Russia's Economy 1999-2001: Strong Growth, But Exhausting Its Foundation

by Jonathan Tennenbaum

At the end of last year, the Western economic press sounded a chorus of praise for Russia's "extraordinary economic boom" over the last three years. Commentators pointed, above all, to a growth of Russia's Gross Domestic Product (GDP) of over 5.5% in 2001, following increases of 5.5% and 8.3% in 1999 and 2000, respectively, and sustained in 2001 despite the sharp downturn in the world economy as a whole.

As any competent economist ought to know, increase in GDP by itself tells nothing about the real health of an economy. At the same time, however, there is clear evidence of a significant revival of physical production and investment in Russia. According to official statistics, in 2001 Russian industrial production grew nearly 5%, construction by 9.9%, agricultural production by 6.8%, and investment in the productive sector by almost 9%. The machine-building sector, which suffered particularly severely from the post-1990 collapse of capital investment and the transformation of Russia's economic structure to "Third-World-style" export of raw materials, shows signs of coming back to life. Aside from a partial, but significant revival of the domestic investment cycle, from 2000 to 2001 there was a 21% increase in exports of machinery, equipment, transport vehicles, and other products of the Russian machine-building industry.

Meanwhile, last year the average real disposable income of the population went up by over 6%, following an increase of about 10% in 2000 (compared with 1999); while average real monthly earnings of workers rose 19.8% in 2001, following an increase of 23% in 2000.

An Economic Locomotive?

At first glance, the growth figures, which can hardly be attributable just to an increase in energy export revenues, seem almost too good to be true. By some sort of miracle, that same country, which was devastated over almost a decade by perhaps the most drastic collapse of production and living standards of any nation in modern times, is now joining China and India as one of the few nations experiencing continued growth of production; while the United States, Europe, and most of the rest of the world slide into a deepening depression! Some even speak of Russia as a new "locomotive" for the world economy.

We do not doubt, that Russia indeed has the *potential* to become such a locomotive in the future, under a suitable economic policy. However, Russian economists, familiar with the reality behind the figures, offer a more sober evaluation about the present situation and its difficulties. An article in the new magazine *Russian Entrepreneur* aptly captured the situation with the following comparison:

"Today's Russia is really very different from the Russia of 1999. The country could be compared with a patient in a hospital, who has been moved out of the emergency care unit, into the ward for normal patients. The patient is no longer in total agony, no longer suffers from pre-death convulsions, but at the same time she is still very far from being healthy."

Although this characterization referred to Russia's social-political situation as a whole, it certainly applies to the economy itself, and to the *relative* nature of the improvements which, undeniably, have taken place since the end of 1998.

Firstly, it must be emphasized that despite the recent "upswing," the basic living conditions of the vast majority of the Russian population—including housing and employment, health care, and educational opportunities—are still very much inferior to those which prevailed before 1990. Having nearly doubled in real terms since 1999, the present average monthly workers' wage at the end of 2001, according to official figures, stood at 4,295 rubles, equivalent to only about $140. However, respected Russian economists have raised serious suspicions about the government's figures on the rate of improvement of the population's real income.

At the very least, the distribution of income and income increases are extremely unevenly distributed among the regions of the country and layers of the population. Without doubt, much of the increased buying power is coming from the relatively prosperous layers, while the lower, approximately 30% of the population continues to live near or below the level of mere subsistence. After a lengthy televised dialogue between President Putin and a cross-section of Russian citizens at the end of the year, Putin acknowledged that very many Russians have experienced little or no significant improvement in their living circumstances.

Russia Survived IMF Poisoning

Secondly, the encouraging production and investment figures, cited above, must be judged against the reality of the

Russian President Vladimir Putin (foreground, third from left) meets with U.S. Export-Import Bank Chairman James Harmon (right) and other participants in the signing of loan guarantees to Russia's Tyumen Oil Co. The oil and gas sector lies at the core of Russia's unbalanced, raw materials-oriented export economy, but increased investment in that area has nevertheless provided a certain stimulus to capital-goods production.

ongoing *depletion of the productive base* of Russia's economy, as a result of: 1) the gradual exhaustion of the overaged stock of agricultural and industrial machinery; 2) the exhaustion of vital transport, energy, and urban infrastructure; 3) the decline of Russia's scientific-technical cadres through aging, increased illness and death rates, emigration, and related causes.

