
Challenges Facing the Russian Economy after the Crisis

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In 1999–2008, Russia was one of the fastest growing economies in the world. In 2009, it was one of the worst affected by the global economic crisis. Its GDP fell by 8 percent, more than any other economy in the Group of Twenty (G-20)—the group of the world’s largest economies. Does this mean that Vladimir Putin’s “growth decade” of 1999–2008 was just an aberration? That Russia failed to respond to the crisis in a smart and resolute way? That Russia is facing a serious crisis in the near future?

The growth in the precrisis decade was not a fluke. The benefits of this growth have trickled down to all parts of Russian society. At the same time, however, the growth decade failed to address several major problems in the Russian economy—most importantly, corruption and dependence on commodity exports. Given these challenges, we argue that (1) Russia’s response to the first wave of the crisis in 2008 was mostly adequate; (2) the dramatic fall was largely to be expected but was exacerbated by poor economic policies in 2009; and (3) the Russian economy is not facing major difficulties in the immediate future. However, our long-term perspective of the Russian economy is not optimistic. We believe that as long as world oil prices remain high, Russia may suffer from the “resource curse” and follow what we call a “70–80 scenario.” Given high oil prices, Russian elites may prefer to delay the restructuring of the economy and building of pro-growth political and economic institutions. This will in turn slow economic growth and make it very unlikely for Russia to catch up with advanced economies in the next 10 to 15 years. In other words, if oil prices remain at \$70 to \$80 per

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barrel, Russia will revert to Brezhnev-era conditions of the 1970s–1980s—a stagnating economy and 70 to 80 percent approval ratings.

In the first part of this chapter we provide a snapshot of the Russian economy before the crisis. We summarize the benefits of the growth decade and the problems economic policy failed to solve. We discuss why Russia did not foresee the crisis. We then analyze Russia’s anticrisis policy—both the swift and mostly adequate response to the first wave of the crisis in 2008 and the “preserving the status-quo” policies of 2009. We pay special attention to the level of decline in 2009 and argue that the poor performance of the Russian economy was due to both its dependence on oil and capital inflows and the burden of the previous lack of reforms and poor economic policies in 2009.

Finally, we discuss lessons the Russian government learned from the crisis—and the lessons it should have learned. We argue that Russia is under a “resource curse”—a situation in which resource rents reduce elite’s incentives to reform and where nonresource sectors are unlikely to grow unless reforms are undertaken.¹ We then draft a reform agenda that Russia needs to carry out and analyze the likelihood of its implementation and alternative scenarios.

Before the Crisis

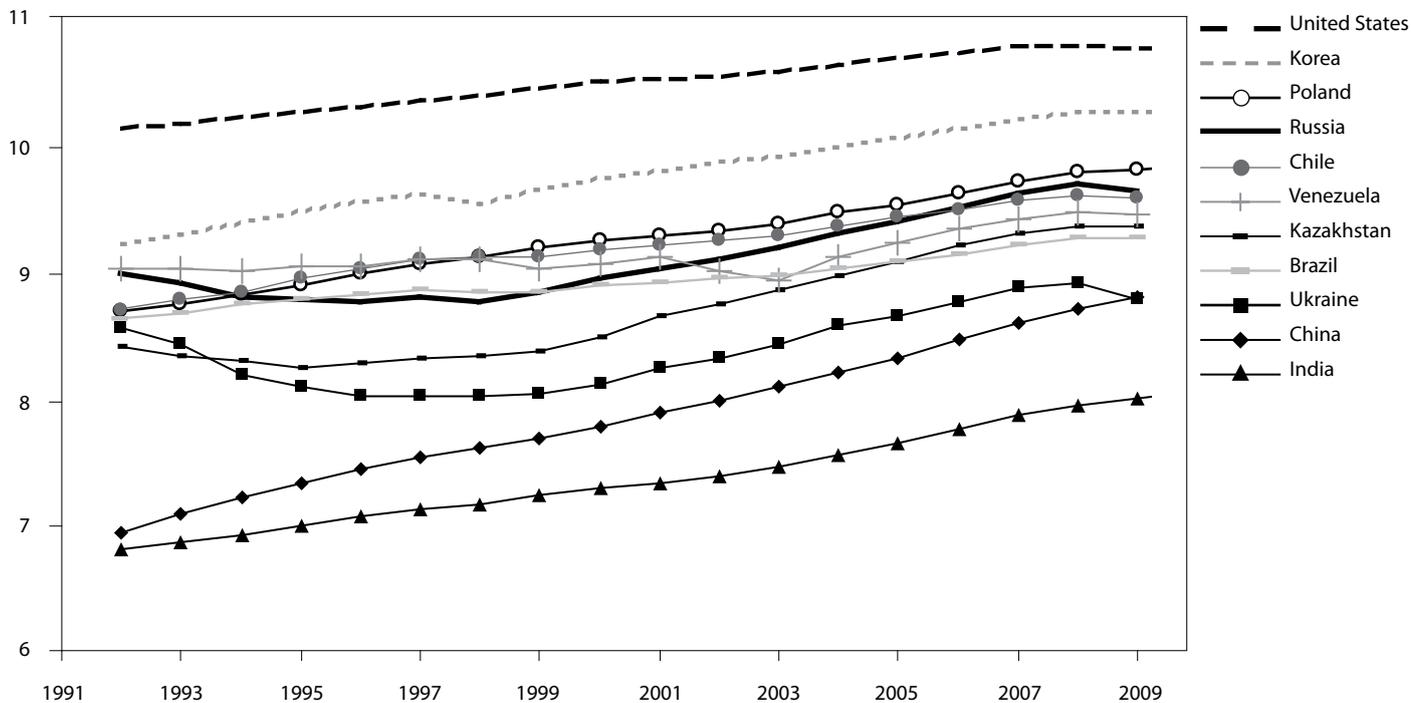
In June 2008 the 12th St. Petersburg International Economic Forum gathered the who’s who of Russian business and government elite and leaders of major world corporations. The Russian economy was at its peak. Long forgotten were the days of the Soviet collapse and the turbulent nineties. Putin’s administration appeared to have left Russia’s economy in an admirable state. Economic growth averaged more than 7 percent per year between 1999 and 2008. The stock market had increased twentyfold. Foreign investors were enamored by Russia being a part of the fashionable BRIC group of the world’s fastest-growing emerging markets (the others being Brazil, India, and China).

This economic growth record was impressive by any measure (figure 1.1). Russia was closing the gap with the advanced and newly industrialized economies, overtaking such successful emerging markets as Chile and its oil-rich counterpart Venezuela. Russia was doing better than other large transition countries such as Kazakhstan, Poland, and Ukraine. Within the BRIC quartet, it was second only to China, which was natural given that China had a lower starting point. Economists explain the faster growth of poorer economies through a “conditional convergence” law that states that, other things equal, richer countries should have a lower rate of growth.

1. Richard M. Auty introduced the term in 1993. See Richard M. Auty, *Sustaining Development in Mineral Economies: The Resource Curse Thesis* (London: Routledge, 1993).

Figure 1.1 GDP per capita (in purchasing power parity) in selected countries, 1992–2009

log GDP per capita, PPP



Source: IMF, *World Economic Outlook*, October 2009.

Russia was awash with cash. The government's reserve fund, created to cushion the economy from a fall in oil prices, stood at \$140 billion, and the National Welfare Fund (NWF), intended mainly to solve the looming pension crisis, held another \$30 billion. The NWF, though not yet officially a "sovereign wealth fund," was already among the 10 largest such funds, rivaling the Brunei Investment Agency. A combined Russian sovereign wealth fund would rival Singapore's Temasek Holdings (the sixth largest in the world) and lag just behind the China Investment Corporation.

The Russian stock market was doing well. According to the World Bank's *World Development Indicators*, the ratio of market capitalization to GDP in Russia was 117 percent, just slightly below the Organization for Economic Cooperation and Development (OECD) average (120 percent) and above France and Korea (both 107 percent). While it was below India and China (both above 150 percent), Russia was ahead of Brazil (103 percent), the eurozone (85 percent), and upper middle income countries (86 percent on average).

Russian private and state-owned companies were expanding abroad extensively, often buying stakes in large foreign companies. A survey of Russian multinational enterprises (MNEs) showed a dramatic internationalization of Russian firms.² The top 25 Russian companies held \$59 billion in assets abroad, which made Russia the third largest investor among emerging markets in 2006 in terms of foreign direct investment (FDI) outflows, following Hong Kong and Brazil, and the second largest in terms of outward FDI stock. Russian companies had nearly \$200 billion in foreign sales and employed 130,000 people abroad. Foreign assets, sales, and employment each had more than doubled since 2004.

Did the growth decade of 1999–2008 benefit the average Russian? Contrary to widespread opinion, growth did trickle down to both the middle class and the poor, not just benefiting the rich or very rich parts of society. Real incomes in 1999–2008 increased by a factor of 2.5. Real wages more than tripled. Mobile phone penetration grew from virtually zero to more than 100 percent. The Russian car market became the largest in Europe. Moscow real estate prices went up from about \$700 per square meter at the end of 1999 to \$6,000 per square meter in the summer of 2008.³ The financial system grew manifestly in terms of size and sophistication. For example, the credit to GDP ratio increased from about 10 percent to about 40 percent reflecting a boom in both retail and corporate lending.

