Russia's Political Economy

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Summary

The paper addresses the issue of sustainability of Russian recovery as experienced in 1999-2000, the first time ever since transformation started. The question of short term components of growth, like devaluation and high oil prices, are compared to possible and foreseeable contribution of institution building measures and policy reforms, such as the new land code, the regulation of natural monopolies and tax cuts. Among the unaddressed issues the problem of financial intermediation and the security of property rights are critically analysed. Finally the possibilities and limits of new forms of western involvement in Russia and involving Russia in world affairs are addressed.
1. Preliminaries.

The collapse of the Russian rouble in August 1998, and the following developments have proven that the Russian economy is by no means peculiar. It functions according to the logic of standard textbooks. If you liberalize the capital account in a premature fashion, use short term money to cover structural deficits on the fiscal accounts, and try to sustain a fixed exchange rate in the meantime, you are heading for trouble, whose occurrence is sure with only its timing subject to circumstances. If you devalue the domestic currency to one fourth of its original value, you create enormous impetus for import substitution, protect your markets and trigger a supply side response, while the current account is likely to improve tremendously.

Add to this a more than tripling of oil prices, where 53 per cent of currency intakes are derived from the exports of fuels and energy. The surplus in the current account is likely to be substantial, and the fiscal account is likely to close with a surplus, while activity indicators will improve. And indeed, the current account surplus of $2 billion in 1998 grew to $18 billion by 1999 and $41 billion by 2000 (according to UN ECE Economic Survey of Europe, 2001 no.1.) General government deficit, consolidated according to GFS standards, were 8.9 per cent of GDP in 1997, 3.2 per cent in 1998, and1.0 per cent in 1999, giving way to a surplus of 4.6 per cent in 2000, to be repeated by various estimates in 2001 with a surplus between 0.25 and 1.5 per cent of GDP (comparative estimates reported in: Voprosy Ekonomiki, 2001 (3, p. 44, consolidated deficit figures ibidem, p.61).

All in all, there is nothing deviant in the way the Russian economy works. There is no ground to talk about a miracle. Likewise all analysts agree that growth is likely to decelerate already this year, to 2-4.5 per cent on an annualized base, with the consensus estimate being around or below two percent, strongly dependent, of course, on the actual level of world oil market prices. Actually as econometric evidence suggests, the correlation between Russian industrial output and world oil prices is over 81 per cent, allowing for a mere 1.0 per cent increase of Russian GDP in the medium run. This is certainly at odds with the overoptimistic assumptions of the Gref Plan, aiming at steady 7-8 per cent GDP growth for a decade.

2. The contribution of economic policy.

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1 Preliminary version of a paper to be presented to the Council on Foreign Relations conference "Toward an
The above-cited numbers reflect a fairly mechanic process of adjustment to external disturbances, which may have happened basically in any economy, irrespective of its economic institutions and policies. When external shocks dominate overall macroperformance, it is particularly important to disentangle what, if any, of the outcomes are attributable to policies and what to circumstantial factors. If we take into account that terms of trade for Russia have improved tremendously, by 48.1 per cent in 1999 and by yet another 66.3 per cent in 2000 over the 1998 actual values, it is hard to overlook the enormous one-time windfall component in shaping macroeconomic landscape in the country. The chief economist in President Putin's administration, Andrei Illarionov, a long-term observer of Russian macroeconomic policies has provided the following table\textsuperscript{2} comparing the windfalls and macroeconomic performance, in terms of percentage points of the GDP.

<table>
<thead>
<tr>
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<th>1997</th>
<th>1998</th>
<th>1999</th>
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<tbody>
<tr>
<td>Windfall</td>
<td>-1.1</td>
<td>-3.3</td>
<td>+1.1</td>
<td>+12.7</td>
</tr>
<tr>
<td>GDP</td>
<td>+0.9</td>
<td>-4.9</td>
<td>+3.5</td>
<td>+7.7</td>
</tr>
</tbody>
</table>

The author interprets the difference between the two as a possible measure of net contribution of economic policies to the overall macroeconomic performance by the respective year. Given that the Primakov and Stepashin periods saw a deceleration of reforms, and 2000 has mostly been spent on presidential elections and establishing the new power structure, the strongly negative contribution is anything but surprising. It also helps explaining why the new President could have been convinced of the urgency to initiate further reforms rather than being content with the status quo of dramatically improving short-term activity indicators (with the partial exception of unemployment). Also the fact that 50 per cent of the population lives under the IBRD poverty level of 2 dollars per day and the level of development at market exchange rate is below $1900 (at PPP about $6000 or two thirds that of Hungary) were rightly seen as stimuli for quick and radical action.

