Russia as an Economic Superpower: Fantasy or Possibility?

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For most observers, it was hard to comprehend how the USSR could be an economic superpower supporting a massive military buildup one day and a nation of almost no economic significance the next. One day we are told that the GNP of the USSR is equal to about half the value of the GNP of the United States, and a few minutes later we are told that the Russian GNP is no more than one-tenth that of the United States. It was not only that the Soviet economy collapsed, but how rapid and seemingly all-encompassing that upheaval was. Had the cold warriors and the CIA been deluding us with smoke and mirrors all these years?

Whether or not it was all propaganda (and most observers believe that the production was real but not of much use to the civilian population), now a decade later a considerably smaller Russia seems to be stirring again. Several analysts have argued that Russia has not only come to embrace the market but is on the way to becoming an economic miracle. The fact that some of these observers came to such conclusions well in advance of Russia's 17 August 1998 financial and economic meltdown is not very reassuring, yet they may have been on target, if a bit premature.

Certainly, the Russian economy seems to have turned some important corners. Not only has the economy stabilized but industrial production has grown steadily since early 1999. Recently its growth has slowed, but measured against the beleaguered economies of powerhouses such as the United States, Japan, and even Germany, Russia's growth has been impressive. At the same time, a healthy foreign trade surplus has brought with it an impressive jump in the country's foreign reserves. After falling to not much more than $10 billion in 1998, dollar reserves soared to over $40 billion in the middle of 2002. The same surge of new wealth spared Russia the need to seek new international loans. Instead, to the pleasant surprise of many both outside and even inside the country, Russia began voluntarily to prepay several of its debts. Flushed with such good news, the Rus-

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sian stock market came to life and registered one of the world's largest gains in late 2001 and early 2002.

I

Many factors led to the collapse of the Soviet economy in the early 1990s. The end of the cold war and the subsequent marginalization of large sectors of the military-industrial complex were particularly important. Mikhail Gorbachev has acknowledged that the military-industrial complex (VPK) accounted for at least 20 percent of the Soviet Union's GNP. Other estimates are even higher. In some parts of the country, as much as 70 percent of the region's industry was devoted to the VPK sector. Consequently, when Gorbachev and U.S. president Ronald Reagan began to sign a series of arms control agreements, almost overnight there was no longer any need for most of those industries. Converting factories producing military hardware is hard enough in the United States. In Russia, where the VPK-GNP ratio is much higher, the task was much more difficult.

Take aluminum. During the cold war, the Soviets classified aluminum production statistics as a state secret. That was because almost the entire output of the aluminum industry went to the military. By 1992, with almost no one in Russia interested in producing aircraft, military or civilian, only 200,000 tons of the 4 million tons produced that year found a buyer. The rest, at least until export markets were tapped, piled up unwanted.

For decades, the financial viability of industries in the Soviet VPK was of little concern. That was true in the United States as well—the extravagant toilet seats were a perfect example. The Soviet VPK, and for that matter most of the nonmilitary sector as well, were spared having to deal with capitalist economic concerns such as market discipline, hard budget constraints, and profitability. These were fetishes of capitalism and were of no concern to central planners in a centrally planned economy. Whatever shortcomings there might be could easily be mended by underpinning them with proceeds from the export of Russian raw materials, particularly petroleum. Thus, nonmarket practices such as overengineering and cost-plus pricing became standard and even highly praised operating procedure. However, once the Soviet military ceased to be a limitless purchaser of Soviet military hardware, it was all but impossible to find any other customers willing to pick up the bill. As a result, factories, particularly those that were the most high-tech and sophisticated, found themselves with no source of revenue. If lucky they were able to operate one or two days per week.

The disintegration of the USSR added to the problem. It was not that the various regions within the USSR were so integrated economically before the collapse. Nonetheless, the breakup of the country into fifteen independent countries proved to be terribly disruptive. Suddenly there was a need to deal with as many as fourteen customs procedures and foreign currencies, exchange rates, and tariffs, whereas before there had been none.

As if all this were not enough, the reform process, with its privatization and "loans for shares" scheme, all but guaranteed further chaos. Rather than act on behalf of the general public, those in charge as well as alert opportunists sought to take advantage of the new circumstances to build up their own personal holdings and divert valuable assets from the state to their own pockets. Amid the raging inflation and economic tailspin that ensued, future and wannabe oligarchs concerned themselves more with thieving and milking than building and innovating. Compared to stripping their newly seized assets, promoting economic growth was low on their to-do list.