Unemployment went down by more than half—from 12.9 percent in 1999 to 6.3 percent in 2008. The poverty rate (percent of population below the official minimum living standard) went down from 29 percent in

2. This survey was conducted by SKOLKOVO Moscow School of Management and the Columbia Program on International Investment.

3. Data are from Real Estate Market Indicators, www.irn.ru.

1999 to 13 percent in 2008. The poverty gap (the income that would suffice to bring all the poor to the minimum living standards) decreased from 4.9 percent of total households' income in 1999 to 1.2 percent in 2008. Moreover, self-assessed life satisfaction rose significantly. Sergei Guriev and Ekaterina Zhuravskaya (2009) use data from a panel of Russian households (Russian Longitudinal Monitoring Survey, RLMS) that underrepresents the rich and upper middle class, thus reflecting a poorer part of the society, and show that both incomes and life satisfaction in this panel have increased substantially.⁴

Even inequality had *not* increased. Using the same RLMS dataset, economists Yuriy Gorodnichenko, Dmitriy Stolyarov, and Klara Sabirianova-Peter show that inequality might have even slightly decreased (from the Gini coefficient of 0.42 in 1999 to 0.38 in 2005).⁵ The official data on Gini coefficients show an increase from 0.40 in 2000 to 0.42 in 2008. Given the quality of Russian inequality data, it is safe to say that inequality in Russia has not changed during the decade.

Yet, despite its real achievements, "Putinomics" failed to resolve several very important issues. First, inflation was still very high (in 2007 and 2008 it remained above 10 percent a year, the highest among G-20 countries). Second, no significant results were achieved in the war on corruption. Figure 1.2 shows that whatever successes in fighting corruption were achieved in the early 2000s were then wiped out so corruption returned to pre-Putin years. Third, even though inequality had not increased, it remained unacceptably high. Fourth, economic policies failed to diversify the economy away from its heavy dependence on production and exports of commodities.

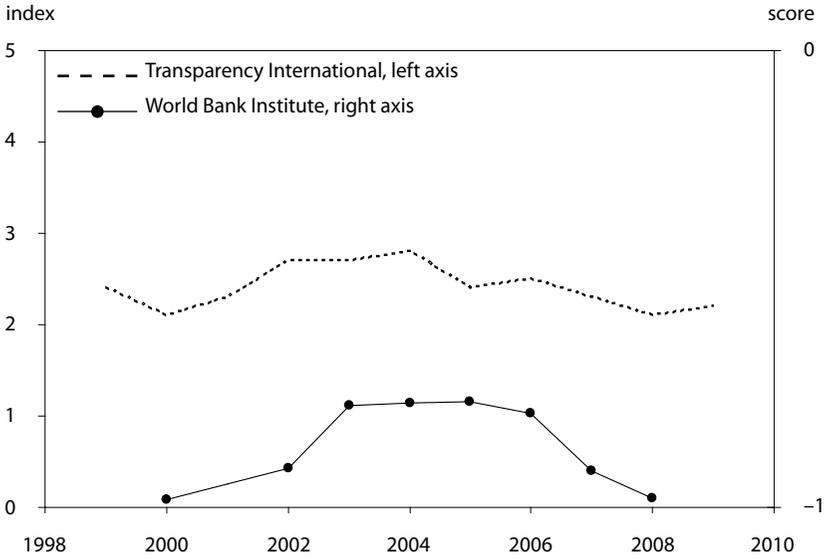
We argue that it was difficult to foresee the crisis in 2008. The reasoning of the government officials and many independent economists at the time was based on three arguments: (1) the oil price was high and rising; (2) Putin's government did undertake certain significant reforms and carried out reasonable macroeconomic policy; and (3) the "decoupling" theory seemed to be consistent with data. We go through these arguments one by one as they are important for understanding the postcrisis developments in the Russian economy.

The first reasoning was that the economy was fundamentally strong, especially because of the skyrocketing oil prices. On January 2, 2008, the oil price rose to \$100 per barrel. Oil broke through \$110 on March 12, \$125 on May 9, \$130 on May 21, \$135 on May 22, \$140 on June 26, and \$145 on July 3, 2008. On July 11, 2008, oil prices rose to a new record of \$147.27. The

4. Sergei Guriev and Ekaterina Zhuravskaya, "(Un)Happiness in Transition," *Journal of Economic Perspectives* 23, no. 2 (2009): 143–68.

5. Yuriy Gorodnichenko, Dmitriy Stolyarov, and Klara Sabirianova-Peter, "Inequality and Volatility Moderation in Russia: Evidence from Micro-Level Panel Data on Consumption and Income," *Review of Economic Dynamics* 13, no. 1 (2010): 209–37.

Figure 1.2 Control of corruption in Russia



Sources: Transparency International, Corruption Perceptions Index, www.transparency.org; World Bank Institute's Governance Indicators Project, data for 2000, 2002–08 (world average is normalized to 0, world standard deviation is normalized to 1).

economic turmoil in the United States did not seem to slow the growth of oil prices, which seemed unstoppable, and the optimism of Russian officials and the business elite reflected the rosy future. The CEO of the Russian gas giant Gazprom, Alexei Miller, made headlines on June 16, 2008 in a briefing to European energy executives, predicting that world oil prices could reach \$250 per barrel by 2010.

Second, Russia's economic success could not be solely attributed to high oil and commodities prices. At most, half of Russian growth during 1999–2008 can be attributed to the growth in oil prices. It is essential to recognize the contribution of economic reforms undertaken during Putin's first term.

Three important reforms stand out in their contribution to growth. First, the tax reform of 2001 improved incentives to work and decreased tax evasion. Second, liberalizing the procedures for corporate registration and licensing and limiting inspections improved the climate for small businesses and entrepreneurs. Third, conservative macroeconomic policy and financial-sector reform lowered interest rates and fueled an investment and consumption boom. These claims are supported by quantitative and empirical evidence.

In a 2009 study Yuriy Gorodnichenko, Jorge Martinez-Vazquez, and Klara Sabirianova-Peter provided microeconomic evidence on the real

benefits of introducing the flat income tax.⁶ They studied a representative panel of Russian households (RLMS) and showed that the tax reform increased labor supply and lowered tax evasion. In January 2001 Russia introduced a reform of its personal income tax, becoming the first large economy to adopt a flat tax. The Tax Code of 2001 replaced a progressive rate structure with a flat tax rate of 13 percent. The study found that the flat tax reform was instrumental in decreasing tax evasion in Russia and that a part of greater fiscal revenues in 2001 and several years beyond can be linked to increased voluntary tax compliance and reporting. The study also found that the productivity effect on the real side of the economy was positive, although smaller than the tax evasion effect.

In a 2007 study, Evgeny Yakovlev and Ekaterina Zhuravskaya followed a representative panel of 1,600 small businesses in 20 regions of Russia over five years—before and after the major deregulation reforms.⁷ Between 2001 and 2004, Russia simplified procedures and reduced red tape associated with entry regulation (registration and licensing) and regulation of existing businesses (inspections). The laws introduced clear measurable limits to the regulatory burden. In particular, the new laws required that registering a business should involve a visit to just one government agency (“one-stop shop”) and take at most one week; each inspecting agency inspects a business no more than once in two years; licenses are valid for at least five years. In addition, about 90 percent of business activities that previously had required licenses became exempt. The authors found that this elimination of administrative barriers resulted in the growth of small businesses—in terms of both number and employment. They also found that the impact of the reform varied greatly across regions. The deregulation was more successful in regions with transparent government, low corruption, independent media, powerful industrial lobby, and stronger fiscal autonomy.

Erik Berglof and Alexander Lehmann provide evidence on the contribution of the financial sector to economic growth in Russia.⁸ They argue that there is strong evidence of strengthening of the links between finance and the real sector in Russia. Russian data show that financial development had a beneficial impact on corporate finance, corporate growth, and broader economic growth. Early reforms had lasting impact, but it took until 2001 for bank credit to the private sector to show strong and sustained growth.

6. Yuriy Gorodnichenko, Jorge Martinez-Vazquez, and Klara Sabirianova-Peter, “Myth and Reality of Flat Tax Reform: Micro Estimates of Tax Evasion and Productivity Response in Russia,” *Journal of Political Economy* 117, no. 3 (2009): 504–54.

7. Evgeny Yakovlev and Ekaterina V. Zhuravskaya, “Deregulation of Business,” CEPR Discussion Paper DP6610 (Washington: Center for Economic and Policy Research, 2007).

8. Erik Berglof and Alexander Lehmann, “Sustaining Russia’s Growth: The Role of Financial Reform,” *Journal of Comparative Economics* 37, no. 2 (2008): 198–206.

The third reason for complacency was a then fashionable economic concept of “decoupling,” which stated that emerging markets such as China, Brazil, Russia, or India had entered a phase of development in which economic crisis in the developed world would not significantly affect their economies. This idea was widespread in media and policy circles worldwide. An article in the *Economist* published in March 2008, “Decoupling Is Not a Myth,” argued the importance of this concept.

