

# Vladimir Popov

## Resurgent Russian economy?

*Putin's policy without Putin?*

On 1 October 2007, two months before the parliamentary elections of 2 December 2007 and less than half a year before the presidential elections of 2 March 2008, President Vladimir Putin agreed to put his name on the electoral ballot sheet of the largest Russian party that had always supported him—United Russia—although he had never been a member. In December's parliamentary elections, United Russia received 64 percent of the votes, whereas Just Russia—a party that was more left-oriented but also openly supported Putin—received another eight percent of the votes. Only two opposition parties managed to overcome the seven-percent barrier in the proportional representation elections to get their deputies into parliament: Communists (12 percent) and the nationalistic Liberal Democratic party (eight percent). Other parties altogether received less than eight percent of the votes.

Shortly after December 2007, Dmitry Medvedev, then deputy prime minister, became a joint presidential candidate of four parties (United Russia, Just Russia, and two minor parties not represented in parliament) and immediately offered Putin the post of prime minister in the future government. Putin accepted, making it clear he was going to stay in politics even

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after his second presidential term came to an end. On 2 March 2008, Medvedev was elected president by an overwhelming majority and nominated Putin as prime minister.

Putin's decision to stay on board in a new administration is understandable: he is prohibited from running for a third presidential term by the constitution but he remains extremely popular—53 percent of the electorate voted for Putin in 2000, 71 percent in 2004, and over 60 percent said they would vote for him in September 2007, even though he was not going to run. The secret of his high popularity is simple: he left the country in better shape than when he came into power eight years earlier.

#### PUTIN'S LEGACY: ECONOMIC ACHIEVEMENTS

The stabilization of the past eight years was especially impressive, if compared to the period of disarray of "the rocky 1990s." The Russian economy lost 45 percent of its output during the transformational recession of 1989-98, income inequalities increased significantly, 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 with the spectacular currency crisis of August 1998, when the ruble lost over 60 percent of its value in several months, resulting in the acceleration of inflation, crime, suicides, and mortality rate.

However, after the 1998 currency crisis, the Russian economy started to grow. The average annual growth rate totaled about seven percent in 1999-2007, so now GDP is gradually approaching its pre-recession level of 1989. Real incomes and personal consumption increased even faster—more than doubling in 1999-2007—and have already surpassed the pre-recession level of the late 1980s. 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 credit for not ruining this growth. Inflation fell from 84 percent in 1998, when prices jumped after the August 1998 currency crisis and dramatic devaluation of the ruble, to 10-12 percent in 2004-07.

Economic growth and high world fuel prices helped the government to collect more tax revenues, so the government budget moved from a deficit to surplus, and government spending as a proportion of GDP increased since 1999, allowing the partial restoration of the institutional capacity of the state that was lost in the 1990s. Moreover, high oil and gas prices in the world markets allowed Russia to enjoy high foreign trade surpluses and to accumulate foreign exchange reserves, which increased from less than \$15 billion

right after the 1998 currency crisis to nearly \$500 billion at the beginning of the 2008.

By comparative standards, Russian performance is not that impressive.<sup>1</sup> In 2007, many other former Soviet republics—Armenia, Azerbaijan, Belarus, Estonia, Kazakhstan, Latvia, Lithuania, Turkmenistan, and Uzbekistan, not to speak of central European countries—well surpassed the pre-recession level of output, whereas Russian GDP was still only 99 percent of the 1989 level. Russian HDI (the human development index, accounting not only for GDP per capita, but also for life expectancy and levels of education) at 65 years, is still below the USSR level and even below that of Cuba, with a life expectancy of 77 years. China, with a life expectancy of 72 years, is rapidly approaching the Russian level of HDI. At least there is more stability in Russia today than there was in the rocky 1990s.

No wonder Russian citizens appreciate the new stability of recent years and are not interested in seeing new leadership or changes to the current course. Opinion polls conducted in September 2007 showed that over 60 percent of Russians were willing to see Putin as their next president (even though he does not have the right to run and said many times he wouldn't try), whereas the majority was apparently willing to vote for any candidate that would be supported by Putin, which led to Medvedev winning in March 2008.