II

Sooner or later, the pillaging was bound to come to an end. But several specific factors helped to precipitate the turnaround. Perhaps the most notable was the relatively rapid three-fold jump in petroleum prices in 1998 and 1999. This brought an enormous windfall to the oil oligarchs. Even as they continued to strip assets and ownership from each other, there was so much in the way of new revenue that eventually even the state and the Ministry of Finance began to benefit. With crude oil prices at $30 per barrel some of the oil oligarchs, especially Mikhail Khodorkovsky and his Yukos Petroleum, came to appreciate that at those prices

TABLE 1. Changes in Annual Russian GDP

Year	GDP as % of preceding year	% change
1989	—	—
1990[a]	97.6 to 95	–2.4 to –5
1991	95	5.0
1992	85.5	–14.5
1993	91.3	–8.7
1994	87.3	–12.7
1995	95.9	–4.1
1996	96.6	–3.4
1997	100.9	0.9
1998	95.1	–4.9
1999	103.2	3.2
2000	109	9.0
2001	105.1	5.1

Source: Goskomstat, *Rossiiski Statisticheskii Ezhegodnik* (Ross Stat), Moscow, 2000 16, 559; Davis Center for Russian Studies, Economic Newsletter, 19 February 2002, 1; June 2002, 1.

[a]1990 is for GNP of USSR; Directorate of Intelligence, Central Intelligence Agency, *Handbook of Economic Statistics, 1991*, Washington, D.C., September 1991, 62.

it might be worthwhile to invest instead of strip. This way they could not only continue to benefit from the high oil prices, but by suddenly embracing transparency they could draw in foreign investors eager to share in what they saw as the bounty. That, of course, would push up the price of stock. In short order, by 2002 Yukos shares were up tenfold from 1998. Suddenly, not opaqueness but transparency, at least more than there had been, became the fashion. The overall effect was that instead of declining, as it had for many years, petroleum output and exports began to rise. In 2001, petroleum output rose 8 percent.

The devaluation of the ruble by 400 percent after the 1998 financial collapse was equally and in some ways more important as a stimulus to the economy. Manufacturing and agriculture both benefited. Because the impact of the financial collapse and bank closings was so widespread, at first few appreciated how beneficial the events of August 1998 were to be. Admittedly, overall consumption and retail sales fell sharply, but the most affected were the importers and foreign manufacturers who prior to the collapse accounted for as much as 60 percent of Russia's retail sales. Because of the magnitude of the ruble's decline (the ruble fell from six rubles to the dollar to twenty-four to the dollar) most foreign importers could no longer compete in the Russian market. Slowly but surely, Russia's manufacturers began to fill the vacuum. Contrary to the International Monetary Fund's insistence on a strong ruble, it was the collapse of the ruble that made possible the first real sustainable economic growth since the fall of the USSR.

The turnaround occurred, oddly enough, shortly after Yevgeny Primakov took over as prime minister in 1998. This was almost a year before Vladimir Putin assumed control. In other words, the Russian economy's rebound was due almost entirely to the jump in oil prices and the drop in the value of the ruble and not to any initiative of Prime Minister or President Putin.

In fairness to Putin, however, the fact that he was a visible presence, especially after he succeeded Boris Yeltsin as president, was important. With Yeltsin's retirement, there was no longer the persistent uncertainty about the health of the country's leader. More than that, by late 2001, urged on by his economic advisers Andrei Illarionov and German Gref, Putin began to push for some structural changes. Especially noteworthy were his efforts to introduce a flat income tax of 13 percent and a reduced business tax of 24 percent. He also pressured the Duma to allow the privatization of land, both urban and agricultural. He put particular emphasis on encouraging the start-up of small businesses. For that reason he worked to shrink the number of businesses that were required to obtain a license and he tried to simplify labor codes. He also moved to remove some but not all of the most rapacious oligarchs. (In the process he hit most strongly at those who made the mistake of criticizing him as president.) To the extent that he can induce the Russian bureaucracy to implement these changes, Putin will have had a major impact.

III

These recent changes, especially Putin's effort to change the country's administrative culture, are important and should be applauded. What remains uncertain is whether, as impressive as such efforts are, they are far-reaching enough. Conceivably, if Putin's efforts to stimulate small business are long-lasting and successful, they could lead to the restoration of Russia as an economic superpower. But given the underlying historical makeup of the Russian economy, there is much room for skepticism.