Decoupling does not mean that an American recession will have no impact on developing countries. That would be daft.... The point is that their GDP-growth rates will slow by much less than in previous American downturns.... The four biggest emerging economies, which accounted for two-fifths of global GDP growth last year, are the least dependent on the United States: exports to America account for just...1% of Russia’s [GDP]. The benefits of the reserves of foreign currencies built up during years of current account surplus are yet to be fully appreciated.... But for perhaps the first time ever, developing countries would be able to make full use of monetary and fiscal policy to cushion their economies.

This was the optimistic picture that the Russian government and businesses were expecting just three months before perhaps the largest economic turmoil that the modern Russian economic and political system built during Putin’s rule had ever experienced.

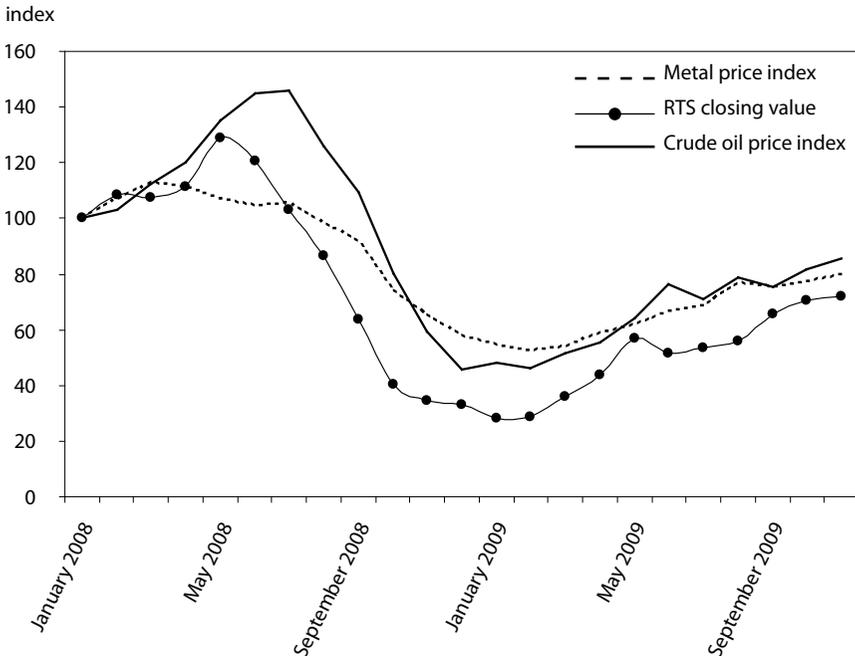
The Crisis

The Shock of the Fall of 2008

Now fast forward to the fall of 2008. By September, the Russian Trading System (RTS) stock index had plunged almost 54 percent, making it one of the worst performing markets in the world. On September 16, trading in Russia’s most liquid stock exchange, the Moscow Interbank Currency Exchange (MICEX), and the dollar-denominated RTS was suspended. Trading was suspended again the next day and on September 18 for the third day. On October 6, the Russian stock market fell by more than 18 percent in a single day. Bank failures worsened the stock market collapse. On September 15, KIT Finance, a large financial institution, failed to pay off its debt.

The price of oil also foreshadowed problems for Russia. On September 15, the oil price fell below \$100 for the first time in seven months. On October 11, it fell to \$78. On December 21, 2008, oil was trading at \$33.87 a barrel, less than one-fourth the peak price reached four months earlier. Prices did not rebound once 2009 started. Instead, after initially climbing above \$48, prices descended by mid-February to below \$34. Russia’s other major export, metals, experienced a similar price decline (figure 1.3).

Even Russia’s oligarchs were pawning their yachts and selling their private jets. Signs of political instability were mounting. Approval ratings

Figure 1.3 Oil, metal, and stock market prices during the 2008–09 crisis

Note: All prices are in current US dollars normalized to 100 for January 2008.

Sources: Russian Trading System (RTS) for the RTS stock market index closing value; International Monetary Fund; www.indexmundi.com for oil and metal price indices.

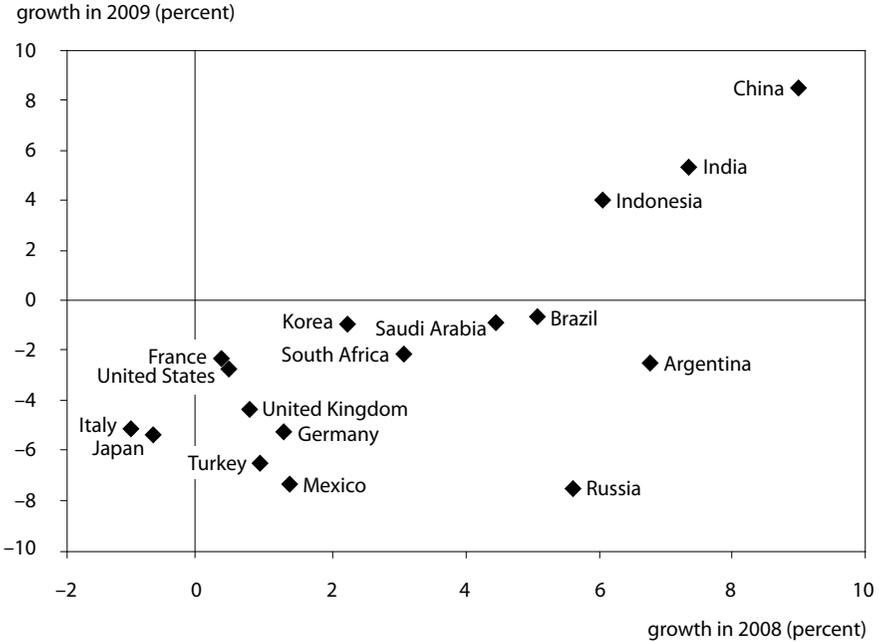
for Russia's president and prime minister were heading south. Mass street protests started—not led by opposition political parties but by workers and middle-class families facing job losses and declining wages. More importantly, protesters were demanding that the government resign, unthinkable just a year before.

Why the Crisis Hit Russia So Hard: Role of Oil Prices

The impact of the economic crisis on the Russian economy was stronger than on any other G-20 economy. Not only was the 8 percent Russian GDP contraction for 2009 the largest among G-20 countries but also the *change* in the growth rate between 2008 and 2009 by far exceeded that in other G-20 members. Figure 1.4 plots growth rates in the G-20 countries before and during the crisis (2008 and 2009, respectively)⁹ based on the Inter-

9. While the acute phase of the financial crisis started in September 2008, the effect on the real economy was somewhat delayed, so it is safe to take 2008 as the last precrisis year.

Figure 1.4 GDP growth in selected G-20 countries, 2008 and 2009



Source: IMF, *World Economic Outlook*, October 2009.

national Monetary Fund’s October 2009 data. It shows that all countries performed worse in 2009 than in 2008. Yet, the difference was largest for Russia—more than 13 percentage points! The next worst change was experienced by Argentina at 9 percentage points. The average change in growth rate between 2008 and 2009 for other countries was just 4 percentage points. Why has Russia switched from being one of the fastest growing countries to one that is faltering the most?

The main suspect is the dramatic fall in oil prices from the peak of \$140 per barrel in summer 2008 to the trough of below \$40 per barrel just half a year later. Can we calibrate this effect? There are two approaches to answering this question based on precrisis data. One can estimate the total rent that Russia generates in oil and gas and then determine the direct effect of the oil price changes. Or one can estimate the covariation of Russian GDP and oil price (controlling for other factors) in recent years.

These two approaches may err on both sides. The first, “accounting,” approach has a number of drawbacks: (1) it is very hard to measure the total oil and gas rent precisely; (2) it does not take into account the indirect effects of oil prices—effects through changes in oil and gas output driven by oil prices, changes in markets for other commodities, and effects on cross-border capital flows; and (3) it neglects the policy responses such

as sterilization of petrodollars through building up the reserve fund and sovereign wealth fund. The alternative, “econometric,” approach captures the actual observed correlation. But it is also problematic as it is not clear whether precrisis data can easily be extrapolated to crisis and postcrisis periods. Indeed, at the very least, reactions of policymakers and investors may change. More likely, the economy that has undergone structural changes during the crisis would respond differently to the change in oil price. Finally, neither approach can help mitigate the nonlinearity of the effect of oil price on GDP. Nonetheless, we discuss the results from both approaches to obtain ballpark estimates.

We start with the estimate of the oil and gas rent. Cliff Gaddy and Barry Ickes argue that official data on the value added in the oil and gas sector (around 10 percent of GDP) are misleading.¹⁰ Using data and assumptions on excess costs and price subsidies they arrive at a much larger number: Total oil and gas rent in 2005 constituted about 25 percent of GDP. This number is similar to the estimate obtained by the World Bank,¹¹ which used 2000 input-output tables for Russia, the United Kingdom, and the Netherlands to offset the effect of transfer pricing. The World Bank’s estimate of Russia’s value added in oil and gas was 20 percent of GDP in 2000 (the official figure for 2000 was 8 percent of GDP). The difference is not surprising given that the average oil price in 2000 was only \$27 per barrel—much lower than \$50 per barrel in 2005.

