Investment, Eurasian Infrastructure Are Burning Questions for Russia

by Rachel Douglas

"Only economic development will allow us to avoid such calamities in the future," said Russian President Vladimir Putin after the Ostankino television broadcast tower burned in August. The sinking of the nuclear submarine *Kursk,* in a moment of high tension that it took Russian-American Presidential consultations to defuse, was fresh in people's minds. Still undecided, is just what will be done to shift economic processes in Russia.

As the State Duma, the Russian Parliament, reconvened at the beginning of September, there was economic policy action in two directions. One of them operates under the old rules of the international financial game. The other, could take Russia into a Eurasian "Survivors' Club," as the biggest Anglo-American financial bubble of all time blows out.

Under the old rules, Russia must adopt a budget for 2001, in which the biggest expenditure line item is servicing the foreign debt. Defense spending is set at 2.66% of the Gross Domestic Product indicator, but after the sinking of the *Kursk,* a political fight over this level has shaped up. Former Prime Minister Yevgeni Primakov's Fatherland-All Russia group in the Duma has called for a defense budget at 3% of GDP, while Deputy Chairman of the Duma's Committee on Economic Policy Anatoli Aksakov says the budget can accommodate a defense line of 3.5% of GDP.

Politicians from all quarters note that the budget calculates Russian oil export revenues at a price of $19 per barrel, whereas it currently fetches nearly $30 per barrel, and they demand that the budget revenues be recalculated upwards. State Duma Speaker Gennadi Seleznyov anticipates attempts to increase not only defense spending, but also monies for "basic science, medicine, and culture," which are all drastically underfunded. Prime Minister Mikhail Kasyanov rejoins, that Russia must have an eye toward a change in "the conjuncture"—that is, a possible dramatic crash of the oil price—and not change the basic rates of calculation.

Eurasian Corridors

Russian defense spending and Moscow's awareness of the conjunctural crisis potential are by no means insignificant, but there is not yet a fundamental policy shift, embedded in the budget debate as such. Far more profound, are the implications of a new level of engagement of Russia, under Putin's leadership, with other Eurasian countries that are in the forefront of a global shift against the financial and strategic power of the Anglo-American establishment.

In St. Petersburg in mid-September, will be held the Second International Euro-Asian Conference on Transport, attended by representatives of over 50 countries, including China and India. According to Kseniya Gokoyeva, writing in *Nezavisimaya Gazeta* of Sept. 7, "The Russian delegation plans to sign agreements with India and Iran on the development of the North-South transportation corridor," ensuring that Russia will not be left out of the new "Silk Road" developments on the Eurasian continent.

On Sept. 7, the Russian cabinet discussed the "Europe to East Asia" transport corridor, as well as north-south routes. On the agenda, according to Deputy Prime Minister Viktor Khristenko, were "priorities in international transport corridors . . . , so that the geographical advantages that Russia has and that were used in the times of the Soviet Union should be restored, considering . . . the shift of the centers from which goods are shipped and accordingly the centers of production from developed countries, to, shall we say, the south." The extension of a Eurasian corridor down the Korean peninsula, said Khristenko, was discussed at the meeting, and by President Putin during his visit to Japan. In October, Putin will visit India.

Engagement in the great Eurasian transport projects can pull Russian economic policy into the critical, neglected area of physical infrastructure. "One of Russia's top economic priorities—rebuilding infrastructure," Prof. Stanislav Menshikov called it, in an Aug. 31 commentary in the *Moscow Tribune*. He wrote that investment in infrastructure construction would be a route to the pressing task of "reviving capital investment" in general.

Because these are burning questions in Russia, the documentation of Russian economic policy deliberation, presented in the next three pages, is excerpted not from the government's current briefs, but from a memorandum by a leading advocate of *change* in economic policy, Yuri D. Maslyukov.

Documentation

A Strategy for National Industrial Development

The memorandum, excerpted here in translation, was prepared by Yuri D. Maslyukov, Chairman of the Russian State Duma's Committee on Industry, Construction, and Science-Intensive Technologies, after hearings he held on an economic program for the nation. It was published on Aug. 31. An expert on the Soviet defense industries, Maslyukov was the last Chairman of the state planning agency, Gosplan. He served as First Deputy Prime Minister of Russia in the Yevgeni Primakov government (1998-99). His memo is subtitled, "The Place of Industry in Providing for Sustained Economic Growth."