3. Yeltsin's legacy.

Much has been written about this topic, whose significance grows with the first ever peaceful handover of power in Russia successfully completed. The economic system of

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Understanding of Russia\textsuperscript{a}, Washington, D.C., 6-7 September 2001.
Russia\textsuperscript{3/} by the time of the handover of power was, beyond doubt, a full-fledged market economy.

Prices mostly reflect scarcities, money can buy any commodity including foreign currency, and allocation follows market signals, while dominant private owners maximize their asset value and switch their portfolios reacting to pecuniary incentives. Certainly the Russian variant of the market economy is not the same as the model of introductory textbooks. It more resembles the developing country variants we describe in advanced courses on comparative and development economics. Still introducing market order has been a remarkable accomplishment, especially if we consider the relatively low cost of re-introducing the market (costs of postcolonial wars, of course, should not be added to this bill).

The fundamental feature of Russian transformation has been conditioned by the weak state, which often lead to the strong presence of vested interest and the ensuing market failures\textsuperscript{4/}. With the phase of major struggles for power being over and the new rules of the game established, inflation has never gone out of control as many of us feared following the collapse of the rouble. In fact, annual inflation in 1998 was 84.5 per cent, in 1999 coming down to the moderate level of 36.6 per cent, and in 2000 to 20.2 per cent with 2001 forecast in the range of 25 per cent. This reflects consolidation of power and also common understanding of all those in power that hyperinflation is mortal to a modern economy and society alike. Also unwillingness to undergo yet another redistribution of wealth is reflected in this remarkable outcome.

Thus Yeltsin managed to liberalize, stabilize and privatize the Russian economy. Moreover he managed to preserve the unity of the federal state, creating a situation where benefits of a cooperative game for local powers outweigh those of full secession\textsuperscript{5/}. This is no small accomplishment for a country whose "natural" or "historical" borders are anything but trivial. The bilateral deals, also anchored in the Russian Constitution, strengthened and formalized the power of local organs and have been exerting a formative influence over the actual workings of the Russian market economy.

4. New anchors for policymaking?

There seems to be a close to consensus view among analysts that the accession to power of Vladimir Putin represented an attempt to redefine the name of the game as it emerged under the Yeltsin years. Quite in line with the mainstream view on development economics, it was understood that a strong state power, emancipated from the patronage of
vested interests, is a necessary condition for meaningful policy reforms to get through. Thus it is self-explanatory why the new President has been focusing so much attention to cutting the umbilical cord tying him to the Yeltsin group and the constituent oligarchs. It is too early to assess at the moment to what extent this initiative proves finally successful. However, the thrust of the initiative can, at least in theory, be interpreted as an attempt to emancipate himself from dependence on the vested interests.

In the first round of managed transition the 1999 Duma elections testified to a floating party system with the emergence of three roughly equal blocks (left, centrist i.e. progovernment, and right). This allows the President to get basically any law passed, and removed a powerful obstacle, Communist domination, that lamed both presidential terms of Yeltsin. Moreover as the parties seem to be more active on representing economic interest than ideological lines, policy compromises are easier to strike. Detailed analysis of the Communist Party is indicative of its ideological decay and growing opportunism, leaving it still able to create trouble but not posing any longer a serious threat of potential reversal in any major policy area. Last but not least the above-cited consolidation of regional power within Russia implied the governors' inability of and disinterest in secession, thus making them vulnerable to centralizing tendencies.