Using the Gaddy-Ickes methodology, we estimated the total oil and gas rent for 2008 (when the oil price peaked) at about 30 percent of GDP. Moreover, their methodology implies that a decrease in oil price by \$10 per barrel costs Russia about 3 percentage points of GDP. Using this benchmark, the fall in Urals oil price from the average of \$95 per barrel in 2008 to \$60 per barrel in 2009 should have resulted in a drop in GDP by about 11 percentage points. The alternative, econometric, approach was used by a number of authors, most importantly Jouko Rautava, who estimated the long-run elasticity of GDP to oil at 0.24.¹² In other words, a permanent 10 percent change in the oil price has a long-run effect of 2.4 percentage points of GDP. Roland Beck, Annette Kamps, and Elitza Mileva extend Rautava’s dataset and methodology and obtain similar results: The long-run effect of a 10 percent change in oil price is 2 percentage points of

10. Cliff Gaddy and Barry Ickes, “Resource Rents and the Russian Economy,” *Eurasian Geography and Economics* 46, no. 8 (2005): 559–83.

11. World Bank, *From Transition to Development: A Country Economic Memorandum for the Russian Federation* (Washington, 2005).

12. Jouko Rautava, “The Role of the Oil Prices and the Real Exchange Rate in Russia’s Economy—A Cointegration Approach,” *Journal of Comparative Economics* 32, no. 2 (2004): 315–27.

GDP.^{13,14} This effect is reached, however, only six years after the shock. The short-run effect is smaller: In the first quarter after the shock, the change in GDP is only 0.5 percentage points, and after the first year, the change is 1 percentage point. Beck, Kamps, and Mileva also deliver an important caveat: As even their extended data series are rather short, the margins of error are large. For example, the 95 percent confidence interval extends from 0.6 to 1.6 percentage points one year after the shock.

Similar to the econometric approach, Bruno Merlevede, Bas Van Aarle, and Koen J. L. Schoors build and calibrate a small macroeconomic model for the Russian economy.¹⁵ They then subject the model to a \$25 per barrel permanent shock to the oil price (considering scenarios with \$20, \$45, and \$70 per barrel from 2005 onward). Even though the model includes two mitigating mechanisms, the “Dutch disease” effect and the Stabilization Fund, the shock still results in a long-term change in GDP of 12 percentage points. Interestingly enough, most of this change (9 to 10 percentage points) takes place within one year of the oil price shock. The results from the two approaches are therefore not very different. The change in the oil price from \$95 per barrel in 2008 to \$60 in 2009 should have resulted in a decline in GDP of 9 to 16 percentage points. For the short run, if we consider the fall from 2008Q2’s \$118 per barrel to Q3’s \$56 per barrel, it should have resulted in the loss of at least 7.5 percentage points of GDP.

Note that these losses should be subtracted from the “counterfactual” Russian GDP—what would have happened if there were no crisis? Assuming the long-run average growth rate of 7 percent per year, the effect of oil price alone would move Russia from growing at 7 percent a year to falling at 2 to 9 percent a year. While the precision of these estimates is very low, they do imply that it is at least plausible to ascribe the dramatic fall of the Russian economy at the end of 2008 and in the first three quarters of 2009 to the effect of oil prices alone (assuming that change in oil prices also affects capital flows, exchange rate, etc.).

Why the Crisis Hit Russia So Hard: Role of Economic Policy

In the fall of 2008, the Russian government responded to the crisis in a resolute and effective way. The fall in the oil price and related capital out-

13. Roland Beck, Annette Kamps, and Elitza Mileva, “Long-Term Growth Prospects for the Russian Economy,” ECB Occasional Paper 58 (Frankfurt: European Central Bank, 2007).

14. The long-run elasticity estimates also allow understanding of the contribution of the oil price to the 1999–2008 economic growth. The elasticity of 0.2 implies that if the world price of Urals oil goes up from \$17 (in 1998, constant 2008 dollars) to \$97 per barrel (in 2008), then GDP should go up by a factor of 1.4 or grow at 3.5 percent a year for 10 years. Therefore, the growth in oil explains about one-half of Russia’s total growth.

15. Bruno Merlevede, Bas Van Aarle, and Koen J. L. Schoors, “Russia from Bust to Boom: Oil, Politics or the Ruble?” Working Paper 722 (William Davidson Institute, 2004).

flows posed a very tangible threat of financial collapse. The government could rely on its reserves but was forced to do so quickly to stop the panic. Fortunately, it did it reasonably well. The Russian financial system came out of the acute financial crisis virtually unscathed, and unemployment remained under control; the Russian government managed to stick to most of its fiscal commitments.

The government prevented the collapse of the banking system. Many Russian banks were heavily exposed in foreign markets and faced severe financial problems once the crisis hit. A massive liquidity injection by the government ensured that no major bank collapsed, and minor bank failures were administered in an orderly fashion.

Moreover, the crisis did not result in major nationalizations of private companies. The government could have nationalized all banks and companies in financial distress under the banner of fighting the crisis, but it did not, despite its large foreign reserves, which gave it the means to acquire a significant portion of the economy at fire-sale prices. Instead, the government mostly provided (high-interest) loans rather than engaging in massive equity buyouts. Contrary to popular opinion, even the oligarchs were not bailed out free of charge. Of \$50 billion that the Russian government gave to the large state-owned bank VEB to refinance the external debt owed by Russian banks and firms in 2008, the government refinanced only \$11 billion. Apparently, the terms offered by the government (reportedly, at least LIBOR+5 percent) turned out to be right on target and expensive—most companies and banks decided not to borrow from VEB. Finally, the government postponed the increase in social taxes (taxes on labor), which was planned for 2010 to finance an increase in pensions. Such an increase would have had a devastating effect on employment.

The government, however, made several mistakes in fighting the crisis. The first important mistake was that it was too slow in depreciating the ruble. While one can argue that a one-off devaluation was risky—as it could have triggered a panic—gradual depreciation should have been faster and should have started earlier than it did. In October 2008 the government insisted on maintaining the exchange rate above the market rate. In the last two months of 2008, the central bank allowed the ruble to weaken at a rate of 1 percent per week, then at 2 to 3 percent per week. In the meantime, the central bank hemorrhaged reserves defending this slow correction, while commercial banks held on to dollars in anticipation of the ruble's further decline. The total decrease of reserves was around \$200 billion, or a third of the precrisis amount.

Not all of the \$200 billion was “wasted.” Only a fraction of it—proportional to the difference between the equilibrium exchange rate and the rate maintained by the government—was lost by the central bank, i.e., it was transferred to the pockets of the private sector (mostly banks and foreign investors). In that sense, gradual depreciation was an implicit bailout of banks and investors. This bailout resulted in substantial collateral dam-

age. One of the universal laws of economics is that indirect transfers are always inferior to direct transfers. If the government wanted to bail out banks, it should have done so directly rather than through an inefficient depreciation. Apart from distorting decisions by economic agents (including destroying all lending in rubles) during the whole period of gradual depreciation, this policy also undermined the government's credibility. One cannot announce a gradual depreciation—if a government official says that the ruble will fall by 30 percent within a month, the market will bring it down by 30 percent immediately. Therefore, economic policymakers had to make confusing and contradictory announcements for several months in a row. This undermined their credibility to such an extent that when the depreciation really stopped, the market did not believe the new monetary policy. The central bank had to prop up the ruble with high ruble interest rates, which further hurt the Russian economy.

The second important mistake was to raise import duties, especially for imported cars. This was not just economically foolish—as with many other import-competing sectors, the automotive industry would certainly be protected by the weakened ruble—but also politically dangerous. Car owners are an affluent, socially active, and easily organized group. Street protests against the import duties became the first serious popular uprising that Russia had seen in many years. Additionally, higher import duties—especially on food—imposed a tax on labor in all other (unprotected) sectors. As import duties raised the cost of basic consumer necessities, firms in other sectors could not react by lowering wages.

The third major mistake was continuing subsidies to inefficient companies. Part of the reason was political, as many such large companies employ a significant part of the population of the cities in which they are located, and their bankruptcy could cause popular protests. Most notably, the notoriously inefficient and unprofitable auto manufacturer AvtoVAZ received more than a billion dollars of subsidies during the height of the crisis. The government was persisting in its desire to keep afloat this behemoth of inefficiency. Japan's "lost decade"—and its main culprit, "zombie companies"—is an important example of how much damage to economic growth a policy of supporting inefficient companies such as AvtoVAZ can do (see box 1.1).

Instead of supporting zombies, the economic policies should have protected the unemployed directly (again, direct transfers are better than indirect ones). The government did start to support the unemployed, their retraining, and relocation. But the support to inefficient enterprises was an order of magnitude higher. Consider the government's Anti-Crisis Plan for 2009.¹⁶ Direct support to the unemployed (increase in unem-

16. Government of the Russian Federation, Prime Minister of the Russian Federation, "Anti-Crisis Measures Program of the Government of the Russian Federation for the Year 2009," June 19, 2009, first published in April 2009 on the prime minister's website and then revised in June 2009, available at <http://premier.gov.ru>.