Even a very rough estimate of those losses, demonstrates that the present levels of physical investment into the Russian economy are still very far below the minimum level, needed to compensate for the depletion of the productive base. The noted economist and Duma Economics Commission Chairman Sergei Glazyev, estimates that Russia's production base is presently shrinking *three times as fast* as new productive capacity is being introduced through investment; and that the current level of investment into the productive sector would have to be at least *doubled,* to arrive at a mere physical "break-even" situation in the economy. That is probably a conservative estimate.

Thus, the last 38 months' "upswing" has at best only slowed down, but not reversed, the gradual erosion of Russia's economic foundations. This being said, one cannot ignore the strategic significance, of the marked positive change in the *subjective mood* in many parts of the country, connected with the revival of domestic investment, and with a certain general sense, that Russia under Vladimir Putin will continue to exist as a world power.

To return to the cited analogy: Having somehow survived the incredible destruction unleashed by International Monetary Fund (IMF) shock therapy—a medicine designed to kill the patient—Russia has become much more hopeful about the future. She looks across the hospital hall and notices how other nations, who were supposed to be "models of robust economic health"—including not only nations such as Argentina, but even the United States itself—are now being carried off, one after the other, into the emergency room! Under such circumstances, Russia is likely to choose her *own* economic medicine in the future, rather than listening to the malicious foreign advice which nearly killed her during 1990-98.

Background of the 1999-2001 'Mini-Boom'

The economic liberals in the present government of Prime Minister Mikhail Kasyanov, and their foreign backers, would naturally like to take credit for the 1999-2001 upswing, as being the long-delayed fruit of Russia's "market reforms." Ironically, the post-1998 recovery of production and investment in Russia is better suited to demonstrate the life-saving advantages of *protectionism* and the crucial role of the state in economics!

In this case, it was the sudden devaluation of the Russian ruble following the financial collapse of August 1998, and certain crucial actions by the Yevgeni Primakov government which served in the period immediately following that crisis, which created the *effect* of protectionist policies—independently of the will of the IMF-supported "liberal reformers"! There is hardly any argument about the fact, that it was the devaluation of the ruble, despite the hardships suffered by the population, which under Russia's concrete circumstances made the upswing of domestic production possible. Overnight, the prices of imported goods, which had been flooding the Russian market, increased by a factor of three. Suddenly it became profitable again to produce in Russia, and to sell domestically produced food and industrial goods, despite the well-known quality problems and unfavorable cost factors affecting Russian producers.

But there would have been no recovery of domestic production, had the Primakov government not intervened, to prevent the country from sliding into chaos after the financial collapse of August 1998, and to establish certain key conditions for a recovery of production. This included measures: 1) to establish a minimum of public confidence in the government; 2) to pay out a crucial portion of the enormous backlog of unpaid salaries, pensions, and other social benefits, alleviating what had become an untenable situation for broad sections of the population; 3) to stabilize the currency and what remained of the banking sector; 4) to promote a gradual remonetarization of the physical economy, entire sections of which had gone over to barter and payment in kind in order to survive under conditions of shock therapy; 5) to provide for an inadequate, but still crucial margin of flow of credit to the productive sector; and 6) to restrain the growth of prices of energy and services of the so-called "natural monopolies," including rail transport, which play a key role in determining the profitability of domestic producers.

To varying degrees, Primakov's stabilization and consolidation policies have been carried forward under Putin, with a strong emphasis on restoring the authority of the state, while at the same time seeking to expand the scope of private enterprise.

Also crucial to the survival of Russia's economy, was the rejection of proposals to introduce a currency board regime and other features of the so-called "Argentine model" into Russia, in the period immediately following the August 1998 collapse of the Russian financial system. Lyndon LaRouche's main collaborator in Russia, the late Prof. Taras V. Muranivsky, played a key role in refuting the massive propaganda campaign around the "Argentine economic miracle," whose domestic sponsors included the present Economic Adviser to the Russian President, Andrei Illarionov.