Mention should be made of the side effects of the 1998 financial crisis that has come to the advantage of Putin. This crisis has lastingly crippled "the oligarchs", i.e. those vested interests based on financial rather than industrial holdings of assets. Their vulnerability has come to the limelight starting up from the Primakov episode, while energy sector corporation flourished. Confiscations of banking assets by the Kirienko crisis managing measures left the state-owned banks, primarily Sberbank and Vneshekonombank without competitors, while most surviving private banks actually are no more than financial departments of large industrial organizations. This, of course, allows for taking over their previously held positions in various areas, as e.g. the take-over of the Berezovsky and Gusinskii media empires have demonstrated.

All in all, in systemic terms the above developments may be interpreted as a series of evolutionary and policy-led actions that allow for a re-definition of those institutions and those rules of the game that emerged during the late Yeltsin period for maximizing wealth. In the following we shall attempt to assess to what extent this potential has materialized or will materialize as a consequence of actual policymaking under the new presidency.
5. Does an activist President equal to efficient central management of the economy?

This question is far from being philosophical, since the difference is often overlooked in current debates in and on Russia, although it determines the final account. Putin has moved with conspicuous speed and deliberation to get rid of symbolic figures and features of oligarchic power. Such cases as the extradition of former financial chief of the Kremlin, Pavel Borodin, or the demotion of the evergreen Chernomyrdin from Gazprom, followed by the demotion of Rem Vyakhirev, the erosion of Moscow major Luzhkov in the presidential campaign, leading to the recent merger of his Fatherland movement in the governmental pool of Bear, and many others may be taken as milestones for this new drive. Changing the federal Constitution and the procedures of formation of the Federation Council (upper house), depriving local governors from their immunity and even allowing for their demotion, followed by a series of presidential outlawing of local regulations are clear enough messages. Successful attempts to control the press evidence the concept of managed democracy attributing the state much more extensive roles than a chief arbitrator and guardian of the rules of the game. This is bound to have immediate repercussions for the way economic rules and institutions function in reality.

In short, under the given conditions of Russia talk about a strong state and of the "dictatorship of the law" is likely to be a far cry from Rechtstaatlichkeit, i.e. authorities being able to commit themselves to uphold property rights and enforce impartially private contracts among parties. This is certainly quite different an agenda from establishing one's own control over the oligarchs with new, not (yet) corrupt ones, loyal to the new bearer of supreme power.

In fact, as far as such reverberations contribute to the overall feeling of insecurity in general and of acquired property rights in particular. They objectively shorten the time horizon under which economic agents optimize their decisions, pushing them even more towards quick returns and disregard for any longer term possible consequences of their deed. Capital flight from insecure to secure places is not criminal, nor is it a robbery of the fatherland, but is a sign of how capital the world over behaves in a rational manner, rationally expecting e.g. interventions destabilizing its workings.

6. The Gref Plan - a new phase in radical reforms?

Under the circumstances described above it is understandable why the Strategy for Development, based on the workings of the group around Minister of the Economy German
Gref (also a member of the Petersburg Clan), aims primarily at securing high growth rates in a sustainable fashion. In order to attain that the plan envisages a series of systemic measures.

It is important to note that the full text of the approved program has not been published. It seems to reflect a deal between two "marketeer" approaches, i.e. a supply side cum deregulation approach, and a major tax cut approach. The concrete formulation of the plan is reflected in the 18 months program adopted for the period 2002-4. The main tasks or areas of actions can be summarized as follows:


As can be seen, this is perhaps the first multiyear program, which is truly unlike the Soviet heritage, i.e. is not dominated by quantitative indicators or sectoral priorities. It reflects the conviction that structural adjustment is a matter of market processes. It treats the diminishing of tax burden as its priority. It also aims at creating that comprehensive institutional infrastructure that has been missing from previous reform packages. It also addresses some traditional wound points of Russian reforms such as overregulation and the underdevelopment of capital markets.

In short it seems to have addressed those bottlenecks which have most commonly been spotted among the weak points of Russian reforms of the Yeltsin period. Coupled with a new strength and vigor regained by central administration the platform may be seen as promising. In the following we shall try to assess whether and to what extent these measures suffice for bringing about sustainingly high growth rates. This is the crux of the matter, irrespective of actual attainments of the quantitative estimates (that seem already to have proven overoptimistic, anyway).

