

Vladimir Popov

## Is Russian economy likely to become a new “Asian Tiger”?

When nearly 13 years ago, in 2000, Putin became a president for the first time, I wrote a policy memo entitled *Why The Russian Economy Is Unlikely to Become a New “Asian Tiger”*. In particular, I argued that there is a need to increase government investment into infrastructure (to trigger the increase in private investment) and to maintain low exchange rate of the rouble in order to promote export-oriented development.

«At the moment there are no indications that the new Russian government has the courage required to break this vicious circle of populist policies, and to embark on a new export oriented growth strategy. Quick progress in adopting the outlined measures does not seem to be politically feasible, but some steps in this direction are more or less inevitable, especially in the longer term. One can be fairly certain, however, that rapid economic growth without major progress in most, if not in all of the above-mentioned policy areas is extremely unlikely»<sup>1</sup>.

The next 12 years my sceptical part was fighting with my optimistic part.

### Reasons for pessimism

In 2004-05 Andrew Schleifer and Daniel Triesman published a short and full version of an article «A normal country: Russia after communism»<sup>2</sup>. They compared Russia to Brazil, China, India, Turkey and other developing countries and argued that in terms of crime, income inequalities, corruption, macroeconomic instability, and other typical curses of the third world Russia is by far not the worst – somewhere in the middle of the list, better than Nigeria, worst than China. In short – a *normal* developing country. They were right in a sense that Russia degraded to the status of a “normal developing country” during the 1990s.

<sup>1</sup> V. POPOV, *Why the Russian Economy is Unlikely to Become a New “Asian Tiger”*, PONARS Policy Memo 129.

<sup>2</sup> A. SHLEIFER - D. TREISMAN, *A Normal Country*, in «Foreign Affairs», vol. 83, no.2, March/April 2004.

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### Abstract

The economic reforming process needed for the passage from Soviet Union to Russia Federation was a hard one with high social costs. By 2012 the economy finally surpassed the pre recession level of 1989 and the budget deficit turned into surplus. Economic growth and political stability along with better conditions of life have been the most relevant improvements of the last decade. Russia again is considered a crucial player in the international system. Despite impressive progress, Russia is nevertheless still struggling with modernization. Corruption, oligarchic, capitalism, deindustrialization of the economy and decline in R&D, income inequalities, deterioration of health and education, increase in mortality, clericalization of the society and cultural degradation are still impediments to the full success story of the country.

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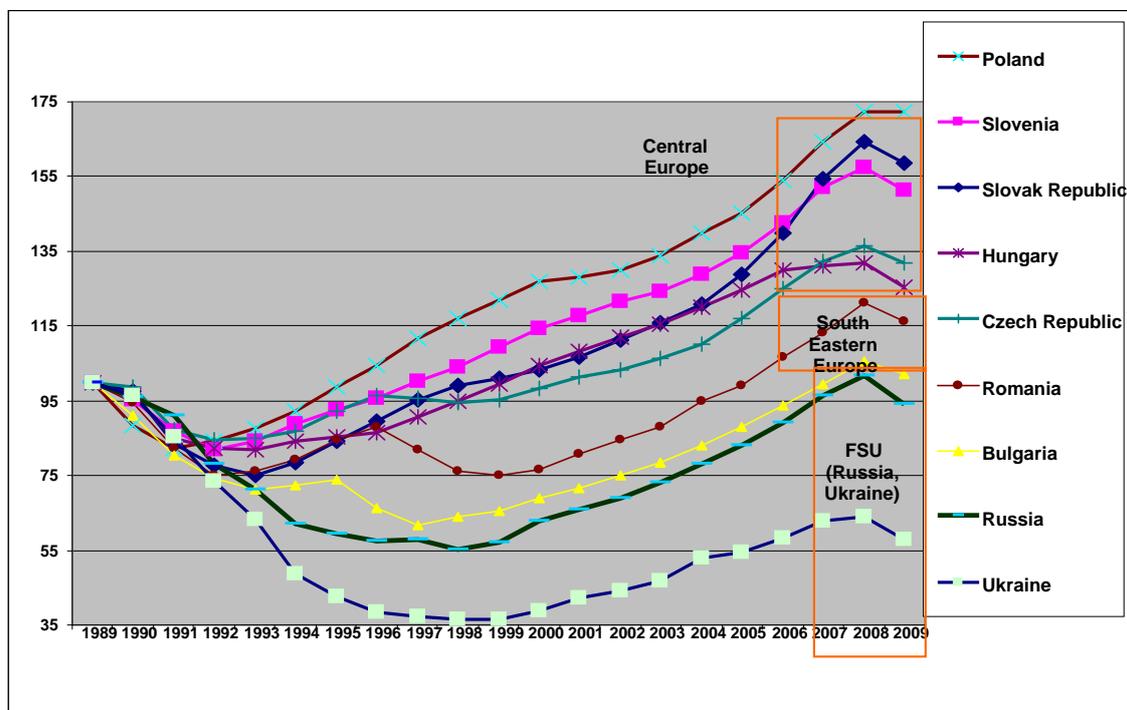
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The USSR was an *abnormal* developing country. The Soviet Union has put the first man into space, had about 20 Nobel Prize winners in science and literature. Out of about 40 living laureates of the Fields Medal (awarded since 1936 and recognized as the “Nobel Prize in mathematics”) eight come from former Soviet Union (that had about 5% of world population). The USSR had universal free healthcare and education (the best among developing countries), low income inequalities and relatively low crime and corruption. By 1965 Soviet life expectancy increased to 70 years – only 2 years less than in the US even though per capita income was only 20-25% of the US level<sup>3</sup>.

