

RUSSIA: Economic growth is not enough to counter negative social trends

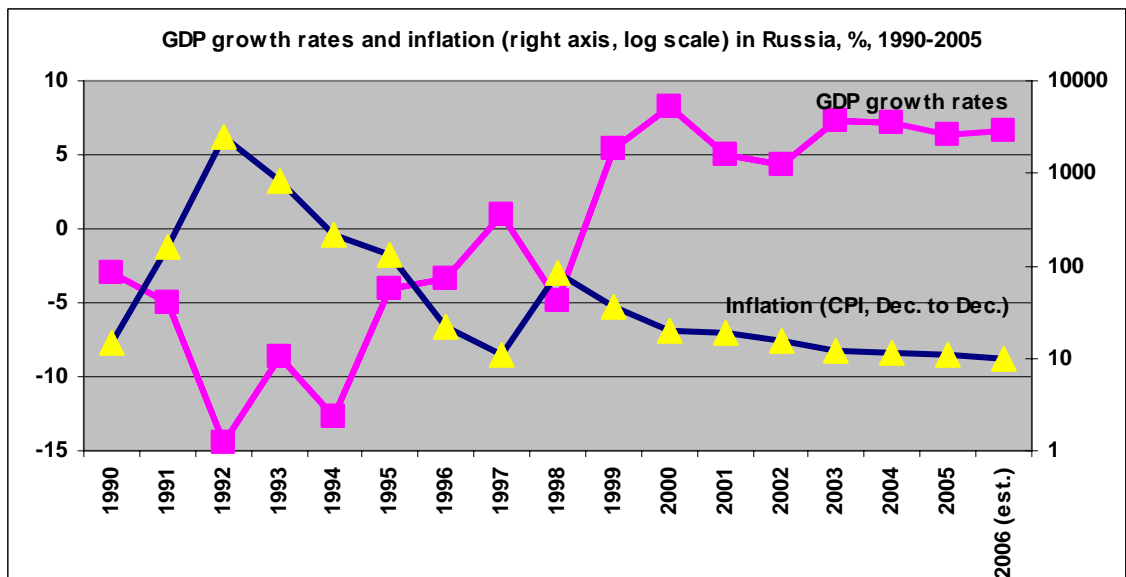
Vladimir Popov, professor, New Economic School, Moscow

Russia should have parliamentary elections before the end of 2007 and presidential elections in early 2008. Putin's popularity today is extremely high – if elections would happen tomorrow, he would win in the first round with over 50% majority according to opinion polls. But he is serving his second term in office and the constitution prohibits the third term, so he is expected to transfer the power to the successor. Journalists discuss candidates for the job (Dmitry Medvedev, First Deputy Prime Minister is mentioned most frequently), but no one seriously doubts that the successor is going to be nominated by Putin himself. Perhaps Putin would even stay as the head of the dominant party and/or the head of the government. It is thus extremely likely that the transfer of power would be smooth and the continuity would be ensured. But the successor will inherit a number of problems and will have to deal with a difficult agenda.

Recent economic developments

After losing 45% of its output in 1989-98, Russian economy started to grow from 1999 (6% in 1999, 10% in 2000, 4-7% in 2001-06) – the major push was given by devaluation of the ruble in 1998 and by higher world prices for oil and gas later, but Putin can at least take the credit for not ruining this growth (fig. 1). 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 2004-06.

FIG.1



True, in comparative perspective Russian performance is not that impressive. Many other former Soviet republics –Azerbaijan, Belarus, Estonia, Kazakhstan, Latvia, Lithuania, Turkmenistan, and Uzbekistan – by 2006 have reached or exceeded the pre-recession (1989) level of output, whereas Russian GDP was still only 85% of the 1989 level (fig. 2). Russian HDI – Human Development Index (accounting not only for GDP per capita, but also for life expectancy and the level of education) is still below the USSR level and even below that of Cuba with life expectancy of 77 years against 65 years in Russia. China with the life expectancy of 72 years is rapidly approaching the Russian level of HDI (fig. 3). But at least there is more stability in Russia today than in the rocky 1990s.