Not surprisingly, now the collapse and default of the "Argentine miracle" has caused great nervousness among Russia's radical liberal reformers, many of whom had strongly associated themselves with the Argentine model less than three years ago.

'Strategic Triangle' Foreign Policy

Primakov also initiated certain important foreign policy thrusts, which have been continued with some success by Putin, and which are closely connected with the potential for a real economic renaissance of Russia. Foremost among these is a qualitative strengthening of relations with the two "giants of Asia," India and China, recalling the Soviet Union's role as a prime supplier of capital goods, know-how, and training for the industrial development of both nations; and the conception of a "strategic triangle" "Russia-China-India." In addition, there is the strengthening of relations with another crucial Asian nation: Iran.

Implicit in Primakov's diplomacy, but now an explicit policy of Putin, is Russia's central role in the development of transcontinental infrastructure corridors linking Europe and Asia—including the revival of the Trans-Siberian Railroad, its future linking with the Korean peninsula and Japan, major pipeline projects to the east as well as the west, and the pursuit of "oil-and-gas-for-technology" agreements with Europe (see "The New Eurasian Land-Bridge Infrastructure Takes Shape," *EIR*, Nov. 2, 2001).

Among other things, this policy-thrust has led to a significant improvement in the export prospects for Russia's machine-building and science-and-technology-intensive industries, sectors which suffered relatively the most from the post-1990 collapse. Concrete results have included major arms-export deals and aerospace contracts; Russia's emergence as the number-one world exporter of nuclear power stations; and some major infrastructure projects. While still limited in scale, these developments have provided a crucial margin of income to a number of strategically decisive industrial sectors of the Russian economy.

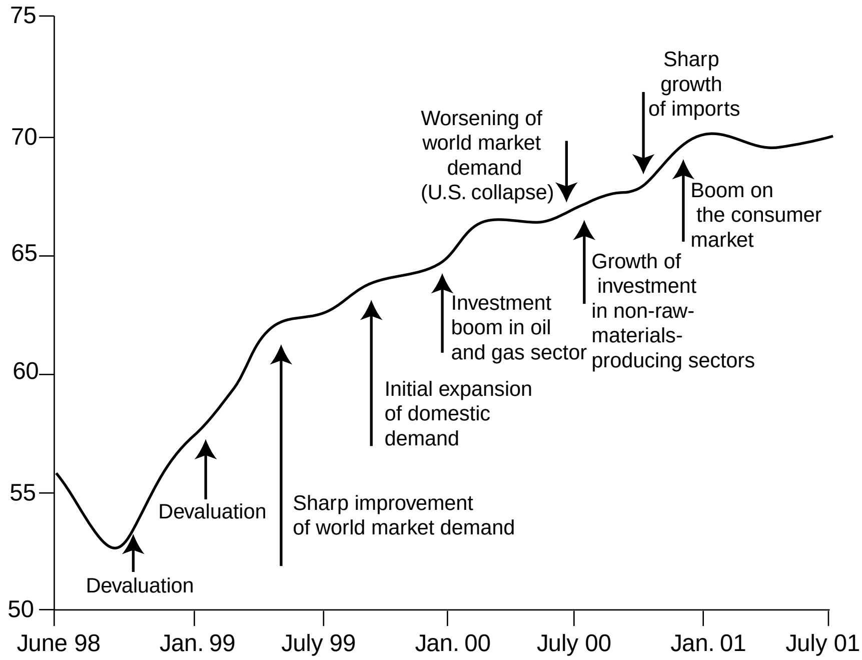
It is important to stress, finally, that the positive measures of Primakov and Putin could never have led to a noticeable recovery, *unless* a sizable portion of the agro-industrial structure in the economy had somehow been preserved relatively intact through the years of collapse, looting, and destruction which followed the institution of shock therapy. As economist Alexandr Anisimov wrote in a recent article: "The fact, that Russia's industry still functions, albeit after a collapse of production in most sectors by several times over, is a true miracle. For this miracle we can thank our entrepreneurs and directors of enterprises" who—despite the sudden collapse of demand and investment, the ruble hyperinflation at the beginning of the 1990s, the virtual disappearance of credit and even the minimal amounts of liquid money, and a huge accumulation of debts among producers—"managed to keep the apparatus of production in working condition." The extraordinary resilience of Russia and its population, has been demonstrated once more.

