empire, especially of the near abroad.

President Putin also has apparently given the military its head, and the consequences suggest an increased influence of the military in economic as well as political decision making. But generals do not make good economic reformers. Their training and mind-set is antithetical to market solutions. Moreover, a continuing quarrel between Minister of Defense Igor Sergeyev and Chief of the General Staff Anatoly Kvashnin over the allocation of defense-budget funds and the autonomy of strategic missile forces has paralyzed even reform of the military establishment.

Another unfavorable circumstance is that most of the Russian people and a significant share of the political elite are not ready for full capitalism. In January 2000, half the population reported that the country was on the "wrong course." Despite the apparent realization of Russia's need to attract direct foreign investment in its economy, the populace is ambivalent about foreign ownership. A recent survey shows that, "in Russians' opinion, it would be good if foreigners gave us money . . . but did not own anything." Only 32 percent, for example, approved of foreign ownership of small enterprises, cafes, and shops. Some 87 percent opposed foreign ownership of large plants and factories (89 percent opposed private ownership of large land plots). More than half also want Soviet-style price controls on consumer goods.

Of course, a favorable circumstance is the realistic nature of President Putin's diagnosis of the Russian economy's problems. This favorable circumstance has been offset thus far by Putin's reluctance to provide an unambiguous and realistic prescription for the economy's ills. Several think tanks have published plans that say all the right things: Russia must guarantee private property rights; ensure competition to prevent monopolistic practices; create healthy market institutions and market infrastructure; ensure free movement in the country for commodities, capital, and labor; reduce and simplify taxes; and assure and reorganize the social safety net. Putin has yet to come down squarely on a plan of action, and the "to do" lists are notably silent on many critical needs, such as eliminating corruption at the highest levels of the government bureaucracy. Also troubling is the 10-year plan (for 2010) authored by principal economic adviser German Gref, which is reminiscent of Soviet-style planning in both form and content. It is too optimistic fiscally, and the "industrial policy" it envisions relies too heavily on domestic political priorities rather than on hard-nosed evaluations of potential foreign investors.

Why has so little focus been placed on implementation of economic and political reform under Putin? Empire envy aside, Putin has moved with great caution in all political arenas. He owes his position to several powerful interest groups. These include first the "Family," the term used to describe Yeltsin's relatives and close associates who were undoubtedly active in persuading Yeltsin to turn over the reins of government to Putin as acting president at the beginning of the year. He is beholden to the "oligarchs," the handful of wealthy individuals who profited greatly from privatization and other governmental perks and control or share control of major industries, banks, and other private and quasi-private institutions and firms. Their support was essential in Putin's quest for the presidency, and they command as individuals and as a group Putin's ear. Putin is also beholden to the military and the Federal Security Service (FSB), the successor to the KGB. The FSB is Putin's old employer and one of the few sources he has of trusty supporters.

Other powerful interest groups must be dealt with, especially republic and regional leaders. The rebuilding of central power that Putin seeks will have to be done at the expense of the republic leaders, and he has made some progress in this direction. Recentralization of power, however, may simply not be feasible because of the extent to which it has drained away to the periphery already, largely with Yeltsin's blessing. It is doubtful that the military and FSB have the means and the will to restore central power by force.

It is too early to tell whether Putin is paralyzed by fear of offending one or more of the main interest groups or if he is simply irrelevant because they are running the show. Political leaders come in two broad types. One type has a mission; they want to accomplish something. Gorbachev and Yeltsin were this type of leader early in their administrations. Then there are leaders who just want to be "somebody," as was the case with Soviet General Secretary Leonid Brezhnev. Those with messianic impulses are prepared to spend political power to accomplish their ends. Those who want to be somebody hoard political power to protect their positions. Putin to date appears to be in the latter category, in which case economic and political reform, elimination of bureaucratic corruption, and modernization of the Russian social system are likely to be casualties.

Prognosis

Putin has had almost a year in which, as prime minister, acting president, and elected president, he could have moved decisively on the economy. He failed to do so. His principal economic advisers hold contradictory views on most issues, and the much-touted economic plan for 2010 has been undergoing extensive and endless fine-tuning by the bureaucracy. The best bet is that economic policy will not change dramatically in the near future.

A market economy has been created in Russia, but it remains fragile and incomplete. Aggregate markets for financial instruments (including banking operations), investment goods, existing productive assets, equity shares, and land are inadequate, or not healthy, or both. Putin must work with the Duma to reduce these deficiencies. Attempts to reform by means of presidential decrees were a failure under Yeltsin.

As was noted, the Russian people are not ready for full capitalism either. They must be educated about the requirements and costs of creating a functional market economy, and trust in governmental economic policy must be repaired through consistency and equitable dealing. Continued economic growth will depend on endogenous sources: land, labor, and capital. Restrictions on land use, unmotivated labor, and the flight of capital all undercut prospects for continued growth.

Putin has moved slowly and ambiguously on the economy, and it is unlikely that the pace will quicken as he and his supporters consolidate political power and pursue pacification in Chechnya and the projection of influence into the near abroad. Economic reform will, for the next six months to two years, be gradual and halting. Radical change will be avoided. Currently favorable economic conditions will allow a degree of maneuverability for the near term. The evidence is that the initial main thrust of economic policy will be to increase the flow of funds and resources to the military and the military-industrial complex.

The political influence of some of the oligarchs may be diminished in internecine political struggles, but dispossession of the oligarchs as a group is highly unlikely because Putin and the political leadership need their financial support. A broad attack could also end badly, leading to a significant increase in economic turmoil. The attempt to rein in the regional leaders has had a degree of success, but it is too early to determine whether it will assert effective control over republic resources and curtail regional power.

The possibility of accession to membership in the European Union and Russia's willingness to seek it earnestly would provide the best possible prospect for market reform in Russia and for Russia's entry into the global economy on a solid footing. However, neither party seems prepared to move in this direction. This is unfortunate, because the plans for economic reform that have been developed for Putin are not promising. Russia appears to be stuck halfway between a command economy and a market economy, incapable of moving forward except by small, halting, and irresolute steps. ■