In the framework of the ongoing discussion of the paths for Russian economic development, one often hears mention of the need to achieve average annual GDP growth of 5-10% throughout the next decade.

It should be understood, that there are only two essential models for the increase of GDP: through the furious development of the financial sector (leading to the inflation of a financial bubble, as is familiar from world experience, as well as Russia's), or through the development of the real sector, industry above all.

The structure of the Russian economy at present is such, that GDP growth is essentially determined by the growth of industrial production, which has been completely sluggish this year. An acceptable increase of GDP, therefore, cannot be ensured without an industrial upswing. . . . Even if there is balanced growth of the financial and real sectors, the very structure of the production of GDP requires that the growth rate of industry consistently exceed growth rates in the economy as a whole.

Therefore, when the necessity of sustained growth at an average rate of 5-10% per annum is discussed, we should understand that this means either a new "financial bubble," or annual growth of industrial production at the rate of at least 10% annually (including growth in the electric power sector of at least 7-8%), which is unlikely under conditions of today's "investment famine."

It cannot be argued, that there are no grounds for such optimistic prognoses. Indeed, thanks to the strengthening of state support for domestic producers and the restriction of the growth of fees for the services of the natural monopolies, certain consequences of the fourfold devaluation [of the ruble] and the increase of world oil prices in 1999 gave a significant positive impulse to the Russian economy. It was preserved into the first quarter of 2000, when there was 11.9% growth in industry, an increase in investments of 5.9%, growth of agricultural production, 1.2%; real incomes of the population, 7.6%; exports, 47.1%; and imports, 2.9% (the data for exports and imports are for January-February). True, the pre-crisis level of the first quarter of 1998 was exceeded only by industrial production (by 10.1%) and exports (by 20%). The decline of investments was also not compensated, and continued at a rate of 7.7% for those two years, while agricultural production fell 4.1% in that period, real incomes of the population fell 21.3%, and imports fell by exactly one-half.

But, despite this, the first quarter of 2000 was the most successful period since the very beginning of reforms [in 1992]. This gave rise to problems, as well as successes.

The main problem, is that the market has pre-divided the economy into two parts: sectors, capable of successful independent development, and sectors in need of active support from the state.

In 1999 and the beginning of 2000, Russia experienced an unprecedented investment boom. It was concentrated, however, primarily in sectors with relatively stable effective demand and, most important, rapid recoupment of investments, which qualitatively reduces political risks. Thus, investments in non-ferrous metallurgy rose by one-third, in machine-building and transport by 28%, and in the chemicals and petrochemicals industries, as well as food-processing, by 17.7%. . . .

The most important sectors for national development, however, are the spheres of life-support and infrastructure, which are capital-intensive sectors with a slow rate of recoupment. They constitute a second, "non-liberalized" sector of the economy. For these sectors, the standard liberal recipes are absolutely inadequate. There has to be some serious activation of state regulation. It is guaranteed, that private capital will not enter this sphere on the minimum scale, required for its survival, simply because the high capital intensity and slow recoupment of investments make the political risks prohibitively high.

Thus, investment in the electric power industry declined by over 10% in 1999.

To ignore this, creates a threat of physical destruction of the life-support systems, due to chronic underinvestment. In this connection, Russia is threatened already today with the emergence of a shortage of material resources, and a qualitatively new phase of degradation, in which national development will be blocked for the first time not by financial, but by resource limitations.

In particular, the countryside today is already suffocating, without equipment. This, and not only bad weather, was the main reason for the harvest failure in 1999. The cause of anticipated difficulties with the 2000 harvest is the same: You could pay the producers tomorrow, if you wished, but there is already no time for the production and repair of the equipment.

During the next three to five years, the electric power, oil, and natural gas industries will begin to reap the fruits of chronic underinvestment. A little bit longer, and no amount of financing for advanced technologies and geological prospecting will save them—and with them, the economy as a whole—from the consequences of the decade-long "investment pause."