Revival of the Internal Market

Russian economists emphasize, that for the first time since the onset of the disastrous shock therapy, thanks to the special circumstances mentioned above, Russia could experience an approximation to a normal investment cycle: increased demand, increasing production, increased investment, and increased wages, leading again to increased demand. Authors Tatyana Gurova and Aleksandr Ivanter described this situation in a recent article in the journal *Ekspert* as follows:

"More important than the [growth] figures is the essential change, which occurred in the nation's economy. Firstly, [in the last 38 months] the Russian economy went through its first normal conjunctural growth, in which thousands of economic entities operated, not under the brutal pressure of external

FIGURE 1
Index Of Russian Industrial Production
(January 1993=100)



Source: Center of Data Analysis GU-VShE.

circumstances, but guided by their own plans for market expansion. And in this way the economy began to incorporate a real mechanism of development. Secondly, in this period, Russia began to shift away from its orientation toward an economic model based on export of primary energy and raw materials, and for the first time *felt* the potential of its own internal market."

The authors' choice of expression, "felt the potential," underlines the subjective nature of the improvement: In reality, as we mentioned earlier, the Russian economy is *still* declining in *net* physical terms, and is still monstrously dependent on primary-materials exports—raw materials make up about 50% of Russia's exports, and in turn, total exports constitute over one-third of Russia's GDP. But for the first time, not only economists, but a broad layer of the population active in agriculture, industry, and other sectors of the economy, got a foretaste of what normal economic life might be like.

Gurova and Ivanter's chronology of the 1998-2001 "mini-boom" is worth briefly excerpting here, although it does not go much beyond the mere surface of the phenomena: "The devaluation began to work immediately and extremely effectively. . . . The index of industrial production already went up to a yearly rate of 3% in September 1998. By October 1998 the yearly growth rate was almost 15%, and in November rose to 20%. The main reason for such a strong increase in domestic production was the sudden liberation of the internal market from imports—already in the fourth quarter of 1998 the flow of imports had decreased from $5-6 billion to $3 billion per month."

The production increase was further supported, in 1999, by a substantial increase in export earnings, as oil prices rose and the world market boomed under the influence of the United States-centered financial bubble. Gurova and Ivanter wrote: "The sharp increase in exports (in 1999 the monthly turnover of exports grew from $5-6 billion at the beginning of that year to $8 billion at the end of the year) supported the high tempo of domestic production. . . . From the beginning of the post-August 1998 crisis period until January 2000, the index of industrial production grew by 20%.

"In 2000 the export orientation of the Russian economy continued to work, but now through stimulating *investment.* The rate of investment reached 17.2%—and there was an unprecedented growth of domestic accumulation unseen since the whole ten years of reform. Two-thirds of this internal accumulation occurred in the oil and gas complex."

Although the oil and gas complex lies at the core of Russia's unbalanced, raw materials-oriented export economy, increased investment in that complex did provide a much-needed stimulus to sections of the capital-goods-producing industry. But by Fall 2000, this export-driven phase of the Russian "mini-boom" began to run out. Why, ask the authors, did the production growth continue beyond that, into 2001?

"The key difference between 2001 and the two preceeding years," these authors say, "is the fact, that in that year the Russian economy . . . 'tore itself away' from developments on the world market and began to expand on the basis of a growth of internal demand. In that year, the legend of the colossal potential of the internal Russian market became reality." Exports rose only slightly, with the real value of the ruble returning to levels comparable to the pre-August 1998 levels. Nevertheless, levels of production, which had stagnated at the end of 2000, began to rise again sharply, reaching an annual growth rate of 10% in August-September 2001. "The only macroeconomic parameter, correlating with such an increase in production, is the real income of the population, which by the Fall had grown at a yearly rate of 15-17%. Just this unexpected increase in real income of Russian citizens

Aircraft production during the Soviet era. Russia's machine-building and science-and-technology-intensive industries suffered most from the post-1990 collapse, and have yet to regain their previous levels—although some progress is being made.

became the basis for the consumer boom in the middle of 2001. . . . The second important factor was domestic investment, which increased by 8.8% in 2001, this time mainly in sectors connected with the internal demand."