Box 1.1 Japanese zombies and the lost decade of growth

What happens to an economy in which the cleansing mechanisms of bankruptcy are turned off and inefficient companies supported? One of the most revealing examples is the experience of Japan in the 1990s. Ricardo Caballero, Takeo Hoshi, and Anil Kashyap show how Japan's policy to support companies that should have gone bankrupt resulted in a lost decade of growth.¹

Recall the history of the Japanese economic crisis. The economy had steadily grown for three decades. During the real estate bubble in the 1980s, land under the Emperor's Palace in Tokyo cost more than all of the land in the state of California. The bubble burst, and 10 years of stagnation followed. The main question is, Why was the growth slowdown in Japan in the 1990s so lengthy? And why did banks continue to lend to companies that economists aptly called "zombies"?

One reason is almost obvious. Banks did not want to admit their mistakes. If the insolvent lenders stopped paying, banks would have been forced to recognize losses, which could have led to bankruptcy of the banks themselves. Instead, lenders chose to place the half-dead, inefficient companies on life support. For example, banks gave new loans so that those companies could pay interest on the old loans! The second reason is government pressure on banks, as one of the goals of Japanese anticrisis policy was to avoid bankruptcies and support small and medium-sized businesses through bank loans.

Japan achieved the goal of supporting the zombies. But at what price? By the beginning of 2000, a stunning 30 percent of all Japanese companies (15 percent of the country's assets) were zombies. The number of zombies grew especially rapidly in sectors that lacked significant international competition—construction, retail, and services. Employment in these sectors did not significantly decrease, but very few jobs were created.

A significant negative effect of the Japanese government policy of supporting zombies was slowdown of productivity. In sectors where the number of zombies grew by only 5 percentage points, productivity growth averaged 2 percent per year. But in sectors where the number of zombies jumped by 20 percentage points, productivity growth fell on average by 5 percent.

It is essential to note that zombies, by the mere fact of their existence, created significant obstacles to the growth of healthy companies. Not surprisingly, in sectors where employment was artificially supported, growth and the number of new jobs were significantly lower. Zombies attracted not only banks' and

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1. Ricardo J. Caballero, Takeo Hoshi, and Anil K. Kashyap, "Zombie Lending and Depressed Restructuring in Japan," *American Economic Review* 98, no. 5 (2008): 1943–77.

Box 1.1 Japanese zombies and the lost decade of growth
(continued)

taxpayers' financial resources but also skilled workers by inefficiently keeping wages too high. For example, a typical healthy real estate developer would have hired 30 percent more workers if zombies had not created additional demand for jobs. If Japan had allowed zombies to go bankrupt, the level of investment in various sectors would have been higher by 4 to 36 percent per year. Not surprisingly, the Japanese economy in the 1990s grew at an anemic 0.5 percent per year (compared with 2.6 percent in the United States during the same period).

ployment benefits and support of regional active labor market policies) constituted 74 billion rubles (about \$3 billion, or 0.25 percent GDP). The support to the “real sector” was an order of magnitude higher: 675 billion rubles (\$20 billion). This sum was about equally divided between “targeted” and “general” support (373 billion rubles and 302 billion rubles, respectively). The former was to provide assistance to specific industries and, in most cases, to specific enterprises. The bulk (282 billion rubles out of 302 billion rubles) of the “general support” was the reduction in the corporate profit tax rate. While it seems to be general, this support certainly disproportionately benefited a few specific enterprises—mostly Gazprom and other raw material exporters—that remained profitable even during the crisis.

Many critics argued that Russia's political system was too centralized and would choose very bad economic policies. They said that the regime's ideology, after all, places the state and loyalty to the rulers ahead of private property and merit. When the crisis hit with full force, such a government would have nationalized major banks and companies, with the resulting inefficiency then burying the Russian economy, just as it doomed the Soviet Union.

How did reasonable economic policies prevail in this crisis? The key factor is that, for the first time in many years, the political and economic system faced a genuine threat. The survival of the system depended on preventing economic collapse. The crisis energized the government and shifted more decision-making power to those who knew about and could do something for the economy. The relatively promarket members of the government were listened to and their advice was implemented to some extent. The global economic crisis finally forced the government to adopt sensible policies, thereby fending off disaster.

Unlike the fall of 2008, however, economic policy actions in 2009,

when the most acute phase of the crisis was over, were quite different. As the oil prices started to recover, the government regained confidence and returned to preserving the precrisis status quo. There was no immediate danger to the economic system, and the urgency of correct economic policies subsided. Why did the government not use the crisis as the opportunity to restructure the economy and create a foundation for new businesses, diversification, and faster growth?

On the one hand, designing an anticrisis policy in a country like Russia would be easy. Given the massive lack of infrastructure, one might argue that the Russian government should have reacted to the crisis with a sizable fiscal stimulus directed at building much-needed and growth-enhancing infrastructure.

Why would such a stimulus have a significant effect on the Russian economy? There is an ongoing debate on the effectiveness of fiscal stimulus in the United States and other OECD countries. The most recent evidence points out that a fiscal stimulus has small effects in a developed economy. The main reason is the so-called Barro-Ricardian equivalence: In response to increased government expenditures, households would expect higher taxes in the future to pay for this extra spending and increase their savings, thus negating the potential impact on current consumption and GDP. Most recent detailed studies put the size of the multiplier at 1, i.e., GDP increases only by a dollar in response to a dollar increase in government expenditures. Economists such as Robert Barro argue that the multiplier is even lower and ranges between 0.7 and 0.8.

On the other hand, in Russia the fiscal multiplier on building roads, airports, electricity transmission lines, and broadband internet would certainly be large. This investment will have to be undertaken at some point in the future anyway, so Barro-Ricardian equivalence does not undermine the effectiveness of the stimulus. The problem with this argument is that the Russian government is ineffective and corrupt. The government's infrastructure spending may be misplaced—thus resulting in no desired long-term effect for the economy. Moreover, it may even lack the Keynesian property of supporting aggregate demand. If much of the stimulus is stolen and taken out of the country, the Russian economy does not receive it. Another issue is that the government did not make sufficient inroads in the fight against corruption, which in addition to the usual effects also complicates support of the unemployed. As we argued earlier, it is better to withdraw subsidies from inefficient enterprises and spend these funds for direct support of Russians suffering from the crisis. However, the government's ineffectiveness and corruption may make such targeted social assistance impossible or prohibitively costly. High inequality further aggravates this problem. If the government opts for restructuring the economy and prefers supporting the unemployed but fails, the increase in unemployment undermines social cohesion further and results in political upheaval.

The disappointing performance of the Russian economy can be con-

trusted with Brazil's much better weathering of the economic crisis, which was also heavily dependent on the prices of commodities. A recent article in the *Wall Street Journal* argues that the better performance in Brazil was largely due to good economic policies.¹⁷

While most economies were battered by the global economic crisis last year, Brazil emerged largely unscathed and, by some measures, set record highs.... Latin America's biggest economy shrank only around 0.2 percent last year. Market and government forecasts now see Brazil's 2010 gross domestic product growth returning to pre-crisis levels of 5 percent to 6.5 percent. The center-left administration of President Luiz Inacio Lula da Silva proved sure-footed during the dark days of the global economic downturn. Government measures maintained employment and domestic demand, while inflation was comfortably kept in check below its 4.5 percent annual target. Thanks to tax cuts, improved credit conditions amid an aggressive easing in monetary policy and the stability of spending power for middle- and low-income households, demand for consumer durables continued through the worst of the crisis.

Another comparison is Chile, which significantly depends on the price of a natural resource (copper). Like Russia during the precrisis years, it maintained prudent fiscal policy, instituted sovereign wealth funds, and accumulated reserves. Chile is also similar to Russia in terms of per capita income (see figure 1.1). Yet, in 2009 Chile's GDP went down only by 1.6 percent and is expected to grow by more than 4 percent in 2010. Why has Chile weathered the crisis so much better than Russia? Chile was better prepared for the crisis as it had a competent and effective government, a flexible, liberal economy, and progressive social spending.¹⁸ The government budget does not have the burden of supporting the pension system (which is privatized) and inefficient enterprises. Thus it can focus on alleviating the shock of the crisis via massive antipoverty programs and on investing in the future through building the education system.

Lessons Learned and Lessons that Should Have Been Learned

What lessons have Russian economic policymakers learned from the crisis? Seemingly, the government has all the evidence for the following:

The government is sufficiently competent to withstand the crisis. We agree only partially. While the government did implement mostly correct economic policies to fight the crisis, it made a few serious mistakes. Yet, the government's resolute response to the crisis shows that even within the current system there are reserves of efficiency that can be tapped.

17. "Brazil Ends 2009 Largely Unscathed by Global Economic Crisis," *Wall Street Journal*, January 5, 2010, <http://online.wsj.com>.

