Russia's Churn: So Far Along, So Far to Go

The 1991 breakup of the Soviet Union threw 150 million Russians into an uncertain future. Nobody really knew how a country that had suffered through three generations under communism could find its way to the prosperity promised by capitalism.

Russia walked away from communism bruised and battered. Economic output contracted, inflation and unemployment increased, birth rates plummeted and death rates rose. The scarcity of basic necessities approached what Russians faced in World War II. Daily life meant long lines—sometimes even elbowing and shoving—to get rationed bread, milk, cheese and other staples.

Russia's transition to a market economy remains very much a work in progress, one that may take decades to complete. Even so, the country has begun to respond to the touch of capitalism's "invisible hand."

Real GDP per capita has grown an average of 7 percent a year since 1999. Adjusted for purchasing power, it reached nearly $9,600 in 2004, putting Russia on a par with Mexico and Malaysia. (Comparisons with Soviet-era GDP, unemployment and inflation are pointless because arbitrary prices and unproductive employment plagued the state-run system.) Private investment has revived to 18 percent of GDP. Unemployment has fallen to 8 percent and inflation to 10 percent, its lowest level since 1991.

Living standards have slowly but steadily begun to rise above their Soviet-era benchmarks. More households have access to consumer goods, ranging from cars and TV sets to cell phones (*Table 1*). The most progress has occurred in the sectors of the Russian economy that have embraced free enterprise. Visitors to Moscow, St. Petersburg and other major Russian cities compare them to traditionally capitalist parts of Europe—clean streets, well-dressed people, a multitude of foreign-made cars, elaborate malls and shops, and a variety of restaurants, cafes, cultural events and entertainment.

After the fall of the Soviet Union, government-planned economic output had little market value and had to be restructured, an immense task that involved overcoming entrenched interests. With economic freedom, the informal sector emerged quickly in response to domestic market forces and growing competition from abroad. Income from underground economic activity as a share of total personal income rose in the early 1990s, peaking at 28 percent in 1997 before dropping off slightly as the more formal business sector developed.

Table 1

Russia Making Progress

	Early 1990s	Early 2000s
Residential space per person	172 sq. ft.	217 sq. ft.
Percentage of housing with:		
Running water	66	73
Hot water	51	59
Central heat	64	73
Percentage of people with:		
Private-sector jobs	20	55
Television sets	37	64
VCRs and video cameras	0	20
Telephones	14	24
Cell phones	0	12
Personal computers	3	10
Internet service (at home)	0	4
Passenger cars	7	14
Russian tourists traveling abroad	1.6 million	4.6 million
Listed domestic companies	0	214
As percentage of GDP:		
Market capitalization of listed companies	0	53
Value of publicly traded stocks	0	10
Bank credit to private sector	0	21

SOURCES: World Development Indicators database, World Bank; *The World Factbook 2004*, U.S. Central Intelligence Agency; *Russia in Figures*, Russian Federal Service of State Statistics, various years; "A Normal Country: Russia After Communism," by Andrei Shleifer and Daniel Treismann, *Journal of Economic Perspectives*, forthcoming.

Private Companies, Jobs

As of last year, the government fully owned 10 percent and partially owned 3 percent of all registered business organizations (*Table 2*). The government still dominates only education and forestry. Such industries as retail trade, chemicals and pharmaceuticals are overwhelmingly private. Russia has also developed the most capitalist of capitalist tools—a stock market. The country's 214 publicly traded companies had a market capitalization of 53 percent of GDP in 2004.

New jobs in private industry are replacing old ones in the state sector. Private domestic and foreign enterprises now employ 55 percent of the labor force. The largest job growth has occurred in wholesale, retail and international trade; food services; IT services; communications; marketing and procurement; finance; insurance; real estate; and tourism.

Communism tried to maintain zero unemployment, but capitalism requires job mobility so that labor resources can shift to more productive uses. Job-turnover numbers show that while Russia lost about 12 million jobs in 2003, companies in its evolving economy hired an equal number of workers.

