

Analysis

After 10 Years of Growth, the Russian Economy May Be Losing Steam

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Abstract

From May to October 2008, Russian stocks, as measured by the RTS index in dollar terms, lost two-thirds of their value. The decline was driven partly by the world financial crisis and partly by declining world oil prices, which fell from a maximum of nearly \$150 in June to below \$100 in October. Between August 1 and October 1, 2008, capital outflows drained foreign exchange reserves by approximately \$40 billion. The seasonally adjusted index of industrial output has not grown since May 2008. If global recession pushes fuel prices further down, the Russian economic growth of the past 10 years may also come to an end. Is the Russian economy today better suited to survive the coming downturn than it was ten years ago?

The Achievement of the Past 10 Years

The Russian economy lost 45% of its output during the transformational recession of 1989–1998, income inequalities increased greatly, the crime rate doubled, and life expectancy dropped from 70 to 65 years. The short-lived stabilization of 1995–98 (when the ruble was pegged to the dollar and inflation subsided) ended in the spectacular currency crisis of August 1998 – the ruble then lost over 60% of its value in several months, inflation spiraled out of control, and crime, suicide and mortality rates increased once more.

However, after the 1998 currency crisis, the Russian economy started to grow. With an average annual growth rate of about 7% in 1999–2007, Russia's GDP is gradually approaching the pre-recession level of 1989. Real incomes and personal consumption increased even faster – they more than doubled in 1999–2007 – and have already surpassed the pre-recession level of the late 1980s. The major push came from the devaluation of the ruble in 1998 and higher world prices for oil and gas in the later years, but the government can at least take credit for not ruining this growth. Inflation fell from 84% in 1998, when prices jumped after the August 1998 currency crisis and dramatic devaluation of the ruble, to 10–12% in 2004–07 (see Figure 1).

Economic growth and high world fuel prices helped the government collect more tax revenue, so the government budget moved from deficit to surplus, and government spending as a proportion of GDP increased since 1999 (Figure 2), allowing a partial restoration of the state's institutional capacity that had been lost in the 1990s. Moreover, high oil and gas prices in the world markets allowed Russia to enjoy large foreign trade surpluses and to accumulate foreign exchange reserves – they increased from less than \$15 billion right after the 1998 currency crisis to nearly \$600 billion by August 2008.

True, in comparative perspective, Russian performance was not that impressive. By 2007, many other former Soviet republics – Armenia, Azerbaijan, Belarus, Estonia, Kazakhstan, Latvia, Lithuania, Turkmenistan, and Uzbekistan, to say nothing of the Central European countries, – had surpassed the pre-recession level of output, whereas Russian GDP was still only 99% of the 1989 level. Russian growth rates in 1999–2007 were high (7%), but still lower than other fuel exporters from the former Soviet Union, such as Azerbaijan, Kazakhstan and Turkmenistan (over 10% in 1999–2007). Even some fuel importers, like Armenia and Belarus, showed higher growth rates than Russia (Figure 3).

Russia's performance on the Human Development Index (HDI), which measures GDP per capita as well as life expectancy and education levels, is still below the USSR level and even below that of Cuba, where the average person lives 77 years, 11 years more than in Russia. China, with a life expectancy of 72 years, is rapidly approaching Russia's HDI level. Nevertheless, at least there is more stability in Russia today than in the rocky 1990s.

Economic growth and the gradual restoration of the government's ability to provide public goods led to improved conditions in the social sphere – since 2002–03 the murder, suicide and mortality rates started to fall, albeit very slowly, while the birth and marriage rates increased, helping to slow the decline of the Russian population (it fell from 148.6 million in 1993 to below 142 million by mid-2008). The number of murders reached a peak in 2002 and fell in 2003–08; the suicide rate decreased in 2001–08 (Figure 4); and the mortality rate stabilized and fell in 2004–08 as life expectancy increased slightly (Figure 5). After reaching a 50-year minimum in 1999, the birth rate started to grow. As the marriage rate increased, divorces fell. On the other hand, the over 50% increase in the crime rate in 2002–

06 most likely indicates that the police were doing a better job registering crimes reported to them rather than an actual jump in the number of crimes committed because the number of violent crimes (which are always registered more accurately than others) continued to decline.