18. Philip Stephens, "Tables Turned: A Lesson from Latin America for the West," *Financial Times*, February 6, 2009.

Accumulation of reserves is good. We agree. Economic literature provides two strong arguments to support the idea. The first is the textbook argument related to the permanent income hypothesis. A country, like an individual, prefers to stabilize the level of consumption and avoid fluctuations. In times of boom (such as a commodity boom) it is optimal to stash away the extra funds for the rainy day of a recession. The second mechanism is described by Ricardo Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas, who argue that the existence of so-called global imbalances is normal.¹⁹ Global imbalances are a situation in which major emerging-market investors (China, Russia) are the net savers investing in the Anglo-Saxon financial system. The reason for such a pattern of investment flows is that these countries have higher risks and relatively less developed financial systems, especially in terms of credible long-term instruments (no developing country has instruments that match the liquidity and trustworthiness of, say, 30-year US bonds). In other words, the optimal policy for emerging markets is to accumulate reserves and invest them in (relatively) safer and long-term assets in developed countries. Before the crisis, the quality of Anglo-Saxon assets was exaggerated, but even after the crisis the quality is still above that of the assets in the rest of the world. An important issue to note is that, while the crisis supported accumulation of reserves, the Russian government was still very inefficient at using the reserves during the crisis. For example, almost a third of the reserves were spent in the ill-fated attempt to support the ruble.

Oil prices cannot stay low forever. Given Russia's reserves, policymakers can hope for luck. We disagree. If the global crisis lasted longer (remember all the discussion about the crisis being the second Great Depression?), oil prices would not have recovered so fast. It is also quite likely that global growth will slow down in the future—which will in turn result in significantly lower oil prices.

State ownership of banks is good. The government's fiscal stimulus has been slow and ineffective, but state-owned banks did relatively well in supporting the economy. However, we believe that it is dangerous to rely on state banks for financing long-term growth. At least outside of a crisis, private banks do a better job. They are free from political pressure in their lending decisions and manage risks more responsibly than state banks. Indeed, while state banks can hope for a complete bailout, private banks—via the deposit insurance system—can rely on only a partial bailout.

19. Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas, "An Equilibrium Model of 'Global Imbalances' and Low Interest Rates," *American Economic Review* 98, no. 1 (2008): 358–93.

In addition, two important lessons *should* have been learned from the crisis. First, the problems inherited from Putin's growth decade, corruption and inequality, are very serious and almost brought the economy to the brink of collapse during the crisis. Most importantly, these problems undermined the government's ability to respond to the crisis. Second, the government—as it acknowledged itself—has failed to use the crisis as an opportunity to restructure the economy.

Russia After the Crisis: The Challenges

Now fast forward to June 2009, the 13th Annual St. Petersburg International Economic Forum. While the receptions were less lavish than those of the previous year and the mood was not very festive, it was far from the panic of the fall of 2008. The topics of the sessions were vague, and they duplicated what almost every other large global conference discussed: the crisis, globalization, and the new financial architecture.

Usually, the interesting part of these forums is the plenary speeches by the main speakers. Of course, the most anticipated speech was by President Dmitri Medvedev. First, he said that the anticrisis economic decisions of 2008 were successful. Second, Russia continues lobbying for reform of the international financial architecture, improving the system of global financial regulation, empowering the international financial institutions, and creating reserve currencies as an alternative to the dollar. Finally, Medvedev rebuked protectionism and supported lowering taxes as part of the growth stimulus.

However, the main message of the forum lay in Deputy Prime Minister Igor Sechin's session, "What Is the Price of Oil?" During the session, participants were asked to answer the question using individual electronic devices. Most people voted for a range of \$70 to \$80 per barrel. Perhaps the "70-80" scenario is what Russian officials are hoping for. And indeed, the price of oil soon climbed back to \$70 per barrel and stayed in the \$70 to \$80 range for the rest of 2009.

The return of high oil prices had important implications for the Russian economy: The markets believed that the global crisis was over and demand for oil was higher, and growth in Russia resumed. The experience in 2009 shows that the Russian economy has not decoupled from the world economy. Russia won the bet that oil prices would rise—and it is now on its way out of the economic crisis. The IMF forecasts Russia's growth (as of October 2009) at 3.5 percent per year until 2014. And the government itself acknowledged in its Anti-Crisis Program 2010 adopted on December 30, 2009 that so far its policies have not resulted in the restructuring of the economy.²⁰

20. Ministry of Economic Development of the Russian Federation, "Anti-Crisis Measures

The postcrisis period for Russia will be very difficult. Russian economic growth will slow down because of both external and—most importantly—internal reasons. Lower worldwide economic growth will almost certainly result in lower oil prices than in the precrisis decade. It is reasonable to expect such slower growth as the world's largest economies will have to increase taxes to pay for the expenditures to support their economies during the crisis and as there is an unprecedented increase worldwide in antimarket sentiment and policies. In the less likely scenario where advanced economies inflate away the debt, Russia—as a reserve holder—will also suffer. Thus, even if oil prices remained high, they are very unlikely to continue to grow at precrisis rates—which will be a significant factor in Russia's growth slowdown. Moreover, tighter regulation of financial markets worldwide will increase risk aversion of investors and therefore decrease capital flows to emerging markets in general and to Russia in particular.

Russia's internal problems relate to the "resource curse." If oil prices remain high, Russia will probably delay much-needed economic reforms. The "low hanging fruit" of basic economic reform and prudent macroeconomic policies has already been picked. Future economic growth requires building political and economic institutions—such as constraints on the executive branch, improving the rule of law, lowering corruption, improving protection of property rights, contract enforcement, and competition. Such institutions are difficult to build in every society.

But in Russia it is especially problematic as the ruling elite is not interested in building such institutions. The "resource curse" provides an explanation: All other things equal, resource-rich economies tend to grow at slower rates. Jeffrey Sachs and Andrew Warner have provided cross-country evidence that resource-exporting countries have lower rates of economic growth.²¹ Initially, the slower growth of resource-abundant economies was ascribed to macroeconomic effects of "Dutch disease," but later a consensus emerged that the resource curse mostly works through the institutional channel.²² In particular, if a resource-rich economy has bad institutions to start with, it is less likely to improve its institutions than a similar resource-poor economy. This, in turn, has an adverse effect on growth. Interestingly, if a resource-rich economy already has good institutions, it does not suffer from the resource curse.

Program of the Government of the Russian Federation," June 19, 2009, available at www.economy.gov.ru.

21. Jeffrey Sachs and Andrew M. Warner, "Fundamental Sources of Long-Run Growth," *American Economic Review* 87, no. 2 (1997): 184–88.

22. See a survey of literature in Sergei M. Guriev, Alexander Plekhanov, and Konstantin Sonin, "Development Based on Commodity Revenues," EBRD Working Paper 108 (European Bank for Reconstruction and Development, 2009); and *Transition Report 2009: Transition in Crisis?* European Bank for Reconstruction and Development, 2009, chapter 4.

How can this pattern be explained? Consider the incentives of the ruling elite in a country with bad institutions. Such an elite trades off the returns from building good institutions against its costs. Good institutions result in higher economic growth and increase the “size of the pie.” However, good institutions also constrain rent seeking by the ruling elite and increase political competition, raising the chances of the elite being replaced. How does resource abundance affect this tradeoff? The answer is straightforward: Resource rents weaken incentives to improve institutions. Indeed, the higher the resource rents, the greater the stakes of staying in power. Also, since growth in resource sectors is less sensitive to institutions, returns to good institutions in resource-rich economies are lower.

Weaker incentives for institutional reforms are only one part of the “resource curse” trap. Unfortunately, the fact that resource sectors are less sensitive to bad institutions creates a vicious circle. Indeed, if institutions are bad in a resource-rich economy, they are unlikely to improve, hence the nonresource sectors do not develop. Therefore, the economy remains resource-dependent with bad institutions. Moreover, the higher the oil price, the lower the incentives to develop institutions.

Figure 1.5 plots the dynamics of six key governance indicators during Boris Yeltsin’s second presidential term and Putin’s first and second presidential terms. The figure shows a clear downward trend in the quality of institutions during Putin’s second term (2004–08), when oil prices rose to historically high levels.