FIG. 2

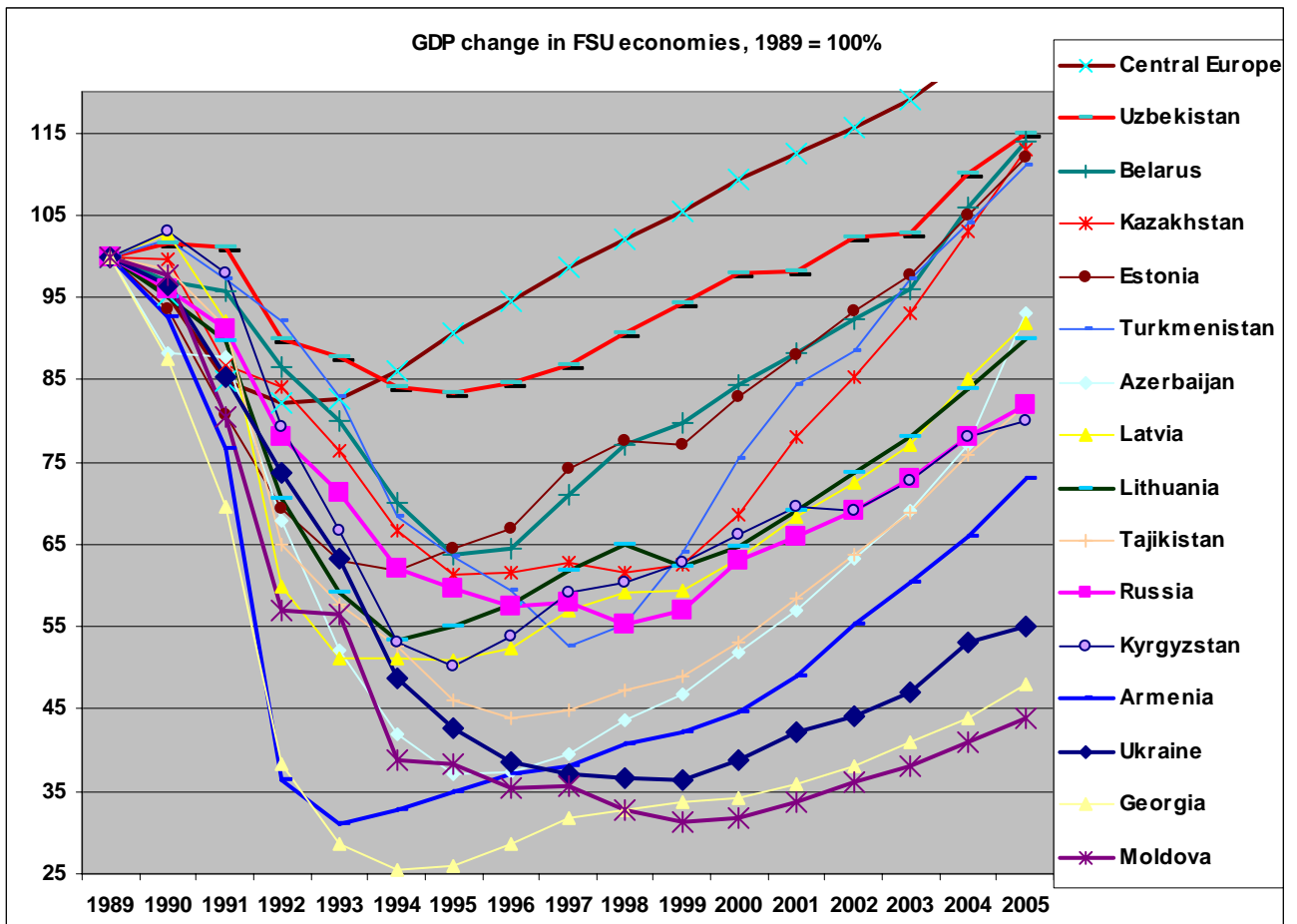
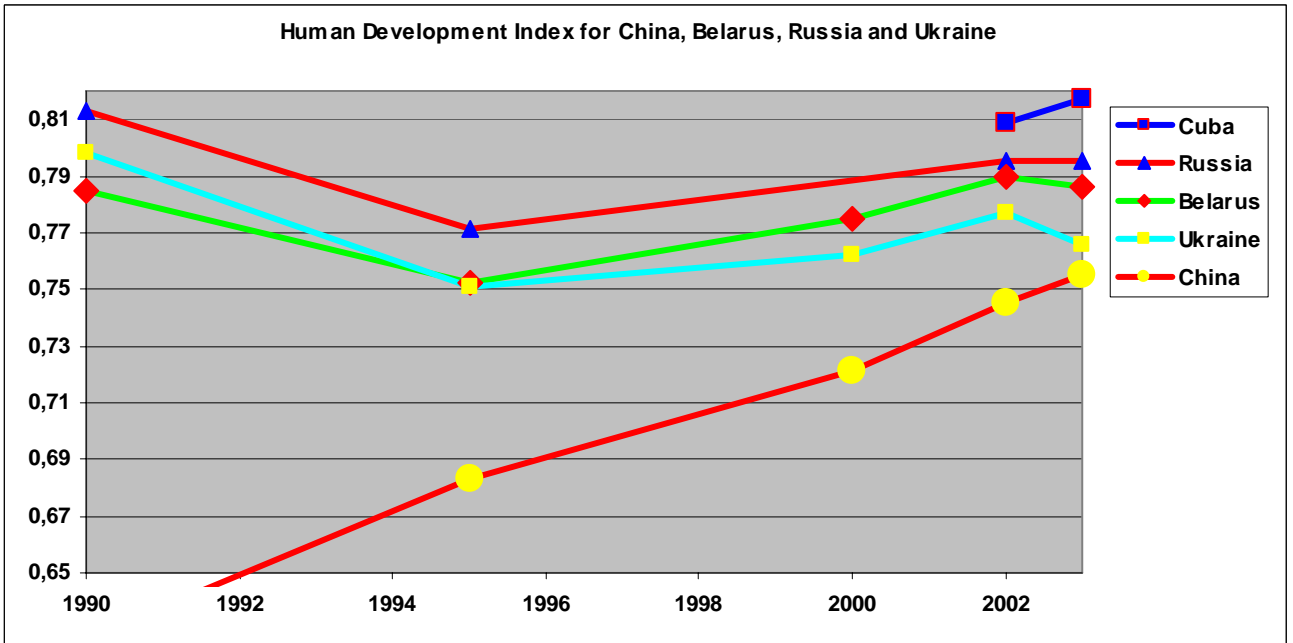


FIG. 3



The government budget moved from a deficit to surplus, the decline in the share of state revenues and expenditure stopped (fig. 4), the government debt – domestic and external – decreased (fig. 5), foreign exchange reserves increased to over \$250 billion by the end of 2006 (fig. 6). The government created a Stabilization Fund to capture the windfall profits from fuel export that is now over \$80 billion.

