ANALYSIS

# The Russian Economy and Russian Economic Policies since 1991

By Philip Hanson, London


## Abstract

Post-communist economic transformation, like old age, is not for wimps. Even in countries that are commonly regarded as success stories, like Estonia and Poland, the going has been tough. In Russia, as in other CIS countries, the change from centrally-planned socialism to market capitalism has been particularly difficult. It has also been only partly successful. In what follows, I offer some thoughts on economic transformation in general, followed by a brief narrative and an even briefer assessment. My conclusion is that Russia, along with the whole of the CIS, has been weighed down by extremely poor initial conditions and by a lack of either elite or popular appetite for radical liberalisation of the economy.


## Liberalisation, Stabilisation, Privatisation and Russia

Centrally-planned communist economies have, if one ignores their black-economy transactions, centrally controlled prices and output levels and entirely or predominantly state-owned production units. To enable these arrangements to function, foreign trade must also be run by the state. Capitalist market economies have mostly uncontrolled prices, outputs and foreign trade and mostly private ownership of resources. Therefore a country moving from one system to the other (and alternatives to these two have yet to be discovered) must liberalise and privatise. Also, centrally-planned economies tend to be shortage economies and liberalisation therefore produces a leap in price levels, so there has also to be macro-economic stabilisation to prevent the one-off leap in prices turning into prolonged high inflation.

The reform prescription of liberalising, stabilising and privatising is therefore unavoidable. True, that leaves considerable scope for variations in pace and timing and in the attention given to the development of appropriate institutions. But the changes have to be made. There is no reason to assume that they can necessarily, within a generation or so, be made in such a way that a well-functioning market economy emerges. In Russia a capitalist, market economy has emerged, but not one that functions well.

## 1990–1998: from 'Catastroika' to the Beginnings of Recovery

The reform team led by Yegor Gaidar was formed in 1991. It became the reform wing of the new Russian government at the end of that year. Its members, with Gaidar himself as acting Prime Minister, held key economic posts. In the immediate run-up to the formation of a new Russian state, the economy was in a systemic vacuum: the controls of the centrally-planned economy had broken down and market arrangements were not yet in place. The initial conditions in which the new government had to operate were dire. A decline in economic activity had begun earlier, in 1990. Inflation, too, was already a problem: over 90% in 1991.

The Gaidar team described themselves as a 'kamikaze' squad. They believed that the forces ranged against liberalisation, stabilisation and privatisation were massive and that resistance to their reforms was deep and widespread. There was, first, some popular attachment to the 'Soviet way of life'. For all its shortcomings, the Soviet social order was a Russian invention. Alexander Zinoviev's assertion that '…they [Western cold warriors] aimed at communism but killed Russia' articulated a feeling that was shared by many. Then there were all those in the Soviet political and economic elite who rightly feared a loss of power in a new order.

The other big obstacle was the huge economic distortion that the new Russia inherited: large and extensive shortages along with decades of protected production that was uncompetitive and in some cases even value-subtracting (industrial output worth less on world markets than the raw materials that went into it). These were worse than the initial distortions in Central-East European economies.

Price liberalisation was the only way of dealing with the extreme shortages of 1990–91. The result was consumer-price inflation in the twelve months to December 1992 that exceeded 1500%. Or rather, that inflation was the result of two things: the initial leap in prices and the failure of the first attempt at macro-stabilisation in mid-1992.

The outcome of liberalisation and further failures in stabilisation was a prolonged decline in output accompanied by high inflation (see Chart 1). This messy state of affairs culminated in the crisis of summer 1998. Attempts at macro-economic stabilisation were short-lived. They failed to produce hard-budget constraints on producers. When the rouble money supply was squeezed, enterprise managers resorted to non-monetary settlements (barter, IOUs, payment delays). These, in turn, were propped up by subsidies to the state suppliers of gas and electricity; the subsidies were made possible by government borrowing. When the pyramid of government short-term bonds collapsed, this virtual economy collapsed with it.

Meanwhile a remarkable programme of privatisation was carried out: by vouchers in 1992–94, and then by 'cash'. However, the restructuring of enterprises lagged behind the formal privatisation (see Chart 2), precisely because of the failure to impose hard-budget constraints on producers, whether state or private. Of the three pillars of transformation it was stabilisation, rather than liberalisation or privatisation, that proved to be the most difficult to achieve. Informal networks of officials and managers, abetted by some of the political leadership, had contrived to undermine efforts at macro-stabilisation from generating real pressure on the behaviour at the micro-level of enterprises.