#### PUTIN'S LEGACY: STATE CAPACITY AND SOCIAL TRENDS<sup>2</sup>

A strong and efficient state is one that has the power to enforce its rules and regulations, no matter what those are. The crime rate and the size of the shadow economy are natural measures of strength in state institutions. A strong state may be more or less democratic. China and some central European countries—with murder rates of about two per 100,000 inhabitants—

<sup>1</sup> For a comparison of the performance of transition economies (China, Vietnam, Mongolia, Eastern Europe, and the former USSR), see Vladimir Popov, "Shock therapy versus gradualism: The end of the debate: Explaining the magnitude of the transformational recession," *Comparative Economic Studies* 42, no. 1 (spring 2000): 1-57; and Vladimir Popov, "Shock therapy versus gradualism reconsidered: Lessons from transition economies after 15 years of reforms," *Comparative Economic Studies* 49, no. 1 (March 2007): 1-31.

<sup>2</sup> This section is partly based on Vladimir Popov, "Russia Redux?" *New Left Review*, no. 44, March-April 2007.

would appear to have a stronger state than Russia, which had about 20-30 murders per 100,000 inhabitants since 1993.

The very notion of the state implies that public authorities exercise at least three monopolies: on violence, tax collection, and 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 in question. Government failure became pervasive and much more visible than market failure.

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

Tax collection fell dramatically in 1992-98, from over 50 percent of GDP to about 30 percent, whereas GDP itself nearly halved. The efficiency of the government in the 1990s deteriorated drastically; low spending levels meant that the state simply could not provide enough public goods. The shadow economy, which the most generous of estimates placed at 10-15 percent of GDP under Brezhnev, grew to 50 percent of GDP by the mid-1990s. In 1980-85, the Soviet Union was placed 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 on the same 54-country list, between India and Venezuela.<sup>3</sup>

Income inequalities increased greatly: the gini coefficient of inequalities in income distribution increased from 26 percent in 1986 to 41 percent in 2004, with the major part of the increase occurring in the first half of the 1990s—an unprecedented jump in such a short period of time. In 1995, there was no person in Russia worth over \$1 billion. But Russia had 53 billionaires in 2007 according to Forbes, a statistic that propelled the country to the second/third place in the world after the US (415) and Germany (55). As well, Russia's 53 billionaires were worth \$282 billion (\$37 billion more

than Germany's richest). In 2008, Forbes reported 87 billionaires in Russia, with a total wealth of roughly half a trillion dollars, making Russia only second to the US.

What is worst of all, the criminalization of Russian society grew dramatically in the 1990s. Crime had been rising gradually in the Soviet Union since the mid 1960s, but saw an unprecedented surge after the collapse of the USSR. In just several years, crime and murder rates doubled and reached one of the highest levels in the world.<sup>4</sup> By the mid-1990s, the murder rate stood at over 30 people per 100,000, against one-two persons in western and eastern Europe, Canada, China, Japan, Mauritius, and Israel. Only two countries in the world (not counting some wartorn collapsed states, which do not have reliable statistics) had higher murder rates—South Africa and Colombia, whereas countries like Brazil or Mexico showed a rate two times lower. Even the US murder rate, the highest in the developed world (six-seven people per 100,000 inhabitants), paled in comparison with Russia.

Generally, when murder rates reach 40-50 people per 100,000 inhabitants and more—as it did Colombia in the 1990s—the country faces complete collapse of the state authority and basically disintegrates into chaos and warlordism. The mix of the unprecedented increase in crime rate in the 1990s—the shocking murders of famous politicians, businessmen, and journalists all effectively bankrupted law-enforcing agencies and brought the Russian state to the point of losing its monopoly on violence.