7. Implementation to-date.

As indicated above, the Strategy has been conceived as a medium term document, whose tasks are to be implemented primarily in the 2002-2004 period. However experience with policy reforms the world over, and in Russia in particular, is indicative of changes being front-loaded. This means that those standing a better chance for implementation which come first, while those sequenced for later day practice often undergoing substantive modifications
or even derailment. Thus early evidence may be treated as a kind of *early warning system* also in economic policy assessments.

Tax legislation has significantly been simplified by the 2000 modification of the Tax Code. Further rate cuts are envisaged by the governmental proposal approved in first reading by the Duma in June 2001, diminishing corporate tax rate to 24 per cent and marginal income tax rate to 35 per cent. It also limits the power of local authorities to levy taxes and levies/excises not specified in the federal legislation, or apply higher rates than federally approved.

One of the problems of these stipulations has traditionally been the fact that local power is often *informal* by nature, is based on *proprietary* and *regulatory interwinings* between local authorities and locally dominant forms. Thus their deals are often covert and inaccessible to external observers.\footnote{13} Corporations take over or simply sustain, by tradition, municipal social *services* and *employ* underpaid local officials. The latter, in turn, reschedule *debts*, tolerate regular non-*payment* of public dues, allow for covert subsidies, impose local *customs* barriers and other *protectionist* measures keeping "outsiders" at bay. "Moscow is far away" - as the old dictum has is. And indeed, despite changes in the balance of power, it would be naive to expect any central organ to be able to penetrate and even less to *redefine* the intricate interwinings. It is more likely that any representative of central power would be quickly absorbed by the networks of local society and economy, if for no other reason, because of the need for continuo crisis management on the spot.\footnote{14}

It would be hard to overlook that federal tax cuts are *not supplemented* by radical *rollback of entitlements*, or discontinuation of the practice of allotted but *not funded* federal *tasks*. Under these circumstances it is practically hard to conceive local powers to adopt a hands off strategy. They continue to be confronted with economic problems cumulating (crime, floods, blasts of pipelines etc.) They can not cut taxes just in order to avoid overtaxation. Given that they too are elected officials, their *incentive* is to continue with the hidden ways of "*taking care of*" the area, including raising sufficient tax revenue and protect "theirs" in the corporate sphere from outside "intruders", primarily from foreigners. Incomplete fiscal reforms by definition constrain the effectiveness of any tax measure.

Given that over 80 per cent (!) of output needs to be *licensed*, the latter has developed into a most profitable business for the authorities to secure their otherwise lacking funding.\footnote{15} Thus it is highly unlikely that abolishing of some type of rules would not immediately be
replaced by "appropriate" substitutes, partly due to tsarist and Soviet legal tradition, and partly out of sheer economic necessity.

Protecting private property would be quite important. However, when violent methods of settling disputes has become the norm, rather than the exception, further the strengthening the proprietary and managerial role of the state has been the dominant tendency over the last years, and exemplary punishment of "plutocrats" in political practice, this aim is unlikely to form practice. Ongoing dispute over such well publicized cases as that in Gazprom, Svyazinvest, EES, to mention but a few, all tend to end up with minority shareholders' being marginalised, with their rights diluted. This tendency has been strengthened rather than weakened in 2000-2001.

It is important to recall that while the Duma has finally adopted the law allowing for private property for land in June, 2001, this law basically condones ongoing practices rather than creates new opportunities. In fact non-arable land could be purchased for years, and even a modest turnover could be observed in some of the regions. In order to secure support of the communist factions the law continues to retain most of previous restrictions.

Addressing the issue of natural monopolies also tended to be high on the agenda of the Gref Plan. In case of the gas industry market building measures have formally been postponed for 2002 at the time of nominating the new leadership. In the electricity market state control of prices and ongoing non-payments make deregulation highly unlikely. In case of railways any marketising reform would presuppose a partial recapitalisation of the underinvested company, together with tariff increases. The latter might prove strategically impossible given the arbitrary location of many Russian industries and cities, while investments in this scale do not figure in the approved budget.