While developing a new economic system, Russians learned some tough

Table 2

Government Ownership Declining in Russia

	Government owned (percent)	Mixed ownership (percent)
All organizations	9.6	3.0
Highest government ownership		
Education	80.8	2.2
Forestry	60.0	4.0
Arts and culture	41.1	3.6
Electric power generation	32.1	16.1
Health care and welfare	30.8	4.3
Housing and public utilities	21.9	3.6
Communications	19.0	7.7
Geological services and research	17.6	8.2
Finance, lending, state insurance, social security	13.0	17.5
Printing	11.9	3.2
Lowest government ownership		
Microbiological manufacturing	0	12.5
Chemicals and petrochemicals manufacturing (nonpharmaceutical)	.9	3.7
Retail trade and food services	1.3	1.4
Ferrous and nonferrous metallurgy	1.9	7.3
Medical and pharmaceutical manufacturing	2.1	6.3
Timber processing, paper and pulp manufacturing	2.4	4.1
Food processing	2.5	6.2
Commercial marketing and distribution	2.7	3.9
Construction material manufacturing	2.7	6.4
Machinery and equipment manufacturing	3.0	4.8

NOTE: Data are for 2004.

SOURCE: Goskomstat database, Russian Federal Service of State Statistics.

lessons the hard way. In 1998, after years of ineffective fiscal and monetary reforms, the government defaulted on its debt and the ruble's value plunged. Individuals lost savings and jobs, but the economy righted itself with adjustments set in motion by market forces.

The crisis passed as rising world energy prices and a cheap ruble invigorated growth. Given a fresh start, the government restructured its domestic and foreign debt and introduced fiscal discipline by reducing government spending and paying off debt. Total public debt hit a low of 32 percent of GDP in 2003. As the ruble appreciated, it lessened the impact higher oil, natural gas and metals prices had on economic growth.

Other developments contributed to Russia's growth as well. Enforcement of property rights and business contracts strengthened. In 2001, Russia decreased the individual tax rate to a flat 13 percent and the corporate rate to a flat 24 percent.

As economists Andrei Shleifer and Daniel Treismann point out in an upcoming article, various measures of Russian economic activity suggest a smoother transition to a market-based system than the official GDP numbers would indicate (*Chart 1*). Because even the underground economy uses electricity, electrical consumption reveals that overall economic activity slowed less dramatically than official GDP. Moreover, household consumption and retail sales indicate that Russia emerged from the transition in just 10 years—impressive given that the whole economy had to reorganize after 75 years of communism and catch up on technological innovations and new business processes.

The Road Ahead

Despite the hopeful signs, Russia has a long way to go in its march from communism to capitalism.

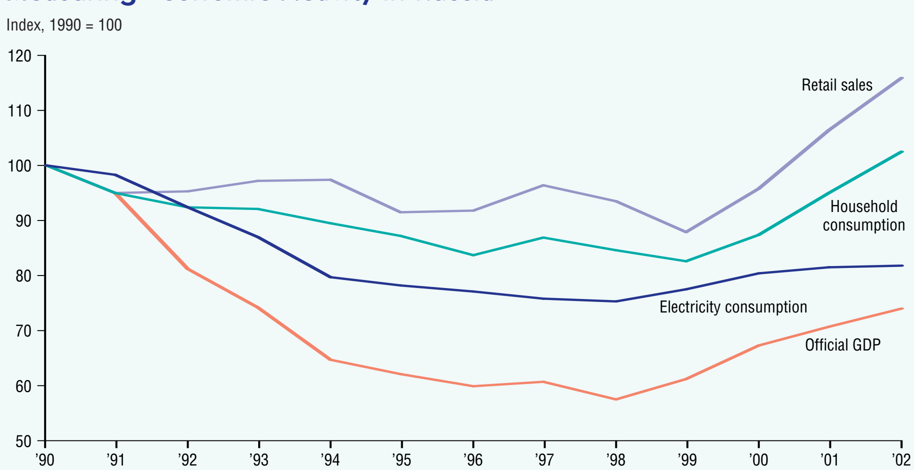
Inequality in income and consumption has increased since 1991. In 2003, 20 percent of Russians got by on below-subsistence-level incomes. Population growth continues to be negative.

The infrastructure is ill-suited to a modern economy. The manufacturing base is dilapidated. Trade barriers are high. Complex regulations still impose burdensome costs. Legally establishing a business takes an average of 12 procedures and 30 days, compared with five procedures and four days in the United States.

Russia's financial sector is developing slowly. The system for assessing the credit risk of firms and individuals remains weak and can be very subjective. Some companies are seeking financing abroad, using exports as collateral. Ven-

Chart 1

Measuring Economic Activity in Russia



NOTE: GDP, household consumption and retail sales are adjusted for inflation.

SOURCE: "A Normal Country: Russia After Communism," by Andrei Shleifer and Daniel Treismann, *Journal of Economic Perspectives*, forthcoming.