These developments were accompanied by a notable rise of *optimism* in many layers of the Russian population, compared to the bitter fatalism which characterized the atmosphere three years earlier. But, as the experience of the Western and other countries ought to teach us, a "consumer boom" is neither a very healthy form of economic expansion, nor one that can be sustained for very long, even under favorable circumstances!

Toward the end of 2001, the signs of a potential new crisis in the Russian economy have been multiplying. These include an ominous buildup of inflationary pressures, and the flattening-out of production growth in the face of a renewed flood of imports. Shifts in the internal price structure have gradually cancelled out the "protectionist" effect of the ruble devaluation, and in the absence of serious, systematic government measures for the protection and support of domestic producers, many of the latter will once again face the danger of extinction at the hands of "free trade." Apart from that, the simple fact remains, that the rates of public and private investment—even at the peak of the "mini-boom"—remained far below those needed to seriously rebuild the nation's productive base, and above all, to revive the vital functions of scientific research and development, which are the key to Russia's future.

Before coming back to these problems in conclusion, let us briefly examine one of the most interesting and encouraging features of the 1999-2001 period, which is the revival of Russian agricultural production.

Agriculture Growing, But Exhausting Capital

Some of the best news in Russia's economy is coming from the agriculture sector, which at the end of last year could celebrate a grain harvest of 83 million tons, compared to an average harvest of 65.2 million tons in 1996-2000 and a disastrous low of only 47.8 million tons in 1998-99. Last year's yields were so high, that the grain output could not be absorbed by the internal market, and Russia suddenly came into the position of being able to export as much as 4-6 million tons to the world market. Russian Agriculture Minister Aleksei Gordeev declared, rather optimistically: "The present result is not to be seen as a record, but rather as the beginning of a gradual recovery of agriculture and the *rebirth of Russia as a world power in grain.*"

In fact, although exceptionally favorable weather was the main factor in this latest harvest, it comes on the background of a steady growth of overall production and investment in the agricultural sector going back three years. Russia's total agricultural output grew in 1999 by 4%, in 2000 by 6%, and in 2001 by 7-8%.

One of the special reasons for the strong food production growth was the role of large Russian companies, including metallurgical, energy, and raw-materials companies, which in recent years began to diversify into large-scale agricultural operations. Realizing that conditions existed for making major profits in the production of food, these companies rented large plots of land and made significant capital investments in machinery and equipment.

Another factor was government-supported programs for the leasing of farm equipment, for supply of credit, and provision of fuel supplies. The government also made some efforts to support farm prices.

The upswing of domestic agricultural production, in turn, stimulated a dramatic revival in the production of farm machinery. Russian production of tractors nearly doubled from 1998 to 1999, and increased again by nearly a third in 2000. Production of harvesters (combines) doubled in 1999, and grew by 2.5 times in 2000.

However, as in practically all areas of the Russian capital goods industry, the increased levels of production of farm machinery are still disastrously low, compared both with earlier levels, and with the monstrous cumulative deficit of physical investment in the agricultural sector.

Above all, production is lagging far behind the rate at which worn-out, obsolete machinery is going out of service.

In the year 2000 the number of newly produced grain harvesters (combines) was *four times* smaller, than the number which permanently stopped functioning due to excessive age. The overall machine stock of Russian agriculture, estimated at about 50% of the required norm, continues to shrink, despite the recent "boom" of agricultural machinery production. That "boom" is itself very modest, having barely reached the levels of 1995, which were in turn only a fraction of the production at the beginning of the 1990s, when the all-out collapse began. The agricultural machinery sector is still operating at an estimated 20% capacity.

