16. Signs of Regress and Progress in Russia's Economy

WHEN ASKED MORE THAN sixty-five years ago for his opinion about the Soviet Union, Winston Churchill observed: "I cannot forecast . . . the action of Russia. It is a riddle wrapped in a mystery inside an enigma."

Since the collapse of the Soviet Union in 1990 and the ensuing Russian administrations of Boris Yeltsin and Vladimir Putin, much of the previous riddle has been resolved as a result of Russia's opening to international trade, investment, and tourism; to the media and the Internet; and to the publication of voluminous (if not always completely reliable) data on the Russian economy and society. Nevertheless, despite Russia's inclusion in the G-8 group of supposedly "advanced industrialized democracies," much of Russia's current situation and future prospects can still appropriately be characterized as "a mystery inside an enigma."

Of the numerous economies often termed to be transitional, Russia's—with a GDP of about one-fifth that of China but a per

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capita product twice that of China—is the second largest. Exactly where the Russian economy fits in the market-oriented gamut of transitioning economies is, however, not yet clear: between, say, Belarus, Uzbekistan, and Vietnam at one end, and the Balkan and Central European States and China at the other end? Also unclear is the pace of the Russian economy's transition and whether it is headed forward, toward market-oriented, decentralized resource allocation; or backward, toward centralized, state-controlled allocation; or oscillating between these two.

Yegor Gaidar, a distinguished economist and former Russian prime minister, has conjectured that Russia's full transition to a market-based economy is likely to take about seventy-five years because of the long "duration of the Socialist period and the distortions connected with it." Nonetheless, Russia has been recognized by the United States and the European Union as a "market economy," a status that ostensibly makes it less likely to have other market economies impose "anti-dumping" or other protectionist measures on its exports. That this status has been accorded to Russia as much for political as economic reasons is suggested by the fact that Russia is not yet a member of the World Trade Organization.

A vehement debate is currently under way within Russia concerning the direction of Russia's economic transition. The debate reflects the sharply different emphasis placed by the two sides on either the "good news" (favoring market-oriented changes) or the "bad news" (heading in the reverse direction). The debate also highlights disagreements about the reliability of certain official data—notably, whether the striking evidence of private-sector growth portrayed by official statistics is credible. The bad news side of the debate contends that the level of state ownership, state production, and state employment prevailing in the Russian economy is at least as large in 2006 as it was before the arrest in 2002 of Yukos's chief executive, Mikhail Khodorkovsky. In sharp contrast is the view of the good-news advocates, who aver that the official data on private-sector growth actually *understate* the pace and magnitude of Russia's transition toward private ownership and market-oriented resource allocation. These advocates contend that the understatement results from efforts by private businesses to avoid or reduce their tax liabilities by not registering or by underreporting the scale of their business activities.

In fact, Russia's economic performance since 1991 has been relatively favorable: its real GDP growth has been more than twice the unweighted average of the other G-8 members (Japan, Germany, France, Canada, Italy, the United Kingdom, and the United States). During President Putin's tenure since 2000, Russia's annual GDP growth has been 6 percent. Foreign debt has been reduced from 50 percent of GDP to less than 30 percent, and Russia's $3.3 billion debt to the International Monetary Fund was repaid ahead of schedule in 2005; of the $40 billion owed to its creditors in the Paris Club, Russia paid $15 billion ahead of schedule. During this period, Russia's foreign exchange reserves have more than tripled, to more than $250 billion.

Thus, although the good economic news is ample, there are also significant indicators of bad news. Inflation continues to hover around 10 percent, and capital flight—an indicator of weakened confidence in the Russian economy among holders of ruble assets—was more than $9 billion in 2004 and increased above that rate in 2005.

Concerning the good economic news and Russia's generally favorable economic performance, how much of it should properly be attributed to higher oil and natural gas prices (hence, to factors not under Russia's control), and how much should be attributed to economic reform (hence, subject to greater influence by domestic Russian policies)?

Empirical work at the RAND Corporation clearly reflects the Russian economy's heavy dependence on fossil fuels: oil and natural gas prices explain between one-third and two-fifths of Russian economic growth over the period from 1993 through 2005. Oil and gas production has accounted for between 16 and 20 percent of Russia's GDP and between 44 and 55 percent of Russia's total export revenues since 2004. The buildup of Russian foreign exchange reserves mentioned earlier is a further illustration of this dependence.

Besides this dependence on oil and gas prices and revenues (notably, global oil prices have fallen by 20 percent from their July 2000 highs), several other indicators suggest that economic reform has also contributed to the economy's good news. In the past decade, the number of privately owned enterprises more than doubled, rising to nearly 80 percent of all enterprises, whereas state-owned enterprises during this period shrank from 14 percent to less than 4 percent of all enterprises. Perhaps of greater significance, the volume of employment in private enterprises grew by 41 percent, whereas that in state enterprises declined by 15 percent. The expansion of private enterprise that occurred—especially of medium-size and small-scale enterprises—covers a wide range of both higher- and lower-technology goods and services, including computer and information technology, financial services, engineering and construction, spare parts manufacturing, and repair and maintenance services. Moreover, as suggested earlier, these data probably understate the actual growth of the private sector: privately owned enterprises—particularly those with fifty or fewer employees—are more likely to avoid their inclusion in the official data, choosing instead to pay a "protection" price to avoid taxes and to escape from the myriad regulatory constraints that might be imposed were they registered in the official data.

A final good news indicator that reflects both external (oil and gas prices) and internal (economic reform) influences is the recent boosting by the major securities' rating agencies of Russia's sovereign debt status from junk to investment-grade. These rating enhancements are significant because they lower the cost to Russia of access to global capital markets and also represent at least a modest expression of confidence in the Russian economy's prospects.

In sum, where the Russian economy is heading—toward decentralized resource allocation by competitive markets or backward toward decision making by the state and its bureaucracies, toward greater reliance on private, market-driven enterprise or back to state enterprise and state regulation—remains highly uncertain. No less uncertain is what these economic puzzles imply with respect to Russia's role and behavior in the international arena.

Although the context has changed drastically, Winston Churchill's insight in 1939 remains strikingly accurate today!

POSTAUDIT

This piece was written too recently to claim much prescience. Fueled by high oil and gas prices, the Russian economy continues its strong performance; the uncertainties and ambiguities remain as discussed in this essay.