Today, it is increasingly a shortage of material resources, not just money, that begins to hold the country back. Russia is finishing up its consumption of "the U.S.S.R. inheritance," especially with respect to investment. It will require a different organization of the economy and the state, to replenish what Russia has grown accustomed to drawing from its seemingly inexhaustible reserves.

According to specialists at the Russian Academy's Institute for National Economic Forecasting, the inertia, which has been taking shape, despite the cheerful current indicators, will lead to a decline of production, investment, and consumption by as much as 8-12% during the first decade of the 21st Century.

In order to ensure an acceptable future, there must be a transition to a qualitatively new model of economic development, which relies on the interconnected growth of consumption and investments, achieving balance among the financial, production, and resource spheres.

Such a transition can be brought about only by an active state. . . . The top priority task is to compensate for the expected gradual deterioration of the conjunctural situation (including as a result of the increase of fees for the products of the natural monopolies, the intensification of domestic fiscal pressures, and the possible decline of world oil prices), with an energetic and well-conceived state policy. In order to implement such a policy, the state must unite all of society's forces and concentrate them on achieving key goals.

An Effective Reproductive Model

. . . It is necessary to create a social-psychological "atmosphere of recovery and upswing," characterized by accord within society on the goals of development and the means to achieve them. . . . A condition of society should be sought, where the key institutions link their vital prospects and strategic interests with expanded reproduction and modernization, with the increase of national wealth and productive capital, rather than with their redistribution, as was the case in recent years.

There need to be powerful motors for an economic upswing—groups of interconnected types of manufactures and economic institutions, which form a coherent system and possess not only a powerful potential for growth, but also sufficient "critical mass" for the qualitative transformation of the economy. The model of economic growth must rest on innovation and improvements in efficiency. . . .

The Key Problems of the Economy Today

In the framework of the indicated preconditions, there are concrete economic problems to be solved, which may destabilize Russia's economy by 2005, if they are left unattended.

The first of these, is the investment crisis. Due to the lack of a consistent state investment policy, investments fell by a factor of five in 1991-99. In 1994, the share of equipment that was "younger" than ten years was 44.5%; by 1997, it had fallen to 29.4%. At current rates of reproduction, fixed capital will have shrunk so much by 2005, that it will become the main factor limiting development. By 2010, fixed capital will have shrunk by 25% since 1998, with only 55-60% of the pre-reform capacity remaining.

The quality and competitiveness of productive capacities must be raised. Their modernization requires an annual increase of investments of 10-12%, or 8% as a minimum. . . . Within this, resources must be reoriented toward the agro-industrial complex (AIC) and capital machine-building. The "investment leap" must occur only on the basis of Russian machine-building, because to import the equipment needed for this growth—more than doubling by the year 2010—is beyond our means (costing $15-18 billion). . . .

The second, is the social crisis. A gap between production and consumption has emerged in Russia. In 1991-98, production fell by more than half, while consumption declined only 21%. Consumption was maintained by building up imports of consumer goods, in exchange for raw materials exports, by reducing investment and defense spending, and—since 1995—by domestic and foreign borrowing. As of 1998, the potential of these factors was exhausted.

The financial crisis of 1998 partially overcame the gap between production and consumption, through a decline of consumption. The number of citizens, whose income is below the subsistence minimum, increased by 20 million people, to 37% of the population. In 1999, the population's consumption fell by 5%. If this tendency were to continue, by 2005 consumption would have fallen 5-10% since 1999, which would bring our social problems into a medical-demographic and political dimension.

Without restoring the standard of living, it is impossible to restore the population's confidence in the state, and to create constructive motivation for business or labor.

The price scissors at the start of the reforms led to the subsidization of industry and middlemen at the expense of the rural areas, which has produced a food crisis. . . . The purchasing power of the rural sector fell by more than a factor of three, in 1992-99, while investment in that sector fell by a factor of 25. The decline of agricultural production has outstripped the collapse of industry since 1995. In 1991-99, it was 44%. . . .