FIG. 4

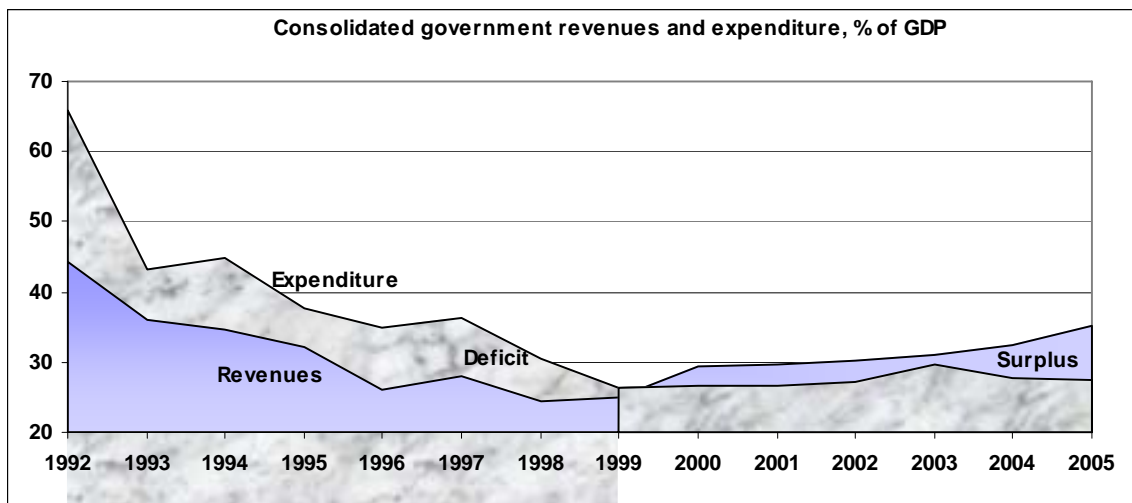


FIG. 5

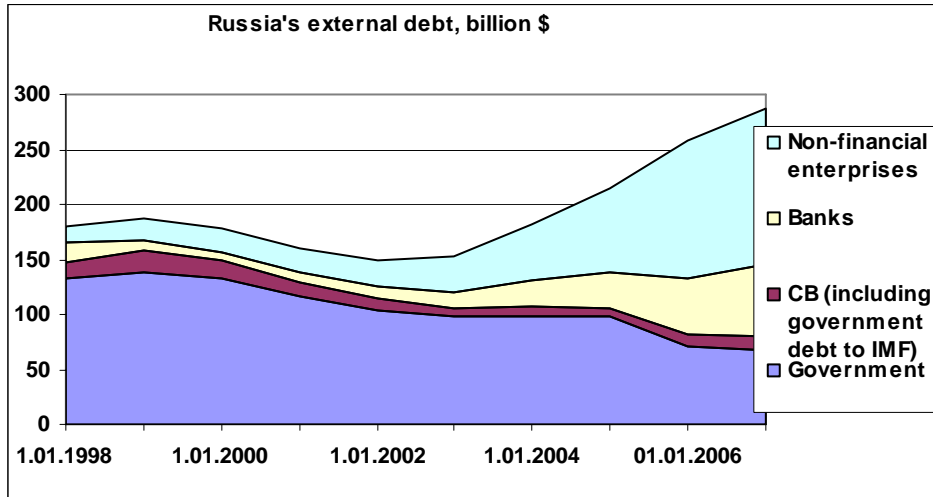
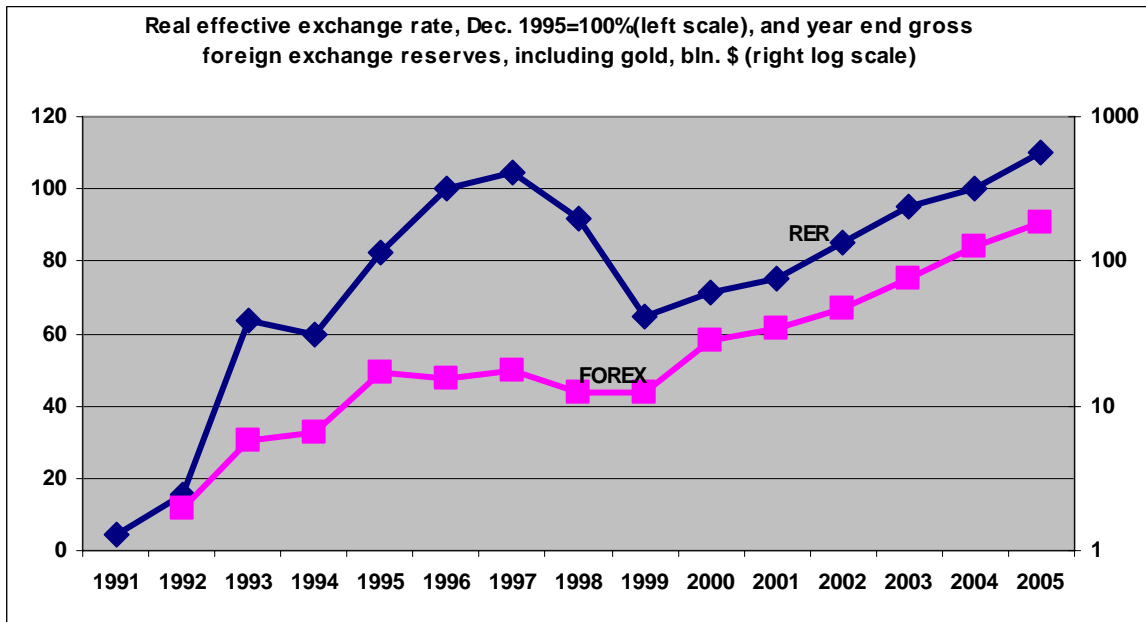


FIG. 6



Analysts, however, pointed out that given the increase of the world fuel prices in recent years, one could have expected an acceleration of economic growth, rather than a slowdown that actually occurred in 2001-06 as compared to 2000. The reason for the slowdown is the overvaluation of real exchange rate (fig. 6) – the typical Dutch disease that Russia developed once again. The first time Russia developed it in 1995-98 – this led to the currency crisis of August 1998, now it seems like history repeats itself. Optimists argue that unlike in 1998, Russia currently has large foreign exchange reserves (over

US\$250 billion), but pessimists point out that if oil prices fall and capital starts to flee away at a rate of \$5 billion a week, like it happened in July-August 1998, reserves would be depleted very quickly. The future devaluation could happen either in the form of the currency crisis or in the form of “soft lending”, but there is hardly any doubt that eventually it would take place.