## 1998–2008: the Inter-Crisis Boom

The 1998 crisis forced the government to let the rouble exchange rate fall. It went from around R6 to the US dollar to around R24 in a couple of months. This devaluation kick-started a recovery. Officially-recorded GDP in 1998 was just under 56% of its 1989 peak. Many enterprises had been unable to pay their way (except by barter, IOUs, etc) because they could not compete with imports at the previous exchange rate. The devaluation gave them a chance of revival. To the surprise of many analysts, they took the opportunity. The reforms of the early 1990s, for all their shortcomings, had at least created a population of firms capable of responding to price signals.

Then the oil price began a long, though not continuous, rise, bringing in a growing flow of revenue from oil and gas and—since other commodity prices also rose—from metals as well. Rising oil prices drove Russian GDP (see Chart 3). They increased state, household and company incomes and therefore aggregate demand. Some of the revenue from oil and gas was siphoned off to offshore bank accounts and holding companies; some was used to pay off external debt, and some was sterilised as a matter of policy by placing it into the Reserve Fund and the National Prosperity Fund. The remainder stimulated demand and therefore domestic economic activity.

In the inter-crisis boom, GDP grew at an average annual rate of 6.8%. Because the starting-point was so low, however, officially-measured GDP at the end of the boom in 2008 was still only 7.4% above the level of 1989. However, the steep rise in oil prices produced a large improvement in Russia's terms of trade, enabling real incomes to rise faster than GDP. I estimate household consumption in 2008 to have been approximately 2.3 times its level in 2000. The corresponding ratio for GDP is just under 1.7.

Fast growth in incomes sucked in imports. The annual rate of growth of car imports in 2000–08 was 51.5%, of refrigerators 14.3% (derived from Russian Customs data). Yet the growth of exports (chiefly because of rising oil and gas prices) was such that Russia continued to run a large trade and current account surplus.

Policies in this period were an odd mixture. Under Finance Minister Aleksey Kudrin, public spending was held back until the electoral cycle of 2007–08. By creating reserve funds based on oil, and latterly on oil and gas revenues, he provided the instruments that helped Russia get through the 2008–09 crisis. His (mostly) prudent policy-making, however, co-existed with policy failures at the micro-level. Informal, corrupt links between business and officials, without independent courts to protect property rights, continued to characterise the business environment. Some early liberal reforms in 2000–03 were followed by a highly-visible shift back to state control. This was signalled by the arrest of Mikhail Khodorkovsky in late 2003 and the subsequent state acquisition of most of the assets of his Yukos oil company.

## After Mid-2008: a New Era?

The year-on-year fall in Russian GDP in 2009 was a remarkable 7.8%. Some countries, e.g. Estonia, fared worse, but the striking feature of the Russian fall in output was that it greatly exceeded the damage done by the first round of the global financial crisis to other large emerging economies and to other major oil exporters. The scale of this set-back, despite the neat synchronicity displayed in Chart 3, cannot be explained simply by the fall in the oil price. My conjecture is that it was caused by the fall in the oil price combined with a very low level of confidence in Russian institutions. This combination produced a panicky withdrawal of capital from Russia by both Russian and foreign-owned business.

The global crisis of 2008–09 was a 'balance-sheet crisis'. It was always likely to be followed by borrowers trying to reduce their debt and lenders trying to cut back their outstanding loans. This has been damaging around the world, and certainly so for Russia, whose banks and companies had in 2004–08 massively increased their international borrowing. In addition, confidence in an ever-rising oil price was shaken and for the first time the working-age population began to fall. At the same time, the European economy, the customer for about half of Russia's exports, stagnated and threatened to implode. In other words, four key sources of growth either dried up or became more uncertain.

For this reason growth has not returned to previous rates, but has been about 4%. In most projections to 2020 growth of that order or somewhat less features in the baseline scenarios. And there is a considerable downside risk as well.

Confidence in the Russian economy has decreased. Private capital flows into and out of the country had produced net positive (in-) flows in 2006 and 2007. Before and—worryingly—since those two years, there have been net outflows of private capital. In part this reflects net debt repayment, but even that means that much old borrowing is not being rolled over. Part of the outflow is a direct expression of low confidence in the country's future.

## Assessment of Russian Economic Policies since 1991

Russia has had some effective, liberal economic policy-makers: Yegor Gaidar, Anatolii Chubais and Aleksey Kudrin, to name just three, who achieved a great deal. The economy has become a mainly-private-enterprise, market economy. In the boom years fiscal reserves were built up in a prudent manner and many (if not all) would-be big spenders were resisted.