In case of pension reform the underdeveloped state as well as the shaken reputation of capital markets makes switchover to a partially funded system improbable. The ever-growing problem of aging and the lack of an affluent middle class also make politically and economically risky such a change. Moreover if there is nowhere to invest to, a funded system can easily degenerate into a costly gamble.

8. Unaddressed issues.

The Strategy failed to tackle some important issues from the very outset. The issue of financial disintermediation that has been plaguing Russia for a long time, is known to be a headache also for governmental officials. It is a depressing sign to see the Duma laying off
even general debates over this issue when limited sustainability of growth are already on the agenda of policymaking. The less developed is financial intermediation, the less this system is able to transform savings into investments, the higher is the probability of ongoing capital flight, since domestic savings can not earn good returns for the risk of staying home rather than fleeing abroad. The tax raising capacity of the central state is unlikely to improve once oil prices start to decline. Corporate expansion based exclusively on retained profits is likely to be sluggish in the longer run.

In a related mirror image, large corporations try to aim at self-sufficiency, even in proprietary terms, further strengthening the already ongoing tendency towards concentrated large ownership patterns. This means that firm restructuring is likely to continue via mergers rather than closures and new establishments. Furthermore, bankruptcy continues to be an instrument in the hands of authorities to punish disobedience rather than serving as a means of horizontal deals including restructuring.

The law on joint stock companies trying to support creditor and property rights against managerial power has been repeatedly dropped from the agenda of Duma in June and December 2000. Meanwhile neither the privatization law, that would discontinue the practice of listing saleable and non saleable firms, nor the nationalization law, foreseeing compensation for unilateral state actions, has been approved by the Duma. It did adopt, however, on the initiative of communists, a general ban on selling large corporations, stopping such obvious targets as LUKOIL and Gazprom from entering the stock exchanges of the world.

Legal reform is also generally seen as a weak point. In a country with regular current account surpluses the currency law requiring 75 per cent home transfers, obviously not adhered to, is still in force. Many other examples can be mentioned, such as articles prohibiting speculation, or the recent Academy of Sciences circular reintroducing Soviet regulations on keeping contact with foreigners. In sum, anybody can be criminalised, basically for anything. This is not the condition for enhancing the propensity to long term investment.

The more one is worried about the long term growth prospects of Russia being constrained by the extreme poverty of close to half of its population (acting as a demand constraint), the more serious one sees the generally business unfriendly overall climate. It is evident that red tape, uncertainty and lack of market prospects act as major deterrents for the small business sector. Special incentive schemes or repeating business friendly slogans can
help little in overcoming this barrier. In turn, the organic, domestic demand-based, slow but steady growth path may also prove hard to enter.

The role of foreign direct investment, currently a hit in the international development literature, tends to be severely underrated in most Russian policy debates. FDI is not just a means to attract technology or to cover current account deficits. In the broader international literature it is seen as a pacemaker, small but vitally important ingredient for the smooth functioning of a modernizing economy. For the time being investors, even in the energy sector, where it is easiest, to survive seem rather deterred. It is embarrassing to read from the chief economist of the President (under 2) that the investment absorption capacity of Russia were technically given, and capital abundance were the problem. This is mixing up cyclical with strategy considerations. Absorption capacity is by definition an ex post concept and conditional upon factors influencing the business climate. Under the conditions of Russia more FDI could be a way of overcoming the bottlenecks created by decades of underfunding in physical infrastructure, market-oriented production line developments and many others. Moving away from the Kuvaitization syndrome is also contingent upon FDI.


On the base of what has been surveyed we may venture to forecast, that the old perestroika slogan, "there is no way back" may be true. There is no ground for Russia to regress into totalitarian political and economic structures, as transformations have been too profound. Likewise there is little hope for Russia to advance to the conditions of normal western democracy and market economy, as has been hoped by the élite of that country.

If oil prices remain sustainingly high, this may help bridge the more obvious loopholes in the central budget, thus slow growth, in the range of 2 plus per cent in the medium term is likely. All the more so since according to UN statistics quoted at the first page the level of Russian GDP is still around two thirds of the pre-1989 level. Thus the room for quasi-automatic recovery is substantial, indeed.