Besides, current growth is not based on solid foundations: wages and incomes in recent years were systematically growing faster than productivity (fig. 7), so the share of consumption in GDP increased at the expense of investment. As a result, whereas Russian personal and public consumption has already exceeded the pre-recession level, investment is still below 40% of what it used to be in the last year of existence of the USSR (fig. 8). Russian gross savings are large – over 30% of GDP, but they are funneled away via the outflow of private capital and the accumulation of foreign exchange reserves, so gross investment amount only to less than 20% of GDP.

FIG. 7

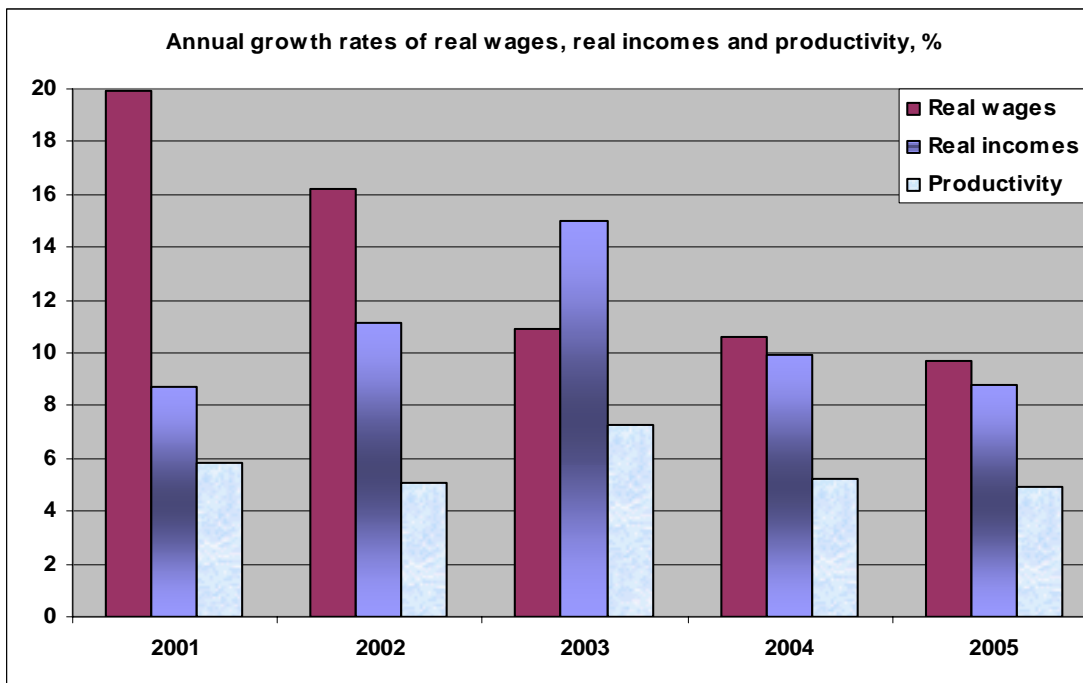
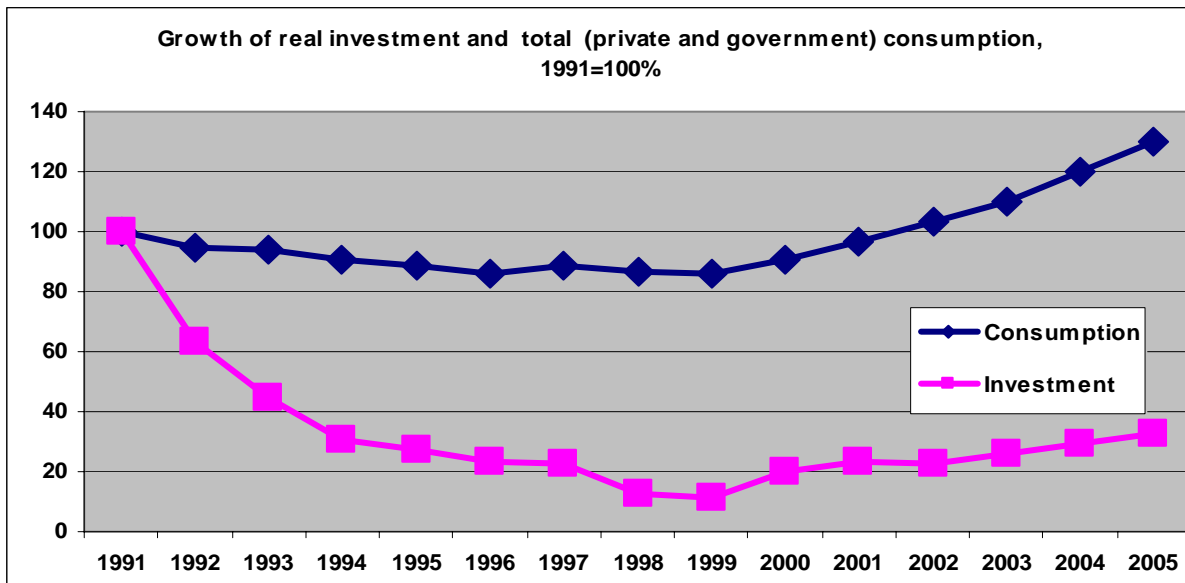


FIG. 8



There is also another important deficiency of the current growth: the government in fact failed to use the windfall revenues from oil and gas exports in 2000-06 to repair the badly damaged state institutions and to restore the provision of crucial public goods, such as law and order, education, health care. Instead, the government was cutting tax rates, allowing the windfall revenues to precipitate into personal and business income, and accumulating the budget surplus, whereas the share of state spending in GDP virtually did not increase, remaining at an extremely low level of 1999 – two times lower than in the USSR (fig. 4).