Despite the recent, significant increase in food production, and the vast inherent potential of Russian agriculture, the present total output level, while recovering somewhat from its collapse to less than 50% of 1990 levels, remains far below what Russia would need to adequately provide for its own population. Last year's "bumper harvest" of 82 million tons of grain, assisted by excellent weather, should be compared with an average harvest of more than 104 million tons in 1986-90. Beef and poultry production is now at 45% of the level of 1990, and milk production at 58%. Ominous is the fact, that in spite of the significant improvement in some branches of agriculture, cattle herds continue to shrink.

Trouble Ahead?

The example of agriculture underlines the key reality which we stressed at the beginning of this article: Even at the height of the recent "boom," overall rates of real investment in the Russian economy remained *far below* the absolute minimum level needed to compensate for the gradual exhaustion of the nation's productive base, and the losses of skilled manpower and scientific cadres. In some respects, the revival of production, in the absence of adequate large scale infrastructure investment, has actually *accelerated* the exhaustion process of Russia's productive base.

There is no way that this situation could be reversed through reliance on "market forces," even under the most favorable internal and external circumstances. What is required is a radical change in government economic policy, breaking entirely with the prevailing IMF-style "fiscal austerity." Instead, state credit-generation and state investment must be used on a large scale, to finance a mobilization recovery based on modernization of Russia's vast infrastructural base, the channeling of massive amounts of low-interest credit to private and public enterprises in the productive sector, and crash programs of scientific and technological progress.

So far, there is no clear sign of a readiness to adopt the sort of radical measures just indicated. On the contrary, the Kasyanov government continues to hold on to its "neoliberal" policy formulas, and even to pursue certain measures—for example the partial privatization of the Russian railroads—which could have absolutely disastrous consequences for the future of the country.

It is not the purpose of the present article, to go into the present economic policy debate in Russia, or the decisions of the government and the Russian Presidency, which are often ambiguous and even contradictory. Economist Dr. Glazyev, whose judgment is to be taken seriously in these matters, has emphasized that the partial recovery of 1999-2001 occurred not *because* of government policies, but *in spite* of them. Above all, Glazyev argues, existing liberal policies are reinforcing Russia's role as a "Third-World-style" energy and raw materials exporter, and preventing the scale and kinds of investment into Russia's productive base and science-intensive production, which are necessary for a real recovery of the economy.

Warning Signs of Crisis

On the other hand, there are many signs of a developing internal crisis in the Russian economy, which may *force* a radical shift in economic policy. Here are some examples:

1. Production showed a marked slow-down toward the end of last year. Meanwhile, the drop in oil prices has caused a major decrease in export income and state revenues, as well as threatening to stop the necessary expansion of money supply, which has been occurring mainly through Central Bank printing of rubles to purchase foreign exchange earned by oil and other exporting companies. The combination of these two could have devastating effects on the economy, and were the subject of a number of emergency consultations, held in the Kremlin at the end of last year.

2. Russia faces a massive buildup of inflationary pressures, particularly connected with continuing price hikes in energy and essential services. In 2001, the production price index rose by 10.1%, while the price of coal increased more than 21%, the price of natural gas by more than 144%, of electricity by over 28%, and of transport by over 38%. A new round of drastic price increases is planned for the beginning of 2002. Unless the government takes strong, dirigistic action to stop this process, the profitability of production will rapidly drop below zero, living standards will fall, and a new social crisis will be unleashed.

3. The "consumer boom" of 2001 was accompanied by an explosion of *imports*, which grew at over 28%, or about six times faster than domestic production, demonstrating the extreme vulnerability of domestic producers. Without adequate protectionist measures, the expansion of domestic production cannot be sustained.

4. Finally, the chronic inadequacy of investment means not only a virtual inability of enterprises to invest in improving products and modernizing production; it also means serious breakdowns in essential infrastructure, as exemplified by the disastrous breakdown of urban heating and energy systems, particularly in the North and Far East of Russia.

It is estimated that in the "boom" year 2001, total capital investments in Russia constituted only about 17% of the GDP, compared to 25% in the United States during the 1950s and 1960s, and 30-50% in Western Germany and Japan during the post-World War II recovery.