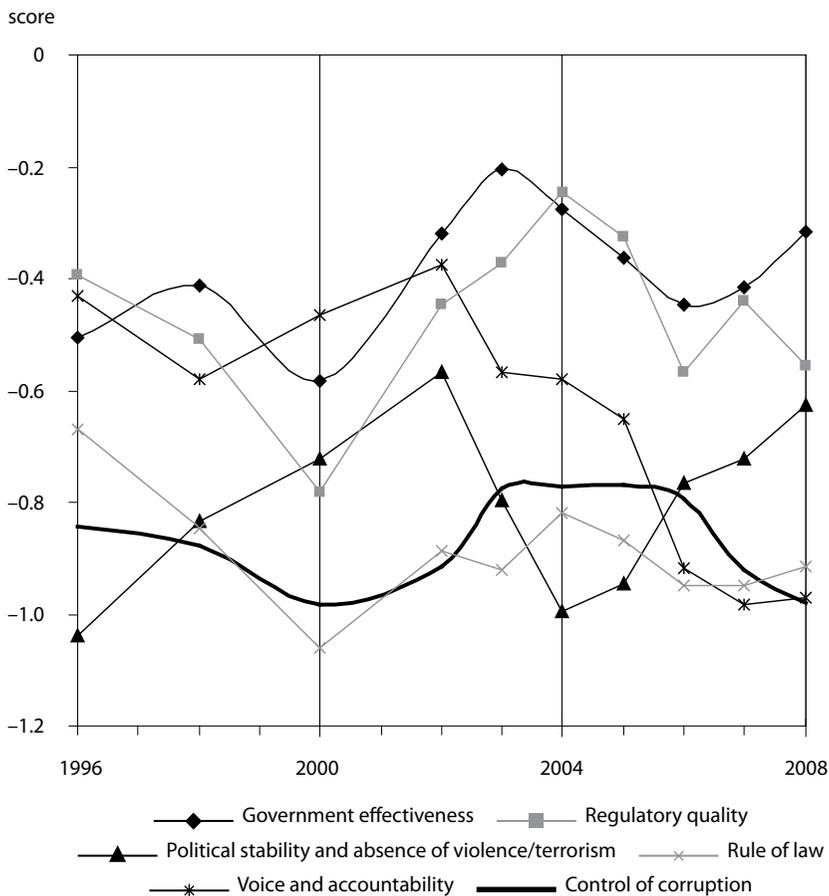
In postcrisis Russia, two specific factors reinforce the resource curse. First, due to a massive renationalization since 2004, state-owned companies are once again controlling the commanding heights of the economy. State companies have no interest in developing modern institutions that protect private property and promote rule of law. Second, high inequality results in the majority preferring redistribution rather than private entrepreneurship.

The Russian elite fully understand these challenges.²³ Yet, the incentives to get out of the resource trap are weakened by the very importance of resource rents.

Inequality and corruption are also crucial obstacles to sustainable economic growth. Despite Russia’s recent economic achievements, both remain at alarmingly high levels. Russians perceive inequality of opportunity to be very high; this undermines their trust in the capitalist economy and their support for private property rights. The majority of Russians believe that to acquire wealth one needs to be involved in criminal activity and have political connections; only 20 percent believe that

23. Sergei M. Guriev and Igor Fedyukin, “Challenges 2020: The View from Russian Business” (Moscow: New Economic School, 2008).

Figure 1.5 Dynamics of six key governance indicators during Boris Yeltsin’s second (1996–2000) and Vladimir Putin’s first (2000–2004) and second (2004–08) presidential terms



Note: For each indicator, world average is normalized to 0, and world standard deviation is normalized to 1.
 Source: World Bank Institute’s Governance Indicators Project.

talent matters.²⁴ These beliefs are self-fulfilling prophecies. Aside from the relatively small middle class and the even smaller business and intellectual elite, most Russians neither take risks to become entrepreneurs nor favor economic and political liberalization. According to the same survey, only 36 percent of Russians support democracy and a mere 28 percent

24. According to EBRD’s Life in Transition Survey, quoted in Irina Denisova, Markus Eller, and Ekaterina Zhuravskaya, “What Do Russians Think about Transition?” *Economics of Transition* (forthcoming 2010).

support market reform, by far the lowest among all transition countries on both counts. The other major barrier to growth is corruption. Forty percent of firms in Russia reported making frequent unofficial payments, and roughly the same percentage indicated that corruption is a serious problem in doing business.²⁵ Unlike in other emerging markets, corruption has not declined with economic growth; it remains as high as in countries with one-quarter the per capita income of Russia. One reason for sustained corruption is that Russia's powerful bureaucracy stands to lose too much from economic liberalization. Perhaps more importantly, it is difficult to fight corruption without political reform, media freedom, and a vibrant civil society.

Yet another, related barrier to growth is overregulation of the economy that slows the process of "creative destruction." More than half a century ago, Austrian economist Joseph Schumpeter (1883–1950) introduced this term, which denotes the mechanism that cleanses the economy. The economy lives and grows, Schumpeter showed, through the destruction of old companies, methods, and ideas and the arrival of new companies that are more productive and profitable.

During crises the rate of self-cleansing in an economy significantly increases, causing the losers to increase their resistance as well. Politicians and lobbyists redouble their efforts to save the "dinosaurs" under the banner of helping "the real sector" or saving the symbols of national industry (such as AvtoVAZ in Russia or General Motors in the United States). Sometimes representatives of the old economy win the battle for resources. But their victory is everyone else's loss. Artificial protection of ineffective companies that wield political influence is possible only by using taxpayers' money. Massive inflows of funds to unprofitable firms that should have gone bankrupt or been liquidated slow economic growth for many years.

Putting up barriers to creative destruction is very costly. For example, Philippe Aghion and Peter Howitt (creators of the modern version of Schumpeterian ideas, the economic theory of endogenous growth) show this by contrasting Europe, with its high barriers to entry and strong employment support, and the United States, where barriers are lower.²⁶ About 50 percent of new US pharmaceutical products are developed by companies that are less than 10 years old; in Europe it is only 10 percent. Twelve percent of the largest companies in the United States were created in the last 20 years; in Europe only 4 percent. In a recent review of empirical research on the effects of forces of creative destruction, macroeconomist Ricardo Caballero concludes that in the long run the Schumpeterian mechanism is

25. *Business Environment and Enterprise Performance Survey*, World Bank and EBRD, www.ebrd.com.

26. Philippe Aghion and Peter Howitt, "Appropriate Growth Policy: A Unifying Framework," *Journal of the European Economic Association* 4 (April–May 2006): 269–314.

responsible for about 50 percent of productivity growth.²⁷ He also studied how productivity grew in 60 countries and how such growth is affected by social protection mechanisms (for example, by a complicated procedure for firing workers). The conclusion of this research is that excessive job protection leads to 0.9 to 1.2 percentage points slower productivity growth compared with countries in which social protection is lower.

Importantly, after a crisis such overregulated countries grow about 30 percent slower. Another essential element of self-cleansing of the economy is free international trade with low trade barriers and tariffs. For example, in sectors that were significantly affected by lower customs tariffs after signing of the free trade agreement between Canada and the United States productivity growth increased by 15 percent in part because of the 12 percent reduction in inefficient jobs.

Schumpeter's theory offers an important lesson for Russia. During Soviet times the mechanisms of competition and creative destruction were essentially turned off. But these mechanisms are responsible for about half of the long-term growth in advanced economies. The main element of technological progress, entrepreneurship, was punished by imprisonment. We all know the result of the Soviet economic policy—inefficiency of industry and agriculture and underdevelopment of the services sector—which eventually bankrupted the Soviet Union itself. The problem of limited creative destruction is exacerbated in Russia by deficiencies in the corporate bankruptcy code, which limits self-cleansing mechanisms of the economy.

The crisis of 1998 showed that without significant government policy intervention, the Russian economy can speedily return to the trajectory of growth. Now the Russian state has significantly more financial resources than 10 years ago, which not only presents additional opportunities but also leads to temptations to engage in protectionist and interventionist economic policies—give money to large and influential companies, help Russian industry by increasing customs tariffs, or force companies to support excessively high employment. Politicians have to remember that the key to fast recovery from the crisis and the foundation for long-term growth is creative destruction, which has to be supported rather than restrained.

Strategic Priorities for Russia

Fast economic growth in postcrisis Russia will be very difficult, both because the external environment is unlikely to be as benign as it was during Putin's years and because there will be no incentives to undertake reforms. Nonetheless, we deem it necessary to spell out a reform agenda

27. Ricardo J. Caballero, "Creative Destruction," in *New Palgrave Dictionary of Economics*, 2d ed., ed. Steven N. Durlauf and Lawrence E. Blume (Palgrave MacMillan, 2008).

in the unlikely scenario that a reform coalition emerges. Our list of reforms does *not* include political decentralization and political liberalization but is likely to result in such social changes. There is no silver bullet for reform and there are no magic recipes for modernization. Most of what we describe is basic economics, which if implemented will result in significantly higher growth rates in Russia. We should emphasize that the list is not about “inventing a bicycle”—most of these reforms were already in Putin’s own economic agenda in 2000. This reform plan (the so-called Gref Program, named after its main author, former Minister of Economy Herman Gref) was adopted by the Russian government at the beginning of Putin’s first presidential term as the government’s official strategy for 2000–10, but most of it was never implemented.

Reforms face general problems in a country suffering from a resource curse. The first is limited capacity of reformers: Reformers in government are scarce and rent seekers abundant. The second problem is limited commitment to reform. Even if reformers have a chance to implement a specific reform package, the resource-curse logic implies such a window of opportunity may not last long. This is why one should start with a short list of reforms to create commitment for further reforms.

There are two devices to create commitment to reforms: a critical mass of stakeholders and outside anchors. A critical mass of stakeholders, namely private owners, who will support reforms can be generated in two major ways. The first is privatization of large companies. The new owners of privatized firms will know that their success is contingent upon building market institutions. Unlike in the 1990s, privatization can now be done in an effective way and will also generate fiscal revenues. Several competitive and open privatization tenders and IPOs have been produced in recent years (including large privatizations of generation capacity during the electricity-sector reform). The capital market is now much more efficient. Corporate accounts are now certainly more informative than in the early 1990s. Unemployment—the nemesis of all privatization supporters—is not going to be a very important issue for Russia postcrisis. Indeed, before the crisis, the *shortage* of workers became a major constraint on economic growth.

