Can Russia Ever Catch Up?

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New Times (Moscow), May 2003

The issue of how quickly Russians' per capita income can catch up with those of Hungarians and Czechs has been the subject of much discussion in government and academic circles, in Russia and abroad. Last year president Putin expressed some frustration with the seemingly unambitious medium-term growth forecasts put forward by government ministers. A narrowing of the per capita income gap with respect to other countries in the EU, even those not quite yet "in" (to say nothing of older members like Portugal and Spain) will require substantially higher real growth rates than the 3-4% projections presently found in most Russian government documents. The issue has more than purely academic importance. There are many economists who believe that transition economies in Eastern and Central Europe—all those countries presently scheduled to join the EU next year—will continue to grow rapidly in coming years, reflecting the beneficial effects of the institutional reforms associated with EU entry, and the ensuing inflows of foreign direct investment and EU transfers. If this is the case (and I think that it is) it could mean that Russia, growing at 3-4% per year, might actually begin to *fall behind*, making the whole discussion of "catching up" a little irrelevant. And if this happens it would raise very fundamental questions about the abilities of those currently managing the key levers of the Russian economy. All of this then raises the question of what are, in fact, those key factors which are likely to play a prominent role in determining Russia's growth path over the next ten years? We take a brief look at three of the most important ones.

Structural endowments

This refers to the structural inheritance of Russia, as it emerged from several decades of central planning in the days of the Soviet Union. In some sense, this set of factors is the one that works most to Russia's advantage. The economic distortions of the Soviet era were far more pervasive here than in other centrally planned economies, many of which, by the early 1990s, had thriving private sectors. In contrast, Russia did not even have the rudiments of a price and tax systems and, in addition, widespread subsidization of production combined with an unhealthy emphasis on boosting the prominence of military output, had made its industrial sector painfully uncompetitive. As these distortions continue to be dismantled, the net result is to boost its potential growth rates—this phenomenon has been seen in operation in other transition economies and there is no reason to believe that it could not benefit Russia in a similar fashion.

Two other features which enhance Russia's long-term growth potential are its natural resource base and its rich human capital endowment. Russia is already the world's largest *energy* exporter, by virtue of its pre-eminent role as the world's top gas exporter, with close to 35% of the global market. But non-energy commodities are also key contributors to the economy. The redeployment of labor from the military industrial complex to the private non-defense sector is swiftly underway; over the medium term this should boost labor productivity, as Russia's well-educated labor force moves to light manufacturing, services and other industries long neglected under the central plan. Although it is difficult to quantify the impact on long-term growth of these structural endowments, they should play a supportive role if accompanied by the two other factors identified below.

External environment

The external environment has played a key role in earlier crises, with the most recent examples being the collapse of oil prices in 1997/98 and in 1986. Both precipitated a fiscal catastrophe, although the effects of the more recent episode were more visible, owing to the substantial opening up of the economy that had taken place in the intervening decade. The Russian economy remains strongly dependent on the energy sector. According to the IMF, the energy sector contributes some 17% of Russia's total output and some 25% of total budget revenues. It has also accounted for 40% of total investment in recent years and energy exports account for 50% of exports. The IMF estimates that a $1/barrel drop in the price of oil translates into a 0.5% GDP contraction; a 0.3% of GDP reduction in federal revenues and a US$1bn drop in exports.

The government seems to be well aware of the vulnerabilities implicit in the above "facts" about the Russian economy. Two possible ways to mitigate the undue influence of oil would be: first, to boost exports over the medium term with a view to generating for the federal budget a given level of revenues, albeit at lower prices. This is likely to happen in any event, as the interests of the state and the oil companies broadly converge. Indeed, after September 11, there is growing recognition that Russia could well emerge over the longer term as a reliable alternative supplier of energy to the West. In this scenario even a price of $15/barrel on a sustained basis could meet the requirements of the budget.

A second component of this strategy would be the creation of a Norwegian-style stabilization fund. To be funded by a share of taxes on the oil (and other commodities) sector, it would aim to capture resources continuously, both to build a cushion of reserves for a "rainy day," and to meet future claims on the budget stemming from the ageing of the Russian population. The external environment has other features which could have a bearing on Russia's ability to sustain high growth rates: the timing and conditions under which Russia would enter the WTO would seem to be perhaps the most important one.

The content of policies

Real growth rates in the 7-9% range, needed to make the kind of difference in the pace of "catch-up" that president Putin wants are not impossible and would require a supportive external environment and, above all else, a much more aggressive stance as regards structural reforms. We take it as given that the budget chaos which was the defining characteristic of Russian economic policy during much of the 1990s is long gone; the actual evolution of the fiscal accounts during the last three years would suggest this to be a reasonable assumption. But a solid budget and tight monetary policies will clearly *not be enough*.

Particular attention would have to be given to measures aimed at creating a friendlier environment for small to medium-sized enterprises, the bedrock of output and employment growth in the more successful transition economies in the region. In particular, by enhancing the intermediation role of Russia's banking sector through a comprehensive set of measures aimed at addressing some of its most glaring distortions, such as the lack of appropriate supervision; the fact that it is dominated by state banks which do not operate on a commercial basis; its sprawling nature, with 800 of more than 1,300 banks with total assets averaging about US$1m each, to focus on just a few of the tasks that need to be resolved with growing urgency.

But this is not all. The authorities need to do much more in terms of improving the legal and regulatory environment. The big conglomerates have no difficulties lobbying the government and the Duma to ensure that the system works for them, just as they have had no problems in financing expansion plans out of their profits or via "pocket" banks. Indeed, the extent to which they dominate the economic and political landscape is itself a worrying development, suggesting the emergence of a South Korean-style *chaebol* form of capitalism. But, at the other end, potential entrepreneurs face a labyrinthine regulatory environment, corrupt officialdom, and have few chances of gaining access to bank credit. Many in the government seem to be aware of these weaknesses; much of the push in the area of structural reforms seen in the past two years is aimed at remedying them. But, there will be no major pick-up in growth rates unless much more is done in these areas.

Higher long-term growth rates are not inevitable, but they are certainly feasible. They will require a supportive external environment and improvements in the content and the implementation of structural policies. These two conditions, combined with Russia's impressive resource endowments, could create the conditions for much higher growth, for the benefit of Russians and the satisfaction of their president.

New Times is the English edition of the Russian newsweekly magazine *Novoe Vremya*. Augusto Lopez-Claros is former resident representative of the International Monetary Fund in the Russian Federation.