The problem is a structural one. Russia's blessing—and its curse—is that, historically, under the tsars, the Soviets, and now Putin, the mainstay of the economy has been its overreliance on raw materials production and exports. During the eighteenth century it was iron and steel; during the nineteenth century it was grain; in the twentieth century and today it is petroleum and metallurgy. It is this dominance of the raw materials sector that accounts in part, but only in part, for the absence in Russia of a labor-intensive manufacturing sector. Why work hard when there are always raw materials available to finance the economy? Although there were some labor-intensive industries in the tsarist era, there were very few in the Soviet years. Today, even to suggest such a notion to most Russians evokes anger. In their minds, they are above "coolie" labor.

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Instead, as many Russians see it, if Russia is to build up its manufacturing sector, it should work to resuscitate the high-technology, heavy-engineering, and assembly-type operations: the "real economy," as they call it. But since many present-day Russians seem to have difficulty adjusting to the demands of the market, the stimulus for all this may have to come from the state, as it did under the tsars and central planning. Whatever the shortcomings of the Soviet model, state ownership of all the means of production meant that the state could channel its export revenues toward the buildup of whatever sector it chose, usually the military-industrial complex. The VPK in turn served as a growth engine, pulling along the leading sectors of the Soviet economy. To use the VPK in a similar way today, Putin would have to find some way to finance all this, especially the need for periodic infusions of foreign inputs such as technology, food, and otherwise unavailable consumer goods. But a tax system alone is inadequate, and since private owners now determine the allocation of natural gas and petroleum proceeds, short of the renationalization of those properties it is difficult to see how Putin can obtain the financing for such a state-underwritten initiative.

If the state can no longer play the dominant role, this means that for Russia to become a manufacturing force it must attract private investors. This will not be easy to do. Admittedly, labor is cheap in Russia today, but labor productivity is hardly high enough to warrant investment in export-oriented manufacturing. Even if labor productivity in Russia were competitive on a world scale, the present

Russian investment climate repels more direct investors than it attracts, whether from Russia or from outside the country. The city of Shanghai alone attracts more foreign direct investment capital than all of Russia. For that matter, so do Hungary, the Czech Republic, and Poland.

There are good reasons to avoid Russia. Even though by mid-2002 capital inflow began to offset capital outflow, many investors, both in direct investment operations and in securities (financial markets), have come off badly. Although there seems to be less of this dishonest manipulation under Putin, there are still very fresh instances of asset stripping, theft of ownership by using the pre-2002 bankruptcy law, and bribery of enforcement officials and judges. The abused include companies such as Subway Sandwich in St. Petersburg and Norex Petroleum, both of whose operations were seized by their joint venture partners. Similarly, Sawyer Research was pushed out by the local governor of Vladimir. In a classic case, Kenneth Dart found himself with worthless assets after his holdings in several petroleum subsidiaries were stripped by Mikhail Khodorkovsky and his now "model" company Yukos.

IV

If it is to reclaim its role as an economic superpower, Russia will have to mend its ways and attract new investors. What are the prospects for such a transformation, and which economic sectors are most likely to be successful?

The most likely candidate for future growth, as it has traditionally been, remains the raw materials sector. Within limits, there is also likely to be more processing in industries such as petroleum refining. In the same way, Russia can be expected to increase its processing of natural gas in the form of ammonia and mineral fertilizer. Similarly, in metallurgy we can expect more value added to steel in the form of rolled metals. Given Russia's abundant timber, there should also be an increase in the production of wood-based products such as furniture and construction materials.

There is also likely to be more investment in consumer goods such as food processing and detergents. Because of the relatively low profit margins and high transportation costs to sales ratio, these are industries that, with modest tariff protection, should find themselves relatively cushioned against foreign imports. For example, Mars, Wrigley's, Cargill, Stimorol, Interbrew, Wimm Bill Dann, Nestlé, and Kraft have been manufacturing within Russia for the Russian consumer for some time. Mars has had some difficult years, but Wimm Bill Dann has actually begun to export some of its products.

It is also to be expected that Russia will continue to manufacture military hardware. This will be largely a spin-off from past investments and continuing but much more limited government subsidies. Military hardware, as in the Soviet era, will be one of the few exportable products manufactured in Russia. Short of a return to a cold war environment, however, it is hard to see how Russia will be able to sustain the research and development that are necessary to continually produce cutting-edge and exportable technology.