Second, further (and drastic) deregulation of small businesses will unlock the entry and growth of such businesses, owners of which are the most faithful proponents of competition, property rights, and contract enforcement. Once a critical mass of small business owners emerges, it will become a powerful lobby against predatory regulation and corruption.

Both these measures will create a (upper) middle class as stakeholders for further reform. It is important to complement these measures with the flat income tax and regressive social tax. Given the persistent attitude toward entrepreneurship as being a “criminal” rather than “lawful” activity, the tax system must provide incentives for entrepreneurs to pay rather than evade taxes.

The next key step is to identify an outside anchor for reforms. Having EU accession as an overarching goal helped Central and Eastern European countries to commit to institutional change. Russia does not have a strong anchor like EU accession. But even weaker anchors like World Trade Organization (WTO) and OECD accessions are helpful. As both can help promote rule of law for both domestic and foreign investors, these goals should be announced and pursued.

Two other major “self-proclaimed” outside anchors are: (1) raise the ruble to the status of an international reserve currency and (2) build an internationally competitive financial sector in Moscow. Both ideas may seem unrealistic at the moment but if pursued with persistence over a long period of time may be successful. As a reserve currency, the ruble may well be in demand as it represents a good hedge against rising oil prices. As long as ruble inflation is low, and the ruble exchange rate is flexible and free of political risks, many oil-importing countries will want to hold rubles or ruble bonds. Russia is a natural economic capital of the postcommunist world and can succeed as an international financial center—provided financial regulation and infrastructure are improved. In both cases, reforms required are exactly those Russia would need to implement anyway. The external anchor helps provide an independent assessment of the reforms’ success.

Given outside anchors, macroeconomic policy becomes rather straightforward. Russia should move to inflation targeting (with slowly decreasing inflation targets) and a floating exchange rate. There is, however, an important challenge. Inflation targeting requires a functioning ruble yield curve. This in turn implies that Russia should borrow domestically, which may crowd out private borrowers and result in positive real interest rates. To what extent is it a serious problem? Russia has not experienced real positive interest rates recently. Yet one can argue that with lower inflation and positive real interest rate, household savings will increase and financial markets will become more stable and efficient, resulting in lower cost of long-term capital for business. Inflation targeting is also connected to a political issue. It is difficult to implement as long as the central bank is not independent. Even though independence of the monetary authority is difficult, it is not impossible. Appointing independent members on the yet-to-be-created Monetary Policy Committee is not more difficult than nominating independent directors to 100 percent state-owned companies, which the Russian government successfully did in 2008 and 2009. Eventually, better monetary policy will promote financial development (due to lower inflation and better regulation) and benefit nonresource sectors.

A key issue is the reform of state-owned companies and their eventual privatization. The Russian government consolidated ownership and created large state-owned corporations, which often dominate their respective industries. The overwhelming economic literature argues that state-owned companies are less efficient than the privately owned. More-

over, the inefficiency of state-owned companies is a substantial tax on every other company, drawing necessary financial and labor resources (see chapter 7, which puts forward a reform plan for Gazprom, and Friebel et al.'s paper, which suggests a reform plan for the Russian railroads along the lines of the Latin American railroad reform).²⁸ On top of restructuring energy and transportation monopolies, Russia should encourage foreign direct investment and raise regulated tariffs to increase energy efficiency.

Several other reforms are necessary but financially costly. The first is army reform (see chapter 8). One may think that this issue has little to do with economics. This is not the case. The current situation in which a large portion of the military is manned by the draft is an important determinant of stratification in society, which fosters and sustains already high inequality in income and opportunity. Michael Lokshin and Ruslan Yemtsov show that the burden of the draft falls disproportionately on poor and less-educated Russians and imposes an additional large implicit tax on their income.²⁹ The probability of being drafted decreases significantly in cities with more than 100,000 inhabitants. A young male from Moscow or St. Petersburg is six times less likely to be drafted than his counterpart from a rural area. The probability of being drafted in a family from the richest part of society is only 3 percent while in the poorest it is 20 percent. Apart from military service itself, the draft significantly affects the income of families with sons enlisted in the armed forces. Lokshin and Yemtsov show that the draft decreases the income of their families by about 15 percent. This number likely underestimates the economic losses as it does not take into account that a returning draftee has to start his career with less work experience, which in turn affects his salary. And it does not count the fact that the probability of getting injured or dying is significantly higher in the military. That is why the draft acts as an additional tax on the poorest parts of society and reinforces inequality in Russian society.

Many proponents of the status quo argue that the current Russian military is in reality made of volunteers—those who do not want to serve could pay a bribe to avoid service. This logic is fallacious. First, the status quo punishes those who respect the law. Second, the bribes paid by the service dodgers are not collected by the state and do not fund the military. Third, in the military, a “free” draftee is valued at an implicit “price” of zero, which is significantly less than the draftee’s value for society or the economy. The solution is evident: A fully volunteer military, in which servicemen and women are paid “market” wages, will clearly improve the efficiency of the military and allocation of resources in society.

28. Guido Friebel, Sergei Guriev, Russell Pittman, Elizaveta Shevyakhova, and Anna Tomova, “Railroad Restructuring in Russia and Central and Eastern Europe: One Solution for All Problems?” *Transport Reviews* 27, no. 3 (2007): 251–71.

29. Michael Lokshin and Ruslan Yemtsov, “Who Bears the Cost of Russia’s Military Draft?” *Economics of Transition* 16, no. 3 (2008): 359–87.

Another significant problem is the pension system. The Russian population is aging and shrinking, leading to a decrease in the number of working-age people and contributions. In a no-reform scenario, the replacement rate of the public system is projected to decline to about 17 percent in 2030, far below the current level of about 26 percent, which is already widely perceived as inadequate and implies that many state pensions will be below the subsistence level.³⁰ The pension reform that started in 2001 is not adequate to address these challenges. The current retirement age is too low, and there are multiple incentives for early retirement. A politically costly yet necessary move toward a fully funded system can be achieved only through raising the retirement age and decreasing incentives to retire early. Economic research gives clear prescriptions for how to provide such incentives, for example, by increasing the income replacement rate with the length of employment history.

The question is how to fund these reforms (and others such as education and health-care reform). If done in conjunction with other reforms, part of the costs can be financed with the increased foreign direct investment in Russia (if the other reforms improve business climate and control corruption) and with increased household savings (if the other reforms build a better-functioning financial market and conservative monetary and fiscal policy is sustained). Another option is to borrow abroad, which is a viable route as Russia has virtually no foreign public debt.

The reforms just mentioned are painful, risky, and not exciting. Is there an alternative plan to modernize and diversify? Is it possible to at least lessen the income gap with the rich countries within 10 to 15 years?

Everybody is looking for a silver bullet. There are many such plans—vertical industrial policy, horizontal industrial policy, development institutions, to name a few—but all have been tried in the last 10 years. The level of corruption has remained the same (if not become worse), and the economy has still not diversified. The only difference from 1998 is that Russia is now a much richer country. The low hanging fruit of “catch-up” growth has been picked. So it is time again to listen to “boring accountants” and undertake the boring “not-inventing-the-bicycle” economic reforms. Interestingly, many of these reforms are already outlined in the government’s own Long-Term Development Strategy (also known as the 2020 Concept Paper). The problem is that—as with the Gref Program in 2000—the 2020 strategy may not be implemented. This would be equivalent to the “inertia scenario” outlined in the 2020 strategy. Such an outcome is not impossible; it seems to be most likely—given the “resource curse” and lack of incentives to reform.

30. David Hauner, “Macroeconomic Effects of Pension Reform in Russia,” IMF Working Paper WP/08/201 (Washington: International Monetary Fund, 2008).

What Next?

To sum up, Russia may follow either of two scenarios: (1) difficult economic reforms that will build the foundation for faster economic growth or (2) Brezhnev era–like “70-80” stagnation (and eventual bankruptcy).

If economic reforms are not implemented, Russia is likely to enter a new decade of Brezhnev-style stagnation. A parallel that we already discussed is the “lost decade” of the 1990s in Japan, when the acute phase of the crisis was mostly over but the economy grew very slowly for more than 10 years. During the fat years of high oil prices in Russia, there was some hope that at least a part of the largesse would be spent on infrastructure or education, which would have contributed to long-term economic growth. During the near collapse of the economy in the fall of 2008, we thought that finally the government would realize the need for pushing ahead with radical economic reforms, eventually leading to a modern and fast-growing economy. But while the government’s policies were effective in dealing with the immediate crisis, they did not address long-term growth slowdown. Russia still has an ossified, corrupt, and inefficient economy built during the fat years of the oil boom.

The “70-80” plan will conserve the status quo, but the rigid system will not be able to withstand another economic crisis. Russia will not have the benefits of uninterrupted, fast growth, which had allowed it to partially close the gap with OECD economies and to build large reserves that saved the economy in this crisis. The only alternative that we see is economic reforms.