The Russian death rate from external causes (accidents, murders, and suicides) had, by the beginning of the 21st century, skyrocketed to 245 per 100,000 inhabitants. This is higher than in any of the 187 countries covered by WHO estimates in 2002. It is equivalent to 2.45 deaths per 1,000 a year, or 159 per 1,000 over 65 years, which is the average life expectancy in Russia today. Put differently, if these rates continue to hold, one out of six Russians

4 Crime statistics are 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, since it registers only illegal murders, whereas the second one records all murders, including capital punishment and "collateral damage" during wars, antiterrorist, and other police operations. Both rates skyrocketed in Russia in the beginning of 1990s and have stayed at the extremely high levels. The gap between these two indicators widened during the first Chechen war (1994-96) and the second (1999-2002), but now the difference is negligible.

born in 2002 will have an “unnatural” death. To be sure, in the 1980s murder, suicide, and accidental death rates were quite high in Russia, Ukraine, Belarus, Latvia, Estonia, Moldova, and Kazakhstan—several times higher than in other former Soviet republics and in east European countries. However, they were roughly comparable to those of other countries with the same level of development. In the 1990s, these rates rapidly increased, far outstripping those in the rest of the world.

The mortality rate doubled in just five years, from 10 per thousand in 1990 to 16 in 1994, and stayed at a level of 14 to 16 per thousand thereafter. This was a true mortality crisis, and a unique case in history, where mortality rates increased by 60 percent in just five years without wars, epidemics, or eruptions of volcanoes. Never in the postwar period had Russia such high mortality rate as in the 1990s. Even in 1950–53, during the last years of Stalin’s regime—with high death rates in the labour camps and consequences of wartime malnutrition and wounds—the mortality rate was only nine–10 per thousand.

Studies have shown that the increased mortality rate was, for the most part, not caused by reduced real incomes, the resulting deterioration in diet, smoking or alcoholism, the breakdown of the health care system, environmental pollution, or by the upswing in the crime and accident rates.<sup>5</sup> The main cause of the rising mortality rate was cardiovascular disease in 40–50-year-old males, who could not deal with the stress of the instantaneous transition to a market economy. The stress index—determined by unemployment rate, frequency of changes in employment (firing and hiring), place of residence (migration), marriage and divorce rates, and disparity in income distribution—is an index that closely correlates with the mortality rate both across postcommunist countries and across Russia’s regions. In China, where reforms were undertaken gradually, life expectancy has grown from 65 years immediately after the death of Mao to its current level of 72 years, while in all other former socialist countries, including the GDR, the transition to a market economy has created so much stress that it led to an increase in mortality.

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) that had joined forces with the

<sup>5</sup> Giovanni Andrea Cornia and Renato Panicià, eds., “The transition’s population crisis: An econometric investigation of nuptiality, fertility and mortality in severely distressed economies,” *MOCT-MOST* 6, no. 1 (spring 1996).

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 seven amalgamated regions, and reforming the federation council, the upper chamber of the Russian parliament that represented the interests of all 89 regions.

In 1999, Putin began a second war against Chechnya, refusing to negotiate with separatists, and today the separatists have largely been defeated. He launched court cases against the "oligarchs"—financial tycoons who gained strength during the 1990s and wanted to supplement their wealth with political power by "privatizing the state" while remaining within the limits of legal rules. They were accused of not paying taxes and of financial machinations; some of them emigrated and some were arrested. The only nongovernmental television channel, NTV, was shut down (incidentally, for completely legitimate reasons, as oligarch Vladimir Gusinsky had refused to pay off the debt to the state-owned Gazprom, having seemingly decided that freedom of speech was not worth terribly much). Another oligarch, Mikhail Khodorkovsky, the owner of the major oil company Yukos, who had open ambitions to replace Putin as president, was arrested for financial fraud (taking oil profits to offshore locations via transfer pricing) in 2003. His company was bankrupted by the government and 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 percent in 2004 to over 30 percent 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. Intensifying centralization may not stop the collapse of the state if it doesn't bring about stronger law and order and limit the shadow economy and illegal activities. Putin has been criticized precisely for taking power into his own hands without delivering greater order. It seems that now the first signs have appeared of a real—rather than ephemeral—stabilization: the growth of the economy and political stability have finally brought about some improvement of social trends. The number of murders reached a peak in 2002 and fell in 2003-07; the suicide rate decreased in this period; the mortality rate stabilized and fell in 2004-07; the birth rate, after reaching a 50-year minimum in 1999, started to grow; marriage rates increased; divorce rates fell. On the other hand, a nearly 50-percent increase in the crime rate in 2002-05 is most likely the sign of better registration of crimes because the number of violent