Social trends

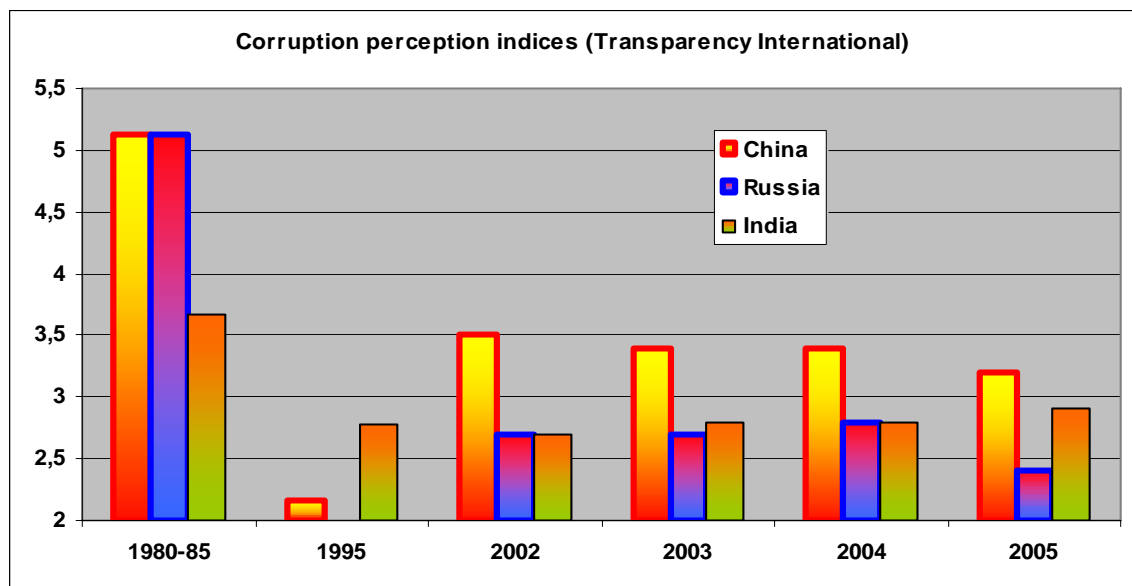
For future political and social developments, the inevitable economic instability in the nearest years would be important, but perhaps less important than the dynamics of the institutional capacities of the state. The strong/efficient state is the one that has the power to enforce its rules and regulations, no matter what are these regulations. Crime/murder rate and the size of the shadow economy are natural measures of the strength of the state institutions. The strong state may be more or less democratic - both China and Central European countries – with the murder rates of about 2 per 100,000 inhabitants have stronger state than Russia with about 25-30 murders per 100,000 of inhabitants.

The very notion of the state implies that public authorities exercise at least three monopolies: (1) on violence, (2) on tax collection, and (3) on money emission (coinage). All three monopolies were undermined in Russia during the 1990s to such an extent that the very existence of the state was put into question. The government failure became pervasive and much more visible than the market failure.

In 1998, right before the currency crisis, the payment system was on the brink of collapse – barter deals exceeded 50% of total transactions and the enterprises were accumulating non-payments (trade, tax and wage arrears), delaying payments to their partners, the government and their workers. After the economic growth resumed in October 1998, the non-payments and barter transaction quickly disappeared, but there is no guarantee that they could not rise again, if the monetary authorities will resort to tight monetary policy.

Tax collection, after dramatic fall in 1992-98, increased slightly (fig. 4), but mostly due to the resumption of growth, not due to better tax compliance. The efficiency of the government in recent years did not improve: different measures of corruption, government effectiveness and rule of law do not register any considerable progress (fig.9-12), so low spending levels mean that the state simply cannot provide enough public goods.