Yet the business environment remains very poor. Of 49 upper-middle-income countries included in the World Bank's 2012 Ease of Doing Business rankings, Russia comes well down, at 40th. This reflects the failure to overcome the heritage from the Soviet Union. Extreme initial distortions of the economy contributed to the acute difficulties of the 1990s. The continuing institutional weaknesses—lack of impartial courts, pervasive corrupt links between business and the state, and a mostly torpid bureaucracy—have deep social roots. Perhaps an inspiring statesman at the helm, a Mandela or a Havel, might have made a dent in these problems, but no leader of that stature has emerged.

*About the Author*
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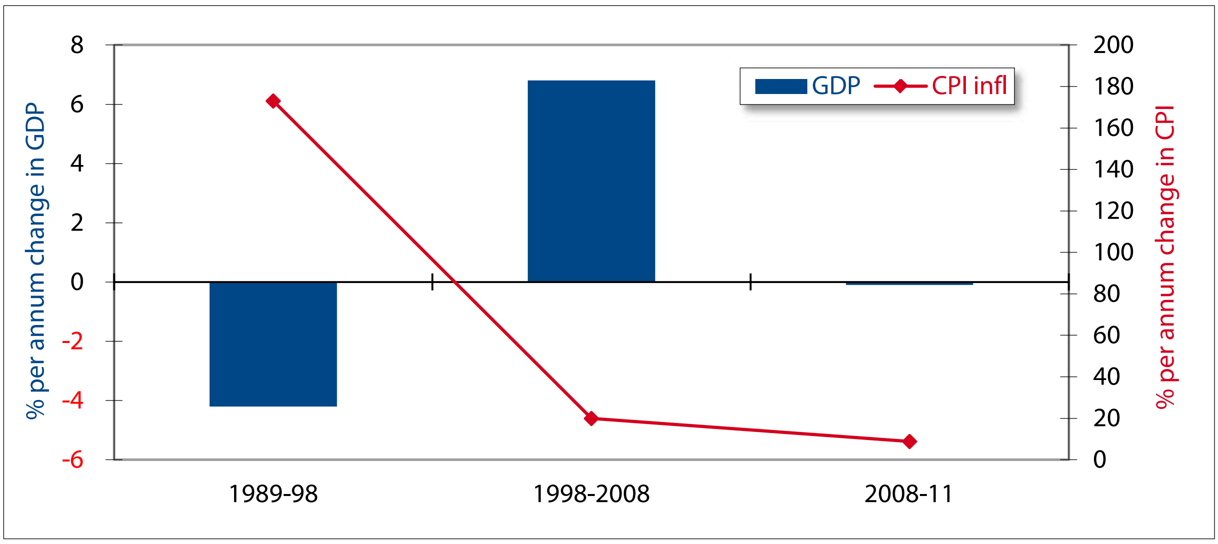
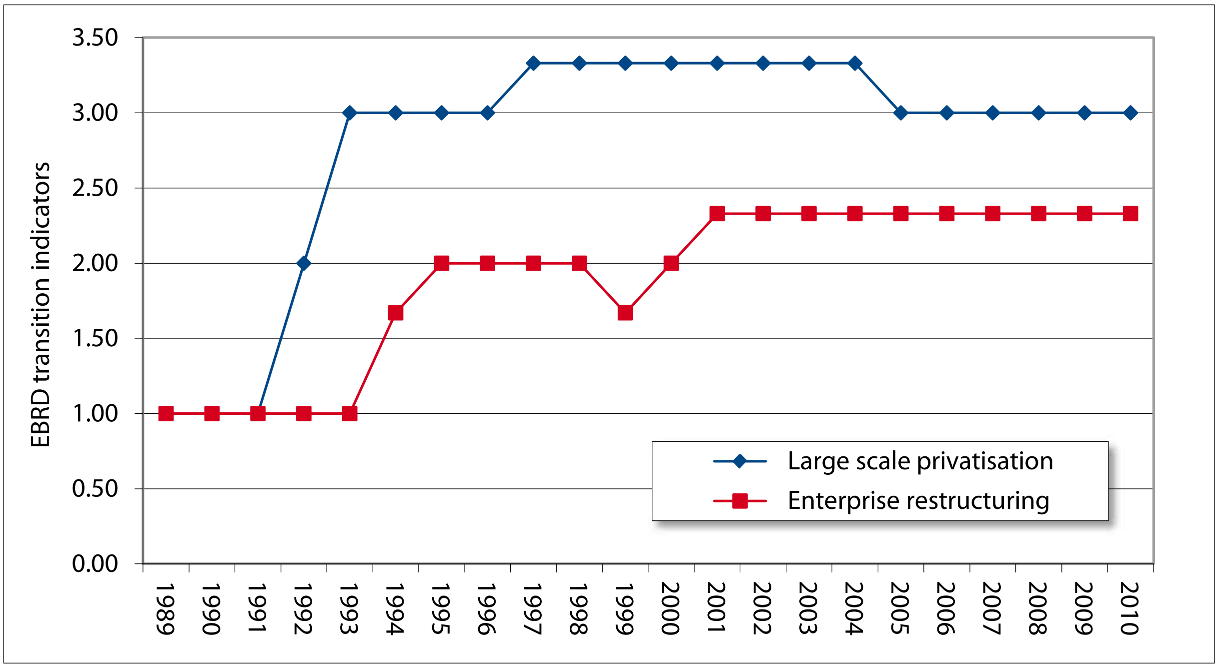
*Further Reading*
- Aslund, Anders., *How Russia Became a Market Economy*, Washington, DC: Brookings Institution, 1995.
- Berglof, Erik, Andrei Kunov, Julia Shvets, Ksenia Yudaeva, *The New Political Economy of Russia*, Cambridge, MA: MIT Press, 2003.
- Sutela, Pekka, *The Political Economy of Putin's Russia*, London: Routledge, forthcoming April 2012.