crimes (always better registered than others) continued to decline. The decline of the Russian population (from 148.6 million in 1993 to below 142 million in 2008) slowed down. True, improvements in social indicators are marginal and have only appeared in the last three-five years, but at least there is hope that had previously been completely missing.

Putin's popularity is explained precisely and primarily by his ability to stop the collapse of the state caused by the reforms of the 1990s. 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 entrepreneurs of lesser stature, the purges in Chechnya, and for the constraints placed on democracy and freedom of speech, because it was all in the interests of strengthening law and order and putting limits on anarchy that knew no bounds.

This 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 percent wanted him to reinstate Russia to its status as a great and respected power; 48 percent wanted assurance of a just distribution of income in the interests of ordinary people; 45 percent wanted to strengthen law and order; 43 percent wanted to put an end to the war in Chechnya; 41 percent wanted the funds returned that ordinary people lost during the reforms; and 39 percent wanted 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 seven percent respectively. In January 2000, 34 percent of people said yes to the question: "Are you concerned that Putin could establish an iron-fisted dictatorship supported by the 'power agencies'?", but in 2004, only 26 percent showed concern. Respectively, 57 and 67 percent showed no concern.

#### PUTIN'S LEGACY: PROBLEMS

Russian economic achievements of recent years may be impressive but unfortunately they are based on weak foundations. The economy is too dependent on oil and gas exports that account for half to two-thirds (depending on world fuel prices) of total Russian exports. And the prosperity of recent years was mostly based on growing world fuel prices. Simple calculations show the importance of windfall oil revenues. Russian GDP at the official exchange rate was about \$1 trillion in 2006, whereas the production of the oil and gas



sector that employs fewer than one million workers is valued roughly at about \$500 billion at world prices of \$80 per barrel of oil. When oil was priced at \$15 a barrel in 1999, Russian oil and gas output was valued at less than \$100 billion. The difference—\$400 billion—is the fuel windfall profit that fell on Russia from the skies.

Russia was unable to properly cope with the growing stream of petrodollars. In recent years it developed a typical “Dutch disease”—Russian growth was concentrated in resource industries and nontradables (services). Increased fuel revenues were mostly used for personal consumption (as opposed to investment) that have more than doubled since 1999. Due to the appreciation of the real exchange rate of the ruble (the growing ratio of Russian prices to foreign prices), Russian nonfuel industries became noncompetitive as compared to foreign goods, so imports in real terms grew faster than anything else in the national economy. The growing trade surplus of recent years is mostly due to constantly increasing fuel prices, whereas the growth of the physical volume of imports (nearly fourfold in real terms in 1999-2006) greatly outpaced the growth of exports in real terms.

Russian growth rates in 1999-2007 were high (seven percent), but still lower than in other fuel exporters in the former Soviet Union region, like Azerbaijan, Kazakhstan, and Turkmenistan (over 10 percent in 1999-2007). Even some fuel importers, like Armenia and Belarus, showed higher growth rates than Russia. 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 did not increase during the period of 1999-2007 despite the threefold rise in average annual oil prices. The answer may be disappointing but is hardly disputable: Russia did not manage to use its growing resource rent in the best possible way.