Market reforms of the early 1990s caused the unprecedented reduction of output and living standards. From 1989 to 1998 Russia experienced the transformational recession – GDP fell to 55% of the pre-recession 1989 level. In 1999-2008 Russian economy was recovering at a rate of about 7% a year and nearly reached the pre-recession peak of 1989. But in 2009 due to the collapse of oil prices and the outflow of capital caused by world recession Russian GDP fell again by 8%. Now, the pre-recession (1989) level of GDP is to be surpassed only in 2012 (fig. 1). For over two decades there was no improvement in living standards for most of the Russians.

The transition to the market economy in the 1990s brought about the dismantling of the state – the provision of all public goods from health care to law and order fell dramatically. The shadow economy, which the most generous estimates place at 10-15% of the GDP under Brezhnev, grew to 50% of the 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 in the same 54-country list, between India and Venezuela.

Figure 1 - GDP change in selected transition economies, 1989 = 100%



Source: EBRD Transition Report

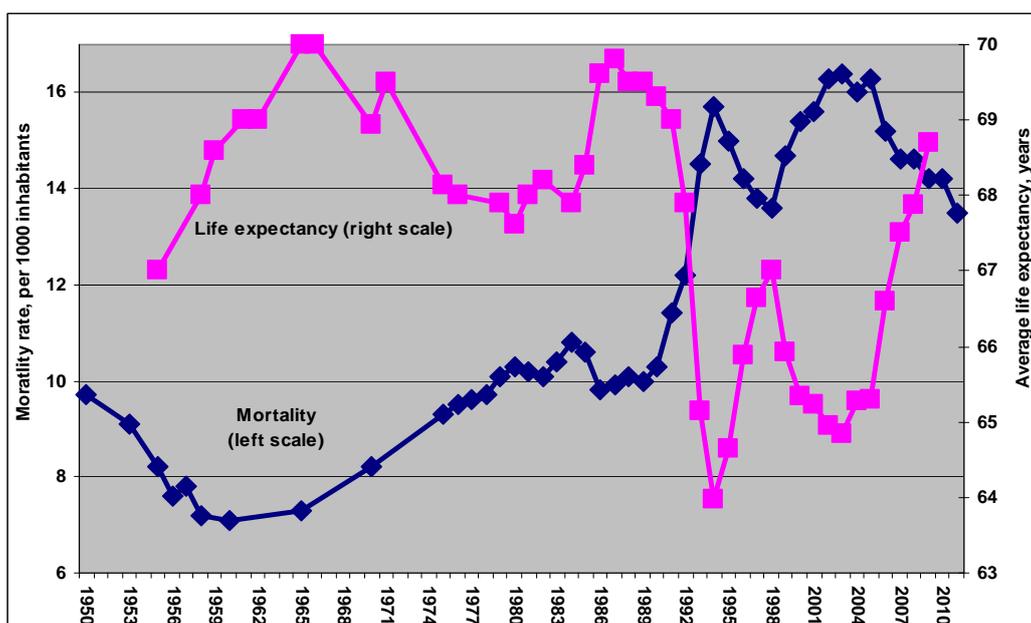
<sup>3</sup> V. POPOV, *The Long Road to Normalcy. Where Russia Now Stands*, UNU WIDER Working Paper No. 2010/13.