Remaining Weaknesses

Unfortunately, the Russian achievements of recent years are based on weak foundations. Russia was unable to properly cope with the growing stream of petrodollars. In fact, the right question to ask about the recent performance of the Russian economy is why Russian growth rates lagged behind the growth rates of other countries and were not even higher in 2001–08 despite a nearly fivefold increase in average annual oil prices (Figure 6). The answer may be disappointing, but is hardly disputable – Russia did not manage to use its growing resource rents in the best possible way.

The Russian economy faces several weaknesses. First, the economy is too dependent on the oil and gas exports that account for one-half to two-thirds (depending on world fuel prices) of total Russian exports. The prosperity of recent years was mostly based on growing world fuel prices. A simple calculation shows the importance of the windfall oil revenues for Russia: Russian GDP at the official exchange rate was about \$1 trillion in 2007, whereas the production of the oil and gas sector, which employs less than 1 million workers, is valued at about \$500 billion at world oil prices of \$80 per barrel. When oil was priced at \$15 a barrel in 1999, Russian oil and gas output had a value of less than \$100 billion. The difference, \$400 billion, is the fuel windfall profit that literally fell on Russia from the skies.

Few specialists would call the USSR a resource economy, but Russia's industrial structure changed considerably after the transition to the market began. Basically, the 1990s were the period of rapid deindustrialization and "resourcialization" of the Russian economy and the growth of world fuel prices since 1999 seems to have reinforced this trend. The output share from major resource industries (fuel, energy, metals) in total industrial output increased from about 25% to over 50% by the mid-1990s and stayed at this high level thereafter. Partly this shift was the result of changing price ratios (higher price increases in resource industries), but also the real output growth rates were lower in the non-resource sector. The share of mineral products, metals and diamonds in Russian exports increased from 52% in 1990 (USSR) to 67% in 1995 and to 81% in 2007, whereas the share of machinery and equipment in ex-

ports fell from 18% in 1990 (USSR) to 10% in 1995 and to below 6% in 2007. The share of R&D spending in GDP amounted to 3.5% in the late 1980s in the USSR, but fell to 1.3% in Russia today (China – 1.3%, US, Korea, Japan – 2–3%, Finland – 4%, Israel – 5%). So today Russia resembles a "normal resource-abundant developing country".

Second, the government failed to channel the stream of petrodollars into repairing the "weakest link" of the national economy – provision of public goods and investment into non-resource industries. Investment and government consumption amounted to about 50% of GDP in the early 1990s, fell to below 30% of GDP in 1999 (right after the 1998 currency crisis), and recovered only partially afterwards – to about 40% of GDP in 2007 (Figure 7). Wages and incomes in recent years have been growing systematically faster than productivity.

Tax collection fell dramatically in 1992–98, from over 50% of GDP to about 30%, whereas GDP itself nearly halved. The efficiency of the government in the 1990s deteriorated greatly: low spending levels meant that the state simply could not provide enough public goods. The shadow economy, which according to the most generous estimates placed at 10–15% of GDP under Brezhnev, grew to 50% of GDP by the mid-1990s. In 1980–85, the Soviet Union ranked in the middle of a list of 54 countries rated according to their level of corruption, with a bureaucracy cleaner than that of Italy, Greece, Portugal, South Korea and practically all the developing countries. In 1996, after the establishment of a market economy and the victory of democracy, Russia came in 48th in the same 54-country list, between India and Venezuela.