#### CAN RUSSIA OVERCOME THE “RESOURCE CURSE”?

Is Russia a typical resource economy? Few specialists would call the USSR a resource economy, but Russian industrial structure changed a lot after the transition to the market. 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 share of output of major resource industries (fuel, energy, metals) in total industrial output increased from about 25 percent to over 50 percent by the mid-1990s and stayed at this high level thereafter. Partly, this was the result of changing price ratios (greater price increases in resource industries),

but the real growth rates of output were also lower in the nonresource sector. The share of mineral products, metals, and diamonds in Russian exports increased from 52 percent in 1990 (USSR) to 67 percent in 1995 and to 82 percent in 2006, whereas the share of machinery and equipment in exports fell from 18 percent in 1990 (USSR) to 10 percent in 1995 and to six percent in 2006. The GDP share of R&D spending was 3.5 percent in the late 1980s in the USSR, but has fallen to 1.3 percent in Russia today (compared with 1.3 percent in China; two-three percent in the US, Korea, and Japan; four percent in Finland, and five percent in Israel). Today, Russia looks like a normal resource-abundant developing country.

It is said that many resource-abundant countries suffer from a “resource curse” that hinders their growth. Studies show that the quality of their institutions is inferior to that in other countries. If, say, a country had poor institutional capacity to begin with, it is very likely to deteriorate in the future proportionately to the magnitude of resource export/production.<sup>6</sup> In addition, resource-rich countries suffer from Dutch disease—an overvaluation of the real exchange rate (RER) that creates obstacles for exports, especially exports of high-tech goods, and hinders growth. To promote growth, resource-rich countries generally keep domestic fuel prices at low level: this policy helps to stimulate growth but at a cost of high energy intensity (that kills part of the growth stimulating effect and diverts resources away from high tech industries). It is no surprise then that resource-rich countries have relatively lower quality of human capital. In addition, in resource-abundant economies the volatility of growth rates is higher and they have smaller chances to develop stable democratic political regimes.<sup>7</sup>

There were virtually no developing resource-abundant countries in the 20th century that carried out the “right” industrial policy (undervaluation of RER, high domestic prices for resources), had a stable democracy, and

6 For an overview see Victor Polterovich, Vladimir Popov, and Alexander Tonis, “Mechanisms of resource curse, economic policy and growth,” NES working paper no. WP/2008/000, 2008, <http://www.nes.ru>.

7 Victor Polterovich and Vladimir Popov, “Democratization, quality of institutions and economic growth,” in Natalia Dinello, ed., *Political Institutions and Development: Failed Expectations and Renewed Hopes* (Cheltenham, UK: Edward Elgar, 2007); Victor Polterovich, Vladimir Popov, and Alexander Tonis, “Resource abundance, political corruption, and instability of democracy,” NES working paper no. WP2007/73, 2007, <http://www.nes.ru>.

demonstrated a growth miracle. All relatively successful resource-rich countries are either developed (Norway, Australia, Canada, and the US) or only succeeded in reasonable management of resource rents without achieving high rates of economic growth (the Persian Gulf states).

One would think that resource-rich countries have natural advantages, but these advantages are not transformed into higher growth. Why has not a single major exporter of fuel become a case of “growth miracle,” showing growth rates comparable to that of Japan, Taiwan, and South Korea in the 1950s-1980s, and China from 1979 onwards? As a matter of fact, of major fuel exporters, only Indonesia experienced high growth rates in 1967-97 (per capita GDP grew at an annual average rate of 3.9 percent), whereas annual population growth rates were about two percent, so that the annual average growth of GDP was about six percent for three decades. The share of oil and gas in Indonesian exports increased in this period from 35 percent in 1960-68 to nearly 80 percent in 1974-83, but then fell to 23 percent in 1994-97 (22 percent in 2005).<sup>8</sup> Indonesian per capita PPP GDP increased from 5.7 percent of the US level in 1975 to 10.4 percent in 1997. However, after the currency crisis of 1997, Indonesian GDP fell dramatically and only now, 10 years later, has surpassed the pre-recession level.

Another example of a relatively successful resource economy is Botswana, which exports diamonds, and has enjoyed the highest growth rates of GDP per capita in the world for half a century, despite extremely high levels of mortality from HIV/AIDS in recent decades.<sup>9</sup>

The most important feature of industrial policy in resource-abundant countries is the maintenance of low domestic energy and fuel prices (via export taxes and direct restrictions on export) and the overvaluation of the exchange rate. The latter—the overvalued exchange rate—is not usually considered to be an instrument of industrial policy, but in fact it is exactly

8 Pierre Van der Eng, “Indonesia’s growth performance in the twentieth century,” in Angus Maddison, D.S. Prasada Rao, and William F. Sheferd, eds., *The Asian Economies in the Twentieth Century* (Cheltenham: Edward Elgar, 2002).