Enough combines and tractors are produced to replace only 10-15% of those taken out of service. The shrinkage of the number of units of agricultural machinery (at the rate of 5-8% per annum) causes a reduction of land under crops (by 25-30% in ten years), and will slash the grain harvest (from 65 million tons in 2000 to 50 million tons in 2005, and 40-45 million tons in 2010). Meat and dairy production will decline by a factor of 1.5 in 2000-10. If events develop according to this scenario in 2005-10, the AIC will supply only 75-85% of the population's biological needs. . . .

To prevent this will require tripling investments in agriculture in 2000-05, and another increase by a factor of 2.4 by the year 2010.

The minimal requirements for subsidies, state institutions, and capital spending by the state currently comprise 33% of GDP. . . . According to Russian Academy of Sciences specialists, no more than 70% of budget obligations are covered by allocated budget spending, which can be called a situation of budget tension, if not a crisis.

Restructuring of foreign debt payments and new borrowing could reduce the rate of printing money to cover this gap, to 1-3% of GDP in the medium term. Exceeding that level means hyperinflation.

The fuel sector is a major creditor of the economy, in which around 40% of the net indebtedness of industrial consumers is concentrated. After 2000, the possibilities for that sector to develop without capital intensity will have been exhausted. By 2005, the volume of investments in the fuel sector should grow 150% above the 1999 level, and they should double by 2010. Otherwise, the country may encounter a shortage of fuel resources by 2005. . . .

The devaluation of the ruble and growth of a trade surplus have created an illusion of prosperity. The necessity of stimulating exports, under conditions of exorbitant costs and poor management, however, requires a lower exchange rate for the dollar. This, in turn, will stimulate inflation. . . .

Scenarios for the Russian Economy

The most important practical question for determining Russia's prospects is the recovery of the state. Without addressing the question of state construction, it makes no sense to prepare programs, and Russia will be condemned to the least favorable, inertial path of development. On that path, the limitations and inadequacy of demand virtually preclude the possibility of smooth, evolutionary development. The devaluation took the economy into a new phase, which may continue until 2002. The growth of import-substitution, exports, the money supply, and the mitigation of imbalances through the decline of the standard of living, may sustain an increase of industrial production of up to 15%, until that time.

In 2003-06, however, the mass decommissioning of production capacities and the reduction of agricultural output will aggravate the systemic crisis. It may unfold in the following way:

1. A low level of investments will reduce the potential of several sectors, including the AIC. . . . Food shortages will force increased imports, straining the country's balance of payments.

2. The trade surplus will be insufficient to increase imports. The tax burden and low investment will allow the increase exports solely by means of reducing the exchange rate of the ruble, which will accelerate inflation.

3. A falling ruble exchange rate will make it more expensive to service the foreign debt. . . .

4. The fall in the exchange rate and increased printing of money will intensify inflation, reducing consumption by the population, leading to a new spiral of collapsing production and retirement of capacities.

5, This will aggravate a negative tendency—regional segmentation of the economy. . . .

Under this inertial scenario, the sole sphere of growth will remain raw materials exports, which will increase by more than 15%. The economy will be further deindustrialized, with production capacities slashed by one-third, in comparison with 2000.

As a result, by 2010 Russia will finally have a model of economy, on the periphery of world development. It will feature a low standard of living, with great social and regional differentiation. . . .

All society is united today, by the rejection of such prospects and the search for an alternative. There are two variants being most actively considered: an attempt to move to sustained growth through the stimulation of exports, or by means of increasing consumer demand.

The "export-oriented" path of development fits the liberal ideology, but calculations show that it is inadequate for today's Russian realities and requirements. . . .

The "consumption-oriented" path of development, through building up consumer demand and promoting import-substitution, will lead to support for consumption and the social sphere, by means of reallocating budget spending from raw materials exports and of economizing on investments (by utilizing idle capacities). This will ensure more rapid growth, but it is also inadequate for the revival of our country's economy.

The only way out of the situation is for the state to stimulate simultaneously exports and consumer demand, which requires active incentives for investments, as the basis for such a policy. The "investment" path of development will not only provide for maximum growth rates, but will make it stable, relying not only on the quantitative increase of output, but on the qualitative modernization of the technologies in use.

The remainder of Yuri Maslyukov's memorandum spells out specific measures for the achievement of an investment mobilization.