Income inequalities increased greatly – Gini coefficient (changes from 0 to 100, the higher, the higher are inequalities) increased from 26% in 1986 to 40% in 2000 and 42% in 2007 (42% in 2011). The decile coefficient – ratio of incomes of the wealthiest 10% of the population to incomes of the poorest 10% – increased from 8 in 1992 to 14 in 2000 to 17 in 2007 (16 in 2011). But the inequalities at the very top increased much faster: in 1995 there was no person in Russia worth over \$1 billion; in 2007, according to Forbes, Russia had 53 billionaires, which propelled the country to the second/third place in the world after US (415) and Germany (55) - Russia had 2 billionaires less than Germany, but they were worth \$282 billion (\$37 billion more than Germany's richest). In 2011 the number of billionaires in Russia increased to 101 – more than in Germany, but less than in China, where it increased from 20 in 2007 to 116 in 2011 (plus 36 in Hong Kong and 25 in Taiwan). But Russian billionaires had more wealth – about 500 billion or 1/3 of annual GDP.

Worse of all, the criminalization of the Russian society grew dramatically in the 1990s. 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. 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 world – 6-7 people per 100,000 of inhabitants – pales in comparison with the Russian one.

The Russian rate of deaths from external causes (accidents, murders and suicides) by the beginning of the twenty-first century had skyrocketed to 245 per 100,000 inhabitants. This was higher than in any of the 187 countries covered by WHO estimates in 2002. 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.

Figure 2 - Mortality rate (deaths per 1000 inhabitants, left scale) and life expectancy (years, right scale)



Source: Goskomstat.

Mortality rate grew from 10 per mille in 1990 to 16 in 1994, and stayed at a level of 14 to 16 per mille until 2011. This was a true mortality crisis, a unique case in history, when mortality rates increased by 60% in just 5 years without wars, epidemics or eruptions of volcanoes. Never in the postwar period had Russia such high mortality rate as in the 1990s (fig. 2). Even in 1950-53, during the last years of the Stalin's regime with high death rate in the labor camps and consequences of the war time malnutrition and wounds, the mortality rate was only 9-10 per mille as compared to 14-16 in 1994-2008.

Russia became a typical "petrostate". Few specialists would call the USSR a resource-based 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% to over 50% 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 also the real growth rates of output were lower in the non-resource sector.

The share of mineral products, metals and diamonds in Russian exports increased from 52% in 1990 (USSR) to 67% in 1995 and to 81% in 2007, whereas the share of machinery and equipment in exports fell from 18% in 1990 (USSR) to 10% in 1995 and to below 6% in 2007. The share of R&D spending in GDP that was 3.5% in the late 1980s in the USSR, but fell to about 1% in Russia today (China – 1.3%, US, Korea, Japan – 2-3%, Finland – 4%, Israel – 5%). So from this angle as well Russia really looks like a "normal resource abundant developing country".

To understand Russia today one has to evaluate the record of the last 20 years. In the late 1980s, during Gorbachev's perestroika, the Soviet Union was aspiring to join the club of rich democratic nations, but instead degraded in the next decade to a position of a *normal* developing country that is not considered either democratic or capable of engineering a growth miracle. For some outsiders a "normal developing country" may look better than the ominous superpower posing a threat to Western values.