Institutional improvement is unlikely to be radical or robust, but slow and steady improvements are conceivable. They can not be taken for granted. Thus the revenue generating and debt servicing ability of Russia continues to be highly and unilaterally dependent on oil and related revenues. The 1996 peak of export intakes has only been overtaken by 2000, with decreasing volumes, i.e. exclusively due to price factors. This may create a problem, unless Russia uses most of its windfalls to amortize external debts, or obtain
lavish write-offs for the Soviet time debt can be negotiated. Both options look less than likely. The most probable scenario is thus a continuous rollover of debt.

On the domestic front the move towards more explicit forms of fiscal federalism seems unlikely as it runs counter to most of the interests of those participating in it. Likewise the most profitable parts of the Russian economy are under state regulation. Thus bargaining with the state remains a major source of revenue. It may well be that a state dominated by oligarchs will be replaced by a system of oligarchs, nominated and dominated by the state.22/ Insider dominance continues to be a dominant factor of Russian capitalism. True, this is still superior to no privatization at all (Belarussian variant), but is also sustains an overall business environment lastingly hostile to foreign ownership and penetration.23/ Thus scenarios of large scale modernization and industrial renewal can not be seriously considered among the feasible options for the medium to long run.

Last but not least the issue of western involvement needs to be addressed. If in early 1990s IMF and World Bank involvement were the dominant, or at least the most visible channels, this period is clearly over. Being a large country Russia is more likely to be involved and included via such fora as the G 8, the Paris and London Clubs or KFOR. Russia can not be lost or gained. Still the west needs to learn to live with Russia without illusions.

In concrete terms it means that disengagement would be counterproductive. Russia continues to have a stake in world affairs, particularly though not exclusively in Europe. It continues to perceive itself as a major European power. Thus it remains to be sensitive to being confronted with European norms, be that human rights conventions or the acquis of the EU. WTO membership is an attainable target that may help formalize reform measures, particularly in the trade sector. Involvement in various fora defining good fiscal practices, banking standards, accounting and disclosure practices may slowly but steadily help Russian reformers to change the entire socio-economic environment of their functioning.

The economic potential that is likely to emerge under the conditions of our baseline scenario, excluding major cataclysms, puts severe limits on what recurring projects of revitalizing CIS as an economic and monetary union, or the reintegration of the Slav neighbors may mean in the medium to long run. On the other hand, a Russia that perceives itself alienated and excluded, still possess with a considerable nuisance capacity, as events in southeast Europe, the Caucasus and central Asia may equally demonstrate. Thus continued inclusion of Russia into various global fora and agreements, like the follow up to the Kyoto
protocol or understandings on the use of the Internet, as well as various forms of fighting organized crime will continue to remain on the agenda.
ENDNOTES


41 in their detailed empirical study talk of parallel fiscal policies conducted by organs of local power.

14) Arguing in a similar vein in a recent presentation Leonid Smiriagin: Who runs the Russian regions? (Russia, Ten Years After. Carnegie, Endowment for International Peace, Washington, 7-9 June, 2001) calls attention to the very strong formal and informal power base of elected local leaders against presidential envoys, as well as to the arbitrariness of the newly created 7 regions, that are already cut across by actual economic processes.

15) In their empirical study Auzan and Kriuchkova (pp 80-81) talk of lock-in phenomena in which regulators and the regulated develop a joint interest in sustaining the status quo and exclude any new entrant. A.Auzan and P.Kriuchkova: Administrativnie bariery v ekonomii: zadachi deblokirovaniia. Voprosy Ekonomiki, 2001/5. pp 73-88.

16) Dolgopiatova, Tatiana: Modeli i mekanizmi korporativnogo kontrolya v rossiiskoi promyshlennosti. Voprosy Ekonomiki, 2001/5. pp 46-60 provides and empirical proof based on the survey of the 300 largest firms in Russian industry.


18) Mau, V.: op.cit (2001, pp. 20-21) adds to this the problem of ongoing conceptual dispute between the government and central bank over the future role of banks.

19) Radygin, A., op.cit pp 36-8. provides empirical evidence for the process of multidimensional concentration.


22) This is the view expressed in Vasiliev, Sergei. The structure of the Russian economy and political trends in Russia. Carnegie, Washington conference (as in 14).


16