Since 1999, state revenues and expenditures increased as a percent of GDP, but by far too little to restore the provision of public goods to the levels of the late USSR. As a result, provision of education, health-care, public utilities and law and order continue to be dramatically underfinanced. Instead of using windfall petrodollars to repair the weakest link – state capacity to provide public goods – the government, on the one hand, decreased tax rates, allowing petrodollars to leak into personal incomes, and, on the other, maintained a budget surplus that expanded to nearly 10% of GDP and was used to finance the accumulation of foreign exchange reserves in the Central Bank and the Stabilization Fund.

The share of investment in GDP increased marginally after 1999, but again, far too little to compensate for the fall of the 1990s. This share remains at a level of

25% as compared to 36% in 1990–91 (Figure 7), whereas the real volume of investment in 2007 barely reached 40% of the 1990 level (Figure 8). These figures mean that Russia was literally “eating up” its capital stock at a time when the stream of petrodollars created better conditions for repairing this stock than ever before.

Third, in recent years Russia has suffered from the “Dutch disease” – a dramatic appreciation of the real exchange rate of the ruble (Figure 9) that undermined the growth of all industries except for those in the resource sector). The Russian Central Bank was doing the right thing by going against the grain and accumulating foreign exchange reserves to prevent the appreciation of the ruble, but it did not do it fast enough, which resulted in the growing ratio of Russian prices to foreign prices. As a result, Russian non-fuel industries could not compete with foreign producers, so imports in real terms grew faster than anything else in the national economy. As Figures 10 and 11 suggest, the growing trade surplus of recent years is mostly due to constantly increasing fuel prices, whereas the growth of the physical volume of imports (fivefold in real terms in 1999–2008) greatly outpaced the growth of exports in real terms.

True, Russia maintains low fuel prices in the domestic market via export taxes and direct administrative restrictions on exports, which create stimuli for the manufacturing industries. But such a policy has a high cost since the Russian economy is one of the most energy intensive in the world, consuming much more energy per unit of GDP created than other developed countries. It is theoretically possible to switch to a more promising industrial policy – undervaluing the ruble exchange rate and imposing high domestic prices for fuel. Such a policy would stimulate growth for the whole economy, and especially in the high tech industries, without the unfortunate energy waste. However, there are virtually no resource-rich countries with this combination of policies. Typically, these countries, like Russia, have

exactly the opposite combination – low domestic fuel prices and an overvalued exchange rate, usually combined with poor quality institutions.

Finally, income inequalities have increased considerably. The Gini coefficient (which ranges from 0 to 100, with higher numbers representing higher inequalities) increased from 26 in 1986 to 40 in 2000 and 42 in 2007. The decile coefficient – the ratio of the incomes of the wealthiest 10% of the population to incomes of the poorest 10% – increased from 8 in 1992 to 14 in 2000 to 17 in 2007. But the inequalities at the very top increased much faster: in 1995 there was no person in Russia worth over \$1 billion, in 2007, according to *Forbes*, Russia had 53 billionaires, which propelled the country to the second/third place in the world after the US (415) and Germany (55) – Russia had 2 billionaires fewer than Germany, but they were worth \$282 billion (\$37 billion more than Germany’s richest). In 2008 the number of billionaires in Russia increased to 86 with a total worth of over \$500 billion – one-third of the country’s GDP.

These weaknesses – an overvalued exchange rate, poorly diversified economy and export structure, low spending for investment and public goods, and high income inequalities – were partially concealed by high oil and gas prices in 2003–08, but are being revealed now, as oil prices fall. Foreign exchange reserves of over \$550 billion (as of early October 2008) provide some room for maneuver and a chance for a “soft landing.” At the current rate of depletion (\$20 billion a month), Russia still has more than two years to adjust to the terms-of-trade shock. But even if oil prices do not fall faster, at the end of the day, there is no way to avoid devaluation and real restructuring in order to tackle the root problems rather than their symptoms. The paradox, however, is that the need to deal with these weaknesses becomes more acute with the depletion of the required financial resources.

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