
Foreword

The global economic and financial crisis of 2007–09 caused more damage to the Russian economy than to any other G-20 country. Russia's GDP shrank by 8 percent in 2009, while the stock index fell 80 percent from its peak. Until 2008, Russia was hailed as an economic miracle, enjoying rapid GDP growth, macroeconomic stability, and an unprecedented rise in real disposable income (more than 10 percent per annum on average over eight years). Huge oil revenues and capital inflows drove Russia's impressive growth. The oil and gas sector's share of the country's GDP, budget revenues, and exports grew with the rise in oil and gas prices.

Since the global crisis hit, however, Russia has seen some of its largest companies go bankrupt, has wasted one-third of its foreign currency reserves, and is suffering from a surge in unemployment. The Russian economy crumbled in 2008–09 for obvious reasons: A sharp decline in the price of oil and other commodities as well as capital outflows (\$131 billion in the fourth quarter of 2008 alone) put the economy in a tailspin. Corporate debt equaled more than 25 percent of GDP by the time the global crisis broke, while the share of foreign borrowing in banks' liabilities reached 20 percent.

The crisis not only hurt Russia's economy but also uncovered some acute problems facing the country, which, if left unresolved, will hinder sustainable growth in the future. Even without a global crisis, these problems would have inevitably led to an economic collapse (or at least a significant slowdown) by the end of the decade. Many Russian economists note that a slowdown in some important sectors began well before the crisis, and the causes were purely domestic, having nothing to do with the global environment. In particular, growth in the construction sector com-

pletely ceased by the end of 2007, and manufacturing growth also decelerated. Capital investments began to decline rapidly in 2008. The existence of a bubble in sectors such as construction and retail (which account for 25 percent of the labor force) is proved by the high share of borrowed funds in these sectors, which had reached 80 percent by 2008. Most of this borrowing was foreign.

The Russian economy has been facing acute problems for the past decade. The spectacular growth of 1999–2007 masked but did not eliminate them. These concerns include:

- Russia’s energy efficiency is the lowest in the world, lagging far behind developed countries. One of the main reasons is cross-subsidization within and between sectors, which has declined from 5 to 3 percent of GDP but is still unjustifiably high.
- Labor productivity is low, amounting to 36 percent of the US level and roughly 72 percent of China’s.
- The official share of small and medium-sized enterprises in GDP has remained flat in recent years, at 17 percent, demonstrating the illiberal character of the Russian economy. Corruption is largely a natural consequence of a lack of economic freedom and the state’s excessive influence on business.
- The burden of social spending, especially pensions, on the budget is excessive, and consolidated budget spending is exceptionally high. Public spending, after declining in 2004–06, started to grow again in 2007 and reached 41 percent of GDP in 2009. Given Russia’s level of development, sustainable growth is hardly possible with such high spending. Russia still does not have a private pension system: Only 2 percent of Russians have transferred part of their pensions to non-state funds.
- The incompetency of the bureaucracy has been “compensated for” by an increase in the number of government officials, by at least 25 percent since 2000. Overall, 16 percent of Russia’s population is employed in the public sector.

Some steps taken by the government undoubtedly contributed to the economic success of 2000–2007. They included the tax reform of 2001 and various measures aimed at strengthening the banking system, which was rebuilt virtually from scratch after the financial crisis of 1998. The corporate loan portfolio grew by an average rate of 37 percent per annum between 2000 and 2009, while the average growth rate of the retail loan portfolio was 63 percent per annum. Along with banks, many private companies have also undergone fundamental changes, improving their transparency, corporate culture, and efficiency.

These new types of businesses, along with a functioning banking sys-

tem and macroeconomic stability, give some hope for sustained economic growth. But the country's unresolved economic problems could jeopardize these hopes. Moreover, these are not problems that can be tackled individually; the entire paradigm must be changed from "survival" (in times of crisis) to growth and not "precrisis stability and consumption."