Table 3

Russian Exports

	Percentage of total exports
Fuel products	57.8
Oil and oil products	40.3
Natural gas	15.3
Other	2.2
Metals	13.8
Machines, equipment and instruments	8.6
Other	19.8
Total	**100**

SOURCE: International Monetary Fund, *Russian Federation: Statistical Appendix*, September 2004.

ture capital for start-ups remains scarce because locals invest mostly short term and foreigners consider geopolitical risks too high for funding Russian-based firms.

An underdeveloped legal system exacerbates the uncertainties and risks of business, especially when companies become large and politically important. The year-long saga of Yukos—a giant oil company accused of owing back taxes—included arrests, asset seizures, a U.S. bankruptcy filing and December's mysterious auction that put valuable petroleum properties back under government control.

Political developments only add to questions about Russia's commitment to building a well-ordered market economy. "Freedom in the World 2005," a study by the international organization Freedom House, grades Russia as "not free" for the first time since the fall of the Soviet Union; it criticizes President Vladimir Putin's government for centralizing power, harassing the media and politicizing law enforcement. Press censorship ranks among the highest in Europe. Distrusting their own justice system, Russians are seeking help abroad. Over the past seven years they have filed 25,000 cases with the European Court of Human Rights.

Russian trade remains overly dependent on natural resources. Petroleum products and metals make up almost 72 percent of exports and more than 30 percent of government revenues (*Table 3*). While rising prices for energy and other raw materials add to growth, Russia could encounter what economists call the "resource curse," a tendency for countries with natural wealth to pursue lopsided development strategies that neglect education, investment and other fundamentals.[1]

Other postcommunist economies on the road to capitalism are moving ahead as exporters, concentrating on manufacturing and performing low-cost services outsourced from other countries. Russia has lagged as a destination for foreign capital, while several other former Soviet bloc countries, India and China have grown fast by attracting outside investment (*Table 4*).

Economic Systems Matter

In the Soviet era, Russia tried to run its economy with bureaucracy and central planning. The country is now marching, however imperfectly, toward communism's antithesis. Capitalism generates economic progress through competition and continual change, all in response to supply and demand. These forces foster efficiency in production and benefit consumers with better products at lower prices.

For capitalism to work, people must be free to pursue their own self-interest. They must accept that some companies and jobs will die so new ones can start and grow. For this reason, economists call capitalism's somewhat messy engine of progress "creative destruction," or "the churn."

Russia is finally experiencing this churn. After a disappointing first few postcommunist years, the country did better as it started to let markets work. The return of economic growth and improving living standards will help build momentum for the country's fledgling capitalist system.

Table 4

Foreign Direct Investment in 2003
(Billions of U.S. dollars)

	Inflows	Outflows
China	53.5	1.8
Hong Kong	13.6	3.8
India	4.3	.9
Kazakhstan	2.1	–.1
Ukraine	1.4	0
Russia	1.1	4.1

SOURCE: Foreign Direct Investment database, United Nations Conference on Trade and Development.

Vestiges of Russia's old order remain, and the country still has a long way to go. Measures of economic freedom bear this out. The Fraser Institute's Economic Freedom of the World index shows that Russia has made significant improvement over its communist past but still ranks 114th out of 123 nations. Russia's score and ranking have shown little progress in recent years.

The Heritage Foundation still rates Russia as "mostly unfree," along with such countries as Bulgaria, Romania and Ukraine. Meanwhile, Hungary, Poland, the Czech and Slovak republics, and the Baltic states have made the transition from communism to "mostly free."

To finish making enterprise truly free, Russia needs to embrace the churn. It has little choice. China, India, Eastern Europe and other parts of the world are moving faster than Russia in an increasingly global marketplace. In economic matters, the competition sets the pace. Russia will find itself left behind if it doesn't do a better job of keeping up as the world marches toward capitalism.

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Note

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[1] Additional discussion of how and why heavy resource concentration in a nation's exports can discourage economic growth can be found in *The Paradox of Plenty: Oil Booms and Petro-States*, by Terry Lynn Karl, Berkeley: University of California Press, 1997; "Natural Resources, Education and Economic Development," by Thorvaldur Gylfason, *European Economic Review*, vol. 45, May 2001, pp. 847–59; "The Big Push, Natural Resource Booms and Growth," by Jeffrey D. Sachs and Andrew M. Warner, *Journal of Development Economics*, vol. 59, June 1999, pp. 43–76; "The Curse of Natural Resources," by Sachs and Warner, *European Economic Review*, May 2001, vol. 45, pp. 827–38.