**Chart 1: Growth and Inflation in Russia: Three Epochs between 1989 and 2011 (average annual % per annum changes within selected periods)**



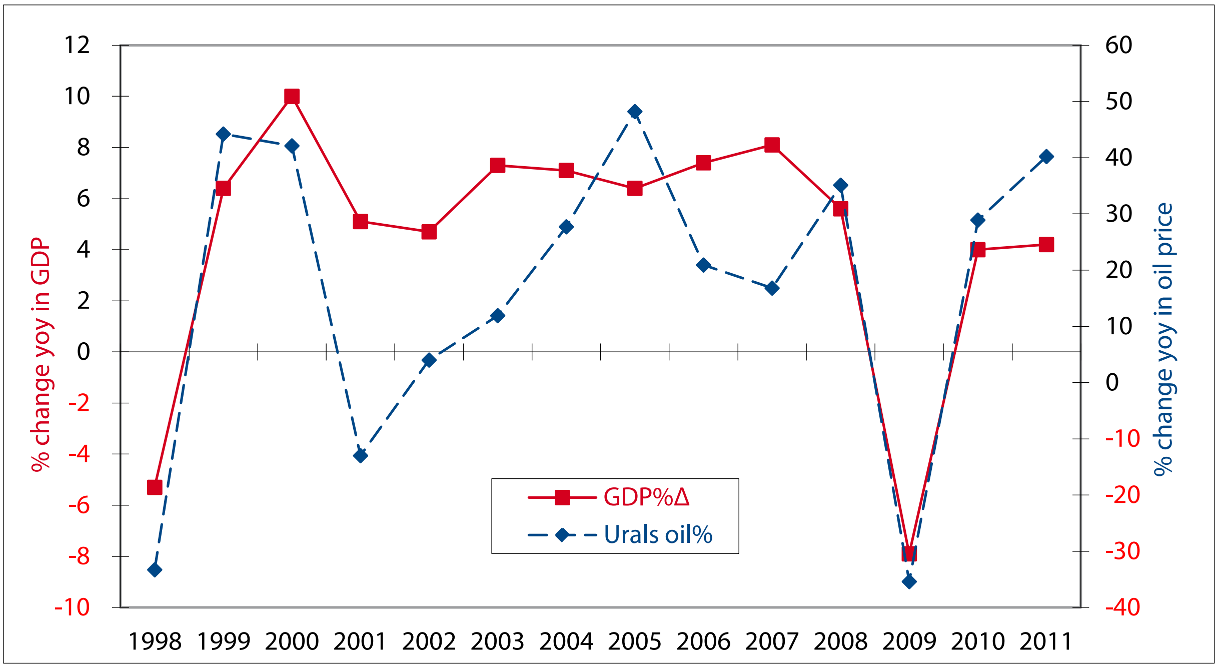

*Sources: European Bank for Reconstruction and Development (EBRD); Rosstat; author's calculations*

**Chart 2: Modest Changes in the World of Enterprises in Russia, 1989–2010 (EBRD 'scores' on large-scale privatisation and enterprise restructuring)**




*Note: the range of EBRD transition indicators is from 1 (no change) to 4.5 (situation equivalent to that in a developed market economy).*
*Source: European Bank for Reconstruction and Development (EBRD)*

**Chart 3: Changes in Russian GDP and in the Annual Average Urals Oil Price (% year on year), 1998–2011**




*Sources: Rosstat (GDP); Central Bank of Russia (oil price).*