9 “Thirty years ago, Indonesia and Nigeria—both dependent on oil—had comparable per capita incomes. Today, Indonesia’s per capita income is four times that of Nigeria. A similar pattern holds true in Sierra Leone and Botswana. Both are rich in diamonds. Yet Botswana averaged 8.7 percent annual economic growth over the past 30 years, while Sierra Leone plunged into civil strife.” J.E. Stiglitz, “The resource curse revisited,” [www.project-syndicate.com](http://www.project-syndicate.com).

that. It was shown that the levels and rates of growth of foreign exchange reserves vary greatly among countries, even after controlling for the objective factors of the accumulation of reserves, such as the ratio of trade to GDP, the volatility of trade, the quality of institutions, GDP per capita, and the level of external debt.<sup>10</sup> These differences in the speed of reserve accumulation—the policy-induced rate of accumulation of reserves—turned out to be very informative for the explanation of cross-country variations in growth rates: whereas for the developed countries the accumulation of reserves in excess of objective needs was detrimental for growth, for developing countries, this accumulation had a strong positive impact on growth even after controlling for the usual variables in growth regressions, such as initial income, the quality of institutions, population growth rates, and investment/GDP ratios.

Meanwhile, recent research suggests that industrial policy aimed at stimulating high-tech exports has important externalities for growth.<sup>11</sup> To put it differently, the export of resources and energy-intensive goods is not as beneficial for growth as exports of high-tech goods. From this point of view, it is better to underprice the exchange rate, not domestic prices for fuel. However, in practice, most resource-abundant countries keep high RER and low domestic fuel prices—a policy combination that helps stimulate growth but not development (because of energy waste and lack of stimuli for high-tech exports). The best policy would be exactly the opposite—to keep RER low and domestic fuel prices high. This was exactly the policy of east Asian countries (Japan, South Korea, Taiwan, Hong Kong, and Singapore, later other ASEAN countries and China)—the only region to demonstrate successful catch-up development in the postwar period.

The Russian economy suffers from the shortcomings of a rather typical resource country—it has poor institutions, low domestic fuel prices, and overvalued RER. Whereas it is difficult to improve the quality of institutions

10 Victor Polterovich and Vladimir Popov, "Accumulation of foreign exchange reserves and long term growth," in Tabata Shinichiro and Iwashita Akiro, eds., *Slavic Eurasia's Integration into the World Economy* (Sapporo: Hokkaido University, 2004).

11 Ricardo Hausmann and Dani Rodrik, "Economic development as self-discovery," *Journal of Development Economics* (December 2003); Ricardo Hausmann, Jason Hwang, and Dani Rodrik, "What you export matters," NBER working paper, January 2006, [www.ksghome.harvard.edu](http://www.ksghome.harvard.edu); Dani Rodrik, "What's so special about China's exports?" Harvard University, January 2006, [www.ksghome.harvard.edu](http://www.ksghome.harvard.edu).

in the short run, it is theoretically possible to switch to a more promising industrial policy—undervalued RER and high domestic prices for fuel. This would have a growth-stimulating effect for the whole economy, and especially for high tech industries, without an unfortunate energy waste (Russian energy intensity is one of the highest in the world). However, there are virtually no resource-abundant countries with this combination of policies; normally these countries have exactly the opposite combination.