The insiders however feel differently. Most Russians want to find the way to modernize the country so as to make it prosperous and democratic. But they also feel that something went very wrong during the transition; the policies and political leaders of the 1990s are totally discredited. And that is why Putin-Medvedev's policy was getting 50% plus approval rate even in the midst of economic recession.

### Reasons for optimism

By 2012 the economy finally surpassed the pre recession level of 1989. Personal consumption on average was nearly 50% higher than in the late 1980s, but government consumption of goods and services was about the same, whereas investment was only 50% of the level of the late 1980s. Unemployment dropped from 13% in 1999 to 6% in 2007 and after an increase during 2008-2009 recession (to 8.4%) dropped again to 6% in 2012. Inflation declined from over 2500% in 1992 and 84% in 1998 to single digits in 2009-2012.

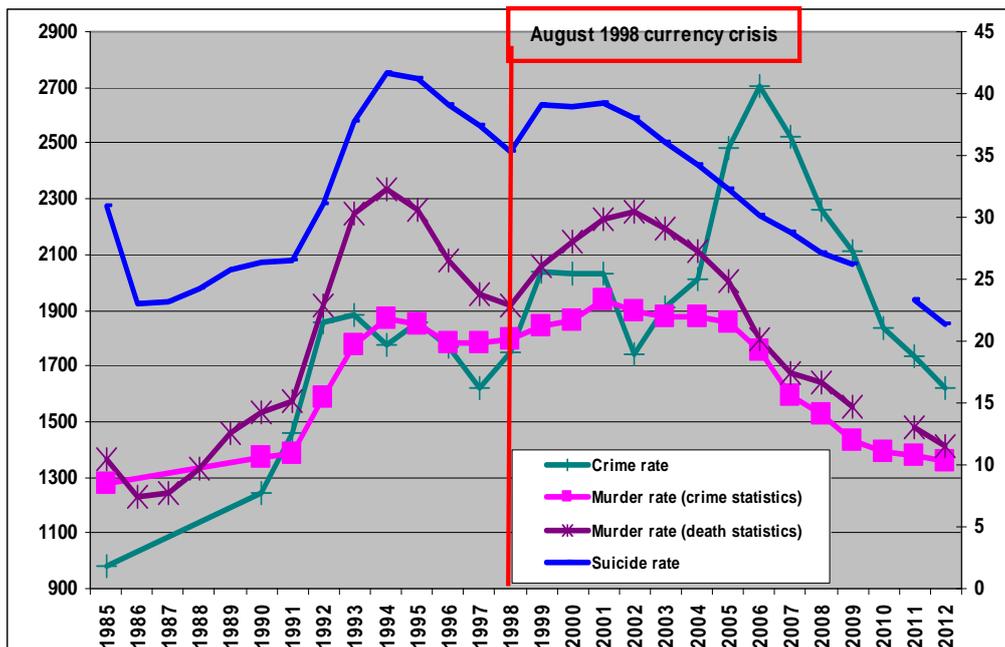
The budget deficit turned into a surplus in 2000-2008, and the government revenues and expenditures as a percentage of the GDP began, ever so slowly, to rise; the foreign debt as a percentage of the GDP decreased, capital flight decelerated and currency reserves expanded. During and after the recession of 2008-2009 the consolidated government budget, as could have been expected, went into red, but it returned to balance in 2011; foreign exchange reserves fell from nearly \$600 billion in 2008 to \$380 billion in mid 2009, but later recovered to about \$500 billion and stayed at this level until late 2012.

The most important result of the last 12 years is probably this: the growth of the economy and the stability of leadership have finally led to increased order and an improvement in the social climate.

The number of murders, having hit a sky-high peak in 2002 dropped back down by over 50% since then; the number of suicides has also been on the decline (fig. 3); the birth rate, which struck a 50-year minimum in 1999, has begun to rise, as has the number of registered marriages (although this is partly a result of the demographic wave of the 1970's); the divorce rate, having reached a maximum after many years, is now on the down slope. Russian population that fell from 148.5 million in 1993 to 141.9 million in 2009, started to grow from 2010 for first time in nearly 20 years. In effect, this means that Russia is gradually backing away from the edge of the abyss of anarchy and chaos, into which it systematically descended in the 1990's. Income inequalities, at least Gini and decile coefficients, are not growing since 2007.