The steady, high growth of real disposable income gave rise to inflated expectations that it would continue for a long time, which was bolstered by official statements and social welfare policy with frequent increases in pensions and wages of public-sector employees. The cult of consumption resulted in twofold decline in savings as a share of an average household's annual income from 2000 to 2008. Wage growth overtook productivity growth. Whereas the gap in productivity between the United States and Russia remained stable, the latter's wage and real disposable income growth was among the highest in the world. The share of consumption in Russia's GDP (66 percent) approximates that in developed countries (67 percent in the United Kingdom and 71 percent in the United States) but far exceeds that in countries that successfully pursue policies aimed at high economic growth (51 percent in China).

At the same time, the share of investment in Russia's GDP (about 20 percent) is well below that of China, India, and Kazakhstan. The Russian economy badly needs investment, especially in infrastructure. Rapid growth after 1998 was achieved largely by resuming use of capacity constructed before the fall of the Soviet Union. In 1998 capacity utilization stood at 55 percent, while in 2006 it was over 80 percent. This number fell during the crisis, but by the beginning of 2010 it had recovered to its previous level. Russia's production capacity is in need of expansion and modernization, which requires huge additional investment. The obstacles to investment remain the same: illiberal economy, corruption, weak legal system, inflation, and lack of long-term resources in the banking system (particularly owing to the absence of private pension funds). The generally opaque business climate scares off not only foreign investors (Russia's level of FDI has traditionally been low) but also Russian corporations: Since 2007, corporate deposits have been growing rapidly because companies put their profits and foreign loans in Russian banks rather than investing them in the economy.

Meanwhile, the state is playing a larger role in investment: Between 2003 and 2007, personal savings as a share of total savings fell by one-third (to 20.8 percent), corporate savings fell from 53 to 42.8 percent, but state savings grew from 22.5 to 43.4 percent. Unfortunately, state investments in Russia are not very efficient.

In essence, Russian authorities have to choose between short-term stability (which can be elusive) and long-term growth. Contraction of budget spending and sterilization of money supply will help lower inflation and increase vital investment. However, the strengthening of the ruble will stymie the growth of an economy mainly driven by commodity

exports. Pension reform is needed for a number of obvious reasons, but it will inevitably lead to a temporary rise in social tensions. The problems of the pension system are aggravated by demographics: 12 percent of Russians are above the age of 65, much more than in Brazil, India, or China. Moreover, the population will continue to age in the coming years, and pension spending has already grown by 33 percent per annum for the last three years.

Russia needs serious economic reforms comparable in scale to those of the early 1990s. Is the government ready? What must be done for these reforms to be successfully carried out? The last Russian leader to face such momentous questions was Mikhail Gorbachev. The fall in oil prices in the autumn of 1985 resembles what happened in Russia in 2008. And Gorbachev was no less popular at the time of that fall than Dmitri Medvedev and Vladimir Putin are today. Unfortunately, he had not yet committed to radical reform and quickly lost his popularity. Reform went ahead without him.

What will the current Russian government do? How long will Russian society be willing to live with low growth, which is inevitable without serious reforms (unless oil prices hit new records)? Will the government remain popular if real disposable income rises at 1 to 2 percent per year rather than 9 to 10 percent? What can and must be done?

This book answers these questions to a considerable extent. It presents a comprehensive analysis of Russia's current state in a comparative context. A similar project of the Center for Strategic and International Studies and the Peterson Institute for International Economics is the China Balance Sheet, which has produced thoughtful analyses on China's rise as a global superpower. The two collaborated once again on the Russia Balance Sheet, releasing their first book of the same name in 2009. Analyzing different countries (or the same countries at different periods) using the "balance sheet" methodology allows us to gain new, more profound understanding of a country's economic and social situation. This second book, in partnership also with the Moscow-based New Economic School, covers a vast range of topics on Russia's economy and society, from army reform to relations within the former Soviet space. Top experts with thorough knowledge of these issues have contributed to the book.

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