Given the Soviet Union's effort to create world-class research institutes, Russia should be able to reap the payoff in the form of other high-technology spin-offs. Certainly there have been some success stories. The IBS Group is often cited as an example, but IBS employs only 1,500 people, nowhere near the number employed by a variety of software firms in Taiwan, Israel, and India. True, Boeing has recruited a staff of several hundred engineers to help with design, since this type of work is less subject to Mafia interference. Yet given that so many of Russia's most talented scientists have already emigrated or gone into other fields, it will take considerable time and effort before high technology in Russia becomes a viable economic sector.

That leaves labor-intensive-type industries, standard machinery, and low- and medium-tech manufacturing. As I discussed earlier, Russia is most unlikely to become a center of labor-intensive manufacturing. This is not part of Russia's traditional culture. It is difficult to expect that many manufacturers of toys, textiles, and computer chips will switch their operations from China or Bangladesh to Russia.

The prospects are somewhat more promising for traditional machinery production. However, several manufacturers such as Gillette, Caterpillar, General Motors, and Ford have or are establishing Russian manufacturing subsidiaries. If Russia is to become a manufacturing power, it is this latter class of mainstream manufacturing that will have to serve as the core of the effort. That a number of foreign investors have decided to test the market along with Russian manufacturers such as Uralmash, and that even some of the raw-materials oligarchs such as Oleg Deripaska and Roman Abramovich have expanded their investments into automobile assembly and engine plants, is a positive sign.

Whether or not Russia becomes a world economic force will largely be determined by the success or failure of these mainstream manufacturers. The fact that Russia has such a large potential market and is relatively isolated from other manufacturing centers is a major factor in its favor.

But there are significant impediments. The first that has been widely discussed is the World Trade Organization. If Russia succeeds in gaining membership, it will not be able to provide the tariff protection that almost all of the automobile manufacturers in Russia, including Ford and General Motors, insist they must have if they are to operate profitably in Russia. It was the absence of effective tariff enforcement that led IBM to abandon its computer assembly operations.

But there is another dilemma that proponents of a buildup of manufacturing must face, and in a sense it is less recognized and harder to resolve. It arises in large part from Russia's wealth—its raw materials—and is a variation of the so-called Dutch disease. It is not only that the rest of the Russian economy feels little need to stir itself so long as Russia can find abundant markets for its raw materials. An even more serious difficulty is that even if entrepreneurs in the economy want to develop manufacturing or non–raw material-related activities, the windfall from the dollar export earnings of the raw materials sector, particularly petroleum, strengthens the ruble and pushes up the ruble-dollar ratio. Remember, it was the collapse of that ruble-dollar ratio in August 1998 and the resulting increase in the price of foreign products that made it possible for Russian manufacturers to move in on the markets heretofore dominated by imports. That explains why, in 1999, imports fell 33 percent from what they had been a year earlier. Exports remained more or less the same. But the following year, in 2000, as petroleum prices kept rising, exports rose by 40 percent. Imports also began to rise, but only 14 percent. However, continuing inflation and a relatively stable ruble-dollar exchange ratio worked to push up prices of Russian-produced goods relative to imports. More than anything, this explains why in 2001 exports fell about 3 percent, while imports were up 19 percent for the year. The more attractively priced imports also help explain why Russia's machinery production in May 2002 was off 63 percent compared to a year earlier. Admittedly, any number of factors could reverse these trends. Moreover, should it choose to, the Russian Central Bank could take steps to immunize this influx of dollars and thus lower the value of the ruble.

None of this is meant to argue that Russia would be better off if it had no raw materials to export. It does mean, however, that even if half the Russian population should suddenly become entrepreneurial and the other half decide to work long, intensive hours, Russian industry would still have to cope with a ruble that will have a continuous tendency to be overwhelmed and thus will be more likely to favor imports, a problem that most countries in Europe and Asia are spared.

Russia's inability to be a major manufacturing competitor won't necessarily mean that it will never be able to transform itself. However, a look at what must happen to spark specific manufacturing sectors suggests that it will not be easy for Russia for re-enter the ranks of the industrially powerful. Technology, attitudes, and new discoveries do make a difference, but for the foreseeable future it is hard to see how such factors can change enough to transform Russia industrially.