FIG.9



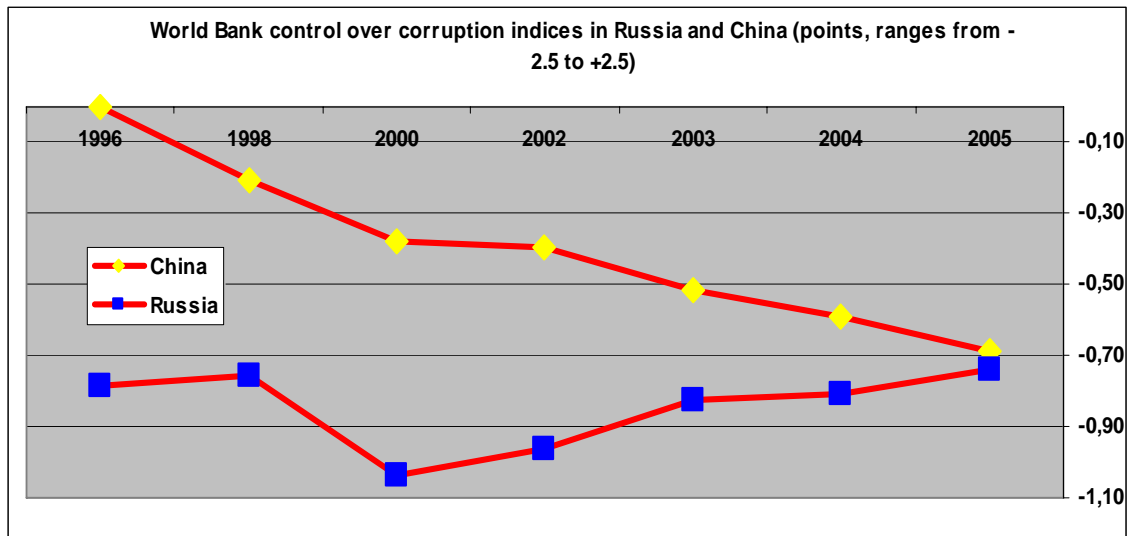


FIG. 11

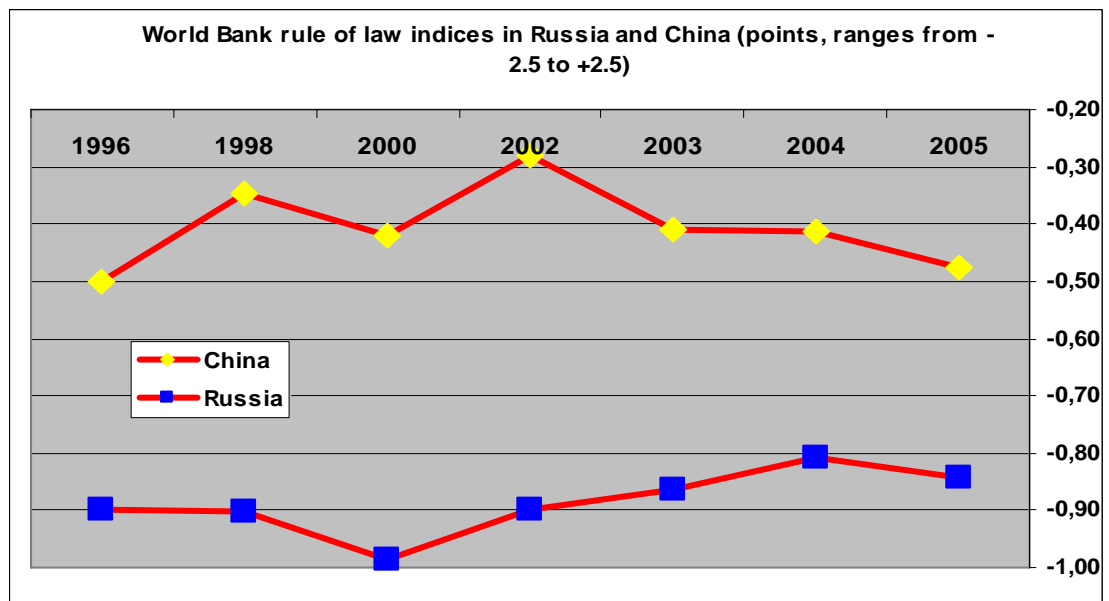
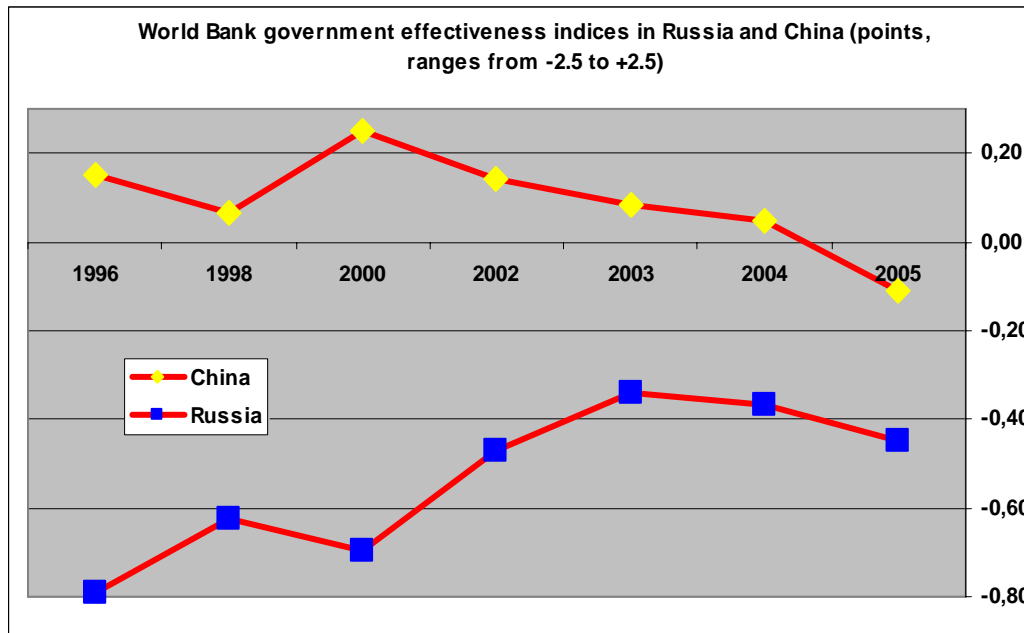