The real exchange rate is usually considered an exogenous variable (in the long term), but the fact is that differences among countries in the rates of accumulation of reserves lead to dramatic variations in level real exchange rates, even after controlling for the GDP per capita (to capture the Balassa-Samuelson effect). The policy of undervaluation of the real exchange rate via accumulation of foreign exchange reserves thus results in disequilibrium—an underpriced exchange rate; this effect is quite large and is sometimes called “exchange rate protectionism.” The reason that such a policy spurs growth is twofold. First, it allows the reaping of externalities from exports, especially manufacturing and high-tech exports, providing extra protection to the domestic producers of all tradable goods, increasing their competitiveness vis-à-vis foreign producers, and reorienting them towards export markets. For developed countries, export-to-GDP ratios may be already at the optimal level, whereas for the developing countries they are still low, so special government efforts are needed to raise them to optimum. Second, rapid accumulation of reserves provides a signal to the foreign investors that the government is strong and also undercharges on domestic assets, so that there is an additional inflow of foreign direct investment that contributes to growth. There is empirical evidence that countries that accumulate excess reserves have lower real exchange rates, higher growth of exports- and trade-to-GDP ratios, and higher investment-to-GDP ratios, and eventually grow faster.<sup>12</sup> Rodrik provides evidence that countries with undervalued exchange

<sup>12</sup> Polterovich and Popov, “Accumulation of foreign exchange reserves and long term growth”; Victor Polterovich and Vladimir Popov, “Appropriate economic policies at different stages of development,” NES project paper, 2004, [www.nes.ru](http://www.nes.ru).

<sup>13</sup> Dani Rodrik, “The real exchange rate and economic growth: Theory and evidence,” July 2007, [www.ksghome.harvard.edu](http://www.ksghome.harvard.edu).

rates do indeed grow faster.<sup>13</sup>

Theoretically, the same effect can be reached via the imposition of import duties and export subsidies (which was a policy of a number of fast-growing countries, especially in east Asia), but the advantage of the undervaluation of the exchange rate via reserves accumulation is that this latter policy is not selective and hence can be effective even with poor institutions and a poor bureaucracy. There is empirical evidence that the effectiveness of import tariffs depends on the quality of institutions, whereas exchange rate protectionism works in all poor countries, even with poor institutional capacity.<sup>14</sup>

If Russia is to adopt a better industrial policy in the future, this would imply a delicate gradual maneuver: the gradual increase of domestic fuel and energy prices (via phasing out export taxes and lifting access to pipeline restrictions) to world levels; higher taxes on fuel companies to capture windfall profits from increasing domestic fuel prices; spending increased budget revenues on infrastructure and assistance to nontradable goods industries to compensate losses from higher domestic fuel prices; and lower RER (via the accumulation of foreign exchange and import subsidies) to compensate the losses of nonfuel industries and tradable goods industries from higher domestic fuel prices.

This delicate maneuver is theoretically possible but requires a good bureaucracy. It remains to be seen whether it can be carried out by the new administration. The precondition for this policy is the high level of consensus in the Russian political elite and in society in general, which is obviously more easily achievable under growing than under plummeting world fuel prices.

#### AFTERWORD: IF OIL PRICES FALL...

It is very likely that with lower oil prices Russia would not be able to maintain the relatively high growth rates of the past several years. The Russian economy is often likened to the drug addict who needs larger and larger injections of drugs just to stay out of depression. Even if fuel prices were to just stop growing and to stabilize at the current high level, the Russian economy would run into the problem of a shrinking current account surplus and the possible outflow of capital. With currently high foreign exchange reserves,

14 Polterovich and Popov, "Appropriate economic policies at different stages of development."

consumption could be maintained at the existing level for several years, but production growth rates would start falling unless the economy were to undergo a structural adjustment through the devaluation of the ruble and greater emphasis on nonfuel industries.

Both options—slowing growth and structural adjustment—would have political implications. Whether Putin can become the Russian Deng Xi-aoping—a “grey cardinal” retaining overwhelming control even without formally holding the top post of the president—depends to a large extent on economic prospects, which in turn are linked to the dynamics of fuel prices. If the latter fall or stop growing, the Russian economic situation would worsen and Putin’s successor would face a temptation to put the blame on his predecessor. At the same time, Putin, for his part, may be willing to distant himself from his “unlucky” successor presiding over the deteriorating economy, in order to have a clean record with which to run in the 2012 presidential elections.