It is these very improvements in the social sector in the past few years that are most encouraging. Economic growth and low inflation alone cannot prevent alone the disintegration of the country if social inequality and crime increase. Building the vertical of power and intensifying centralization may not be able to 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. 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 levelled out, the number of marriages and the birth rate are rising, and the divorce rate is down.

Figure 3 - Crime rate (left scale), murder rates and suicide rate (right scale) per 100,000 inhabitants



Source: Goskomstat.

Putin's popularity, which the polls say is, in fact, greater than 71% of voters who cast their ballot for him in the March 2004 elections (many of his supporters simply did not turn out to vote, as they were certain that he would win anyway), is explained precisely and primarily by his ability to stop the collapse of the state caused by the reforms of the 1990's. All other problems pale in contrast to the threat of social and national disintegration. The majority of Russian citizens are prepared to forgive Putin for his hard-handed tactics in dealing with the oligarchs and even with entrepreneurs of a lesser stature, and his "purges" in Chechnya, and the constraints placed on democracy and freedom of speech, all in the interests of strengthening law and order and putting limits on a situation 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»<sup>4</sup>.

The future, of course, harbours many dangers. The current real exchange rate of the rouble (the ratio of domestic to world prices) is too high. Therefore, a drop in world energy prices could easily provoke a new currency crisis and interrupt economic recovery, despite what would seem to be the major contribution to stability provided by the 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 Eastern European countries and many of the former Soviet republics, where the price of energy sources is 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 rouble, accumulating reserves even faster, 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 rouble rate. This could have increased the savings and investment rate, especially if supplemented by the expansion of budgetary financed investment into infrastructure. However, such a policy is not even on the drawing board for the moment.

### Instead of conclusions

I tried to give the objective picture of what happened to the Russian economy in the recent 25 years and I am sure the reader would be able to draw his or her own conclusions. The USSR ambitiously compared itself to the US and was proud of its status of the second superpower aspiring to become the first superpower. Time changes the yardsticks for comparison, we live in the age of diminished expectations. Russia today has to compare itself to *other developing countries*. Russia is richer than Sub Sahara Africa (SSA), South Asia (SA) and is roughly at par in terms of per capita income with Latin American (LA), Middle East and North Africa (MENA) and East Asia (EA) countries. Life expectancy in Russia is lower than in LA, MENA and EA countries and distribution of income is often worse (except for LA countries), but levels of education are still higher and recently institutional capacity has increased to virtually late Soviet levels (higher than in LA and SSA, although not as high as in EA and MENA).

The time comparison may be less flattering for Russia. As one Russian journalist put it, what Russia could have been proud of in the XIX century? Great Russian literature and arts, Pushkin and Dostoyevsky, Repin and Chaikovsky. What Russia should have been ashamed of in the XIX century? Serfdom and tsarist regime, pale for the Jews and poverty of the peasantry. What Russia could have been proud of in the XX century?

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<sup>4</sup> Press releases of VTsIOM (<http://www.levada.ru/press/>).

The attempt to built just society – the first state of the workers and peasants in the world, free education and health care, elimination of illiteracy and avant-garde arts, defeat of fascism and space achievement, Nobel prize winners and ballet. What Russia of the XX century should have been ashamed of? Stalin's purges and labor camps, mass famine of 1932-33, authoritarianism and oppression of dissidents.

What Russia should be ashamed of in the XXI century? Corruption and bribery of state officials, oligarchic capitalism, deindustrialization of the economy and decline in R&D, income inequalities, deterioration of health and education, increase in mortality, clericalization of the society and cultural degradation. What Russia can be proud of in the XXI? Nothing. It is a second rate developing country, in no area it is number one. It is behind this or that nation in each and every area. And it even does not have the ambition to become number one. Or does it?

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