FIG. 12

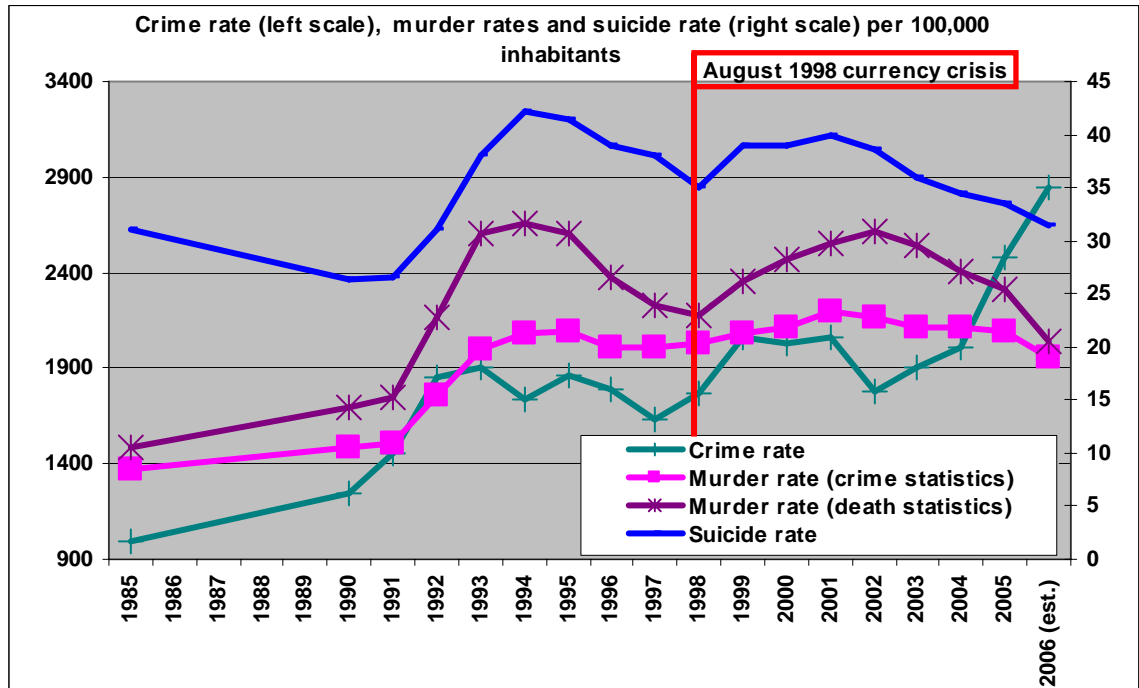


But what is worse of all, the criminalization of the Russian society remains extremely high. Crime was rising gradually in the Soviet Union since the mid 1960s, but after the collapse of the USSR there was an unprecedented surge – in just several years in the early 1990s crime and murder rates doubled and reached one of the highest levels in the world (fig. 13)¹. By the mid 1990s the murder rate stood at over 30 people per 100,000 of inhabitants against 1-2 persons in Western and Eastern Europe, Canada, China, Japan, Mauritius and Israel. Only two countries in the world (not counting some war-torn collapsed states in developing countries, where there is no reliable statistics anyway) had higher murder rates – South Africa and Colombia, whereas in countries like Brazil or Mexico this rate is two times lower. Even the US murder rate, the highest in developed

¹ Crime statistics is usually perceived to be incomparable in different countries because of large variations in the percentage of registered crimes. But murders are registered quite accurately by both criminal statistics and death (demographic) statistics. The first one is more restrictive than the second one, since it registers only illegal murders, whereas the second one – all murders, including “legal” (capital punishment and “collateral damage” during wars, antiterrorist and other police operations). Both rates skyrocketed in Russia in the beginning of 1990s and stayed at the extremely high levels until today. The gap between these two indicators widened during the first Chechen war (1994-96) and the second war (1999-2002) – fig. 13.

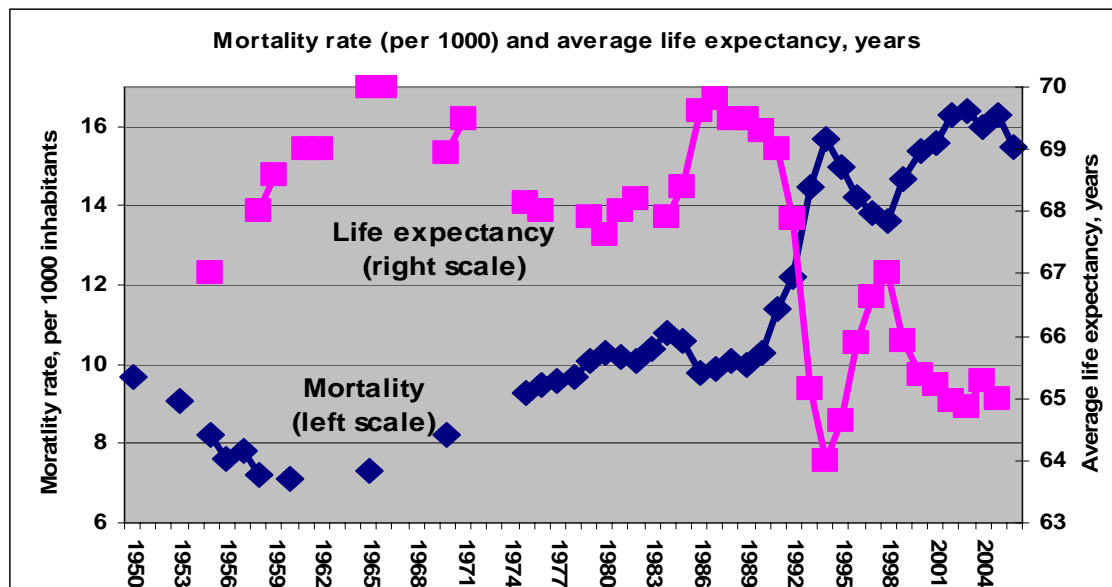
world – 6-7 people per 100,000 of inhabitants – pales in comparison with the Russian one.

FIG. 13



When the murder rate reaches 40-50 people per 100,000 of inhabitants, like it did in Colombia in the 1990s, the country faces complete collapse of the state authority and basically degrades to chaos and warlordism. The unprecedented increase in crime rate in the 1990s, shocking murders of famous politicians, businessmen and journalists that went unpunished de facto bankrupted the law enforcing agencies and brought Russian state to the point of losing its monopoly on violence.

FIG. 14



The most important achievement of the recent years is that the growth of the economy and the political stability finally brought about some improvement of social trends: the number of murders reached a peak in 2002 and fell in 2003-06; suicide rate decreased in 2001-06 (fig. 13); mortality rate stopped growing in 2004 (fig. 14); birth rate after reaching a 50-year minimum in 1999 started to grow, marriage rate increased, divorce rate fell. On the other hand, a nearly 50% increase in the crime rate in 2002-05 is most likely the sign of better registration of crimes. True, the improvements are very marginal, but at least there is a hope that was completely missing previously.

Rebuilding the state?

The victory of "Yedinstvo", the "party of power," in the parliamentary elections of 1999 was, among other things, a victory for the have-nots (subsidized regions) over the haves (donor regions), which had joined forces in the Primakov-Luzhkov bloc "Otechestvo-Vsya Rossiya". Putin tried to limit the all-powerful regions by changing the principles of fiscal federalism, appointing presidential viceroys in 7 amalgamated regions and reforming the Federation Council, the upper chamber of the Russian parliament, which represented the interests of all 89

regions. In 1999, Putin began a second war against Chechnya, refusing to negotiate with separatists, and by today the separatists are largely defeated.

He launched court cases against the “oligarchs” – financial tycoons, remaining within the limits of legal rules, however. They were accused of not paying taxes and of financial machinations; some of them emigrated, some were arrested. The only non-governmental television channel, NTV, was shut down (incidentally, also for totally legitimate reasons, as “oligarch” Gusinsky had refused to pay off the debt to the state-owned Gasprom, having seemingly decided that freedom of speech was not worth that much money). Another “oligarch”, Mikhail Khodorkovsky, ended up in jail for fraud (taking oil profits to offshore locations via transfer pricing), and his company, “Yukos” was bankrupted by the government; its assets were seized to collect the tax arrears to the state coffers. Another oil company, “Sibneft” was purchased in the open market by Gazprom, so the share of the state in the oil industry increased from less than 15% in 2004 to over 30% in 2005.

But the improvement of social indicators was the most important achievement of all. Economic growth and low inflation alone cannot prevent the disintegration of the country if social inequality and crime increase. Building the vertical of power and intensifying centralization may not stop the collapse of the state, if they don't bring about stronger law and order and limit the shadow economy. In fact, Putin has been criticized precisely for taking all the power into his own hands without greater order resulting. Well now, it seems that the first signs have appeared of a real, rather than an ephemeral, stabilization: the crime and suicide rates are falling, the mortality rate has leveled out, the number of marriages and the birth rate are rising, and the divorce rate is falling. Yes, the trend is hardly noticeable and has only appeared in the last 2-3 years. Yes, notorious terrorist attacks have been undermining confidence in the authorities, but still there is a ray of hope, hope that was non-existent before.

Putin's popularity is explained precisely and primarily by his ability to stop the collapse of the state caused by the reforms of the 90's. All other problems pale in comparison with the threat of social and national disintegration. The majority of Russian citizens are prepared to forgive Putin for his heavy-handed tactics in dealing with the “oligarchs” and even with entrepreneurs of a lesser stature, for the “purges” in Chechnya, and for the constraints placed

on democracy and freedom of speech, – all in the interests of strengthening law and order and putting limits on a situation of anarchy that knows no bounds.

Here is how Russians responded in polls conducted on the eve of the February 2004 elections. When asked what they expected first and foremost of the new president, 58% wanted him to reinstate Russia to its status as a great and respected power; 48% - to ensure a just distribution of income in the interests of ordinary people; 45% - to strengthen law and order; 43% - to put an end to the war in Chechnya; 41% - to return the funds that ordinary people lost during the reforms; 39% - to strengthen the role of the state in the economy. Such priorities as “keeping Russia on the road of reform” and “continuing the policy of closer ties with Western countries” garnered only 11 and 7% respectively. “Are you concerned that Putin could establish an iron-fisted dictatorship supported by the ‘power agencies’?” In January 2000, before Putin’s first presidential elections, 34% said yes to this question, while in January 2004, 26% showed concern. Respectively, 57 and 67% showed no concern.

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Where is Russia headed? The future harbors many dangers. The current real exchange rate of the ruble (the ratio of domestic to world prices) is too high. It has been growing throughout the past 5 years and in 2006 has exceeded the 1998 pre-crisis level. Therefore, a drop in world energy prices could easily provoke a new currency crisis and interrupt economic recovery, despite large currency reserves. Domestic fuel and energy prices remain several-fold lower than world levels, creating incentive for inefficient energy consumption and the highest energy intensity in the world. And so, unlike in Eastern European countries and many of the former Soviet republics, where the prices of fuel and energy have already approached or are already approaching world levels, the restructuring of the Russian economy is still far from complete. What Russia should have done in past years was slowly devalue the exchange rate of the ruble, and at the same time increase domestic prices for oil, gas and electricity, compensating the producers for losses from the rising cost of energy with the benefits of stronger competitiveness resulting from the depreciating ruble rate. However, such a policy is not even on the drawing board for the moment.

Another danger is too rapid a decrease in taxes, which the government has already implemented (income tax, corporate tax and the unified social tax). The critics of such measures, including the Moscow office of the IMF, justifiably point out that the current revenues of the budget and the current surpluses are based primarily on high prices for energy sources, and, therefore, if these prices should fall, the government could once again find itself penniless. Plus, it isn't the right time to reduce taxes when virtually all government services – health care, education, defense, law and order – are much worse off than the private economy.

Other dangers continue to exist: corruption, the inefficiency of the state apparatus, high social inequity. But generally today Russia is in the better shape than 6 years ago, when Putin just assumed power. Russia now needs more than anything to strengthen law and order and to restore the institutional capacity of the state. Democracy is also needed, but only later, when the rule of law has been established. Yes, it goes without saying that there is a danger of the leadership using political centralization just to line everyone up along the vertical and eliminate the opposition to live in serenity and abundance at citizens' expense and perhaps also to embark on the occasional escapade. Particularly since this has happened in Russia before. But, one must choose the lesser of two evils. The chance of strengthening law and order exists only under centralization. Without centralization, there is no chance at all of it happening, so chaos and lawlessness will rule with no limits, guaranteed 100%. This seems to be the choice in Russia today.