

**Meeting Summary**  
**Russian Economic Goals to 2020: Dreams or Reality?**  
**August 29, 2008**

Presenter: **Mikhail Dmitriev**, Director, Center for Strategic Research (Moscow)

Respondent: **Anders Åslund**, Senior Fellow, Peterson Institute of International Economics

Chair: **Andrew Kuchins**, Senior Fellow and Director, Russia and Eurasia Program, CSIS

Rapporteur: **Samuel Charap**, Visiting Fellow, Russia and Eurasia Program, CSIS

This was the first of six meetings in the series, "Economic Change in Russia and its Implications for U.S. Policy," a CSIS project sponsored by the Carnegie Corporation of New York.

Russia's "2020" development strategy forecasts three possible development scenarios: inertia, resource-based development, and innovation-based development. Mikhail Dmitriev's presentation focused on the question of how Russia can maintain the 7% GDP growth through 2020 required to reach the goals of the innovation scenario. This would bring Russia up to the level of developed industrial economies, with a GDP per capita of approximately \$30,000 in purchasing power parity.

Dmitriev began by putting this challenge in historical perspective, noting that only 13 countries have sustained 7% growth for 20 years. Of these 13, Oman was the only one where natural resources exports accounted for the growth. None of the 13 had a steadily declining population, as Russia does; all had growing working age populations. Finally, there was a strong correlation between strong institutions and growth in per capita income in these states. Countries

with Russia's institutional weakness had no more than 4.5% GDP per capita growth. There are thus three major challenges to maintaining 7% growth: the resource curse, demographics, and weak institutions.

**The 1<sup>st</sup> challenge: the “resource curse.”** The current consensus is that prices for Russia's commodity exports will remain stable or decline; it is very unlikely that they will maintain the high levels of mid-2008. Even stable prices will mean that the role of resources in Russia's GDP will decrease; economic growth will have to rely on other factors.

The direct impact of lower resource prices is clear: government revenues, which rely on taxes and tariffs on natural resource utilization and export, will decrease. Thus, the state investment in infrastructure necessary for economic growth will decline to levels below those necessary to maintain a 7% growth rate in the medium term. The indirect impact of stable or declining natural resource prices could be even more important. There is a mismatch between the investment the country needs and the investment that its market financial system can provide: the financial system cannot generate enough long-term investment needed for high growth rates. In other words, there is a mismatch between the lending structure and borrowing needs. As a result, large enterprises turn to foreign lenders. In total, 45% of all investment needs of Russian companies are financed from abroad. When resource prices decrease, country risk will increase and it will

become more expensive for Russian enterprises to borrow abroad. They will likely borrow less, and thus invest less in infrastructure and new projects, which means lower mineral-resource output and a weakening of the manufacturing sector that is dependent natural resource extraction. Therefore, given lower or stable prices for Russia's commodities, the structural mismatch between the lending structure and investment needs will not allow Russia to maintain 7% growth; according to Dmitriev's estimates, it will be more along the lines of 3.5%-4% —closer to the pessimistic scenario in Russia's 2020 strategy.

**The 2<sup>nd</sup> challenge: demographics.** Dmitriev offered an assessment of what Russia can do to offset the decline in the labor supply. No demographic or migration measures can prevent this decline; however, there are structural sources of increasing the working-age population. Russia is clearly underperforming in terms of using human capital for growth generation; the country's human resources contribute only 14% to gross national wealth, while in most OECD states this number is 80%. Russia can thus do a lot to improve the contribution of human resources to economic growth. If the contribution of human resources to national wealth reaches 60% by 2020, the demographic problem could be alleviated.

How can this be accomplished? First, Russia has one of the highest rates of differentiated employment by region. For example, Chechnya has almost 100 times more unemployment than Moscow.

Due to restricted labor mobility, workers cannot move freely to regions where there are shortages. If housing market constraints improve as the government envisions, territorial migration rates will increase three times in 5-7 years. Second, Russia's public sector employs many more workers than most OECD countries; as a middle-income country, Russia should employ fewer. If policy-makers cut the number of public sector employees to the level of the UK and increase productivity, 3.5 million extra workers will be generated. Third, Russia's disability rate is as high as in the OECD countries, but the employment rate of the disabled is three times lower. If this and the previous two challenges are addressed, the working-age population will be large enough to contribute significantly to economic growth. Therefore, the demographic challenge is not insurmountable. But institutional reforms, such as healthcare provision, which have been delayed for many years are needed and the government thus far appears unwilling to undertake them.

**The 3<sup>rd</sup> challenge: Weak market institutions.** Given the current gap in institutional development, Russia will need 10 years of extremely difficult reforms to achieve the innovation scenario. Studies show that only 26 countries in the world have been able to reform this quickly. Data from the Center for Strategic Research shows that the pace of institutional change is negatively related to the size of the population; only two of the 26 are large countries (Congo and Iraq) and

both of these had extremely low starting points. If Russia wants to achieve the level of institutional development of Portugal or Spain, it needs an institutional miracle. Currently, policy-makers have not even begun to push through the critical reforms; their focus has been on rent distribution. Institutional reform is both the low-hanging fruit of these three challenges and perhaps the most pressing; massive overhaul of the financial and banking sectors and reform of the state's regulatory, judicial and contract enforcement capacities are precursors to implementing effective solutions to the first two challenges. Without an institutional breakthrough, the innovation outcome in the 2020 strategy will remain a distant dream.

**Åslund's response** focused on ten immediate concerns that could pose a long-term challenge to Russia's development goals:

1. Corruption, the rate of which is growing out of control.
2. A decline in or stabilization of commodity prices, which can only go down, combined with stagnant energy production.
3. Bottleneck in infrastructure.
4. Lack of qualified labor. The quality of improvement in human capital is far less than it should be.
5. Renationalization trend leading to decline in efficiency. In the EBRD index, Russia is heading towards the bottom of the rankings among transition states in terms of private sector contribution to GDP.
6. Lack of institutional reforms in the public sector.
7. A moderate investment ratio ---only 20%, while the Baltic states have a level of 32%.
8. WTO membership is now out of reach. Membership would have provided 1% GDP growth per year in medium-term. Without WTO membership, this number goes in the opposite direction.

9. Weakness of the banking system, which is currently less developed than Ukraine's or Kazakhstan's and remains dominated by state-controlled banks.
10. Inflation, which is now at 15%. According to Åslund, the reason for this spike is poor exchange rate and monetary policies. There should not be a negative real interest rate of 4% in an inflationary crisis situation; there should be high positive real interest rates. Russia's negative real interest rate results from its de facto peg of the ruble to a currency basket of dollars and euro, when it should move to a more flexible exchange rate.

He concluded by noting that these short-term trends make the perspective for meeting the 2020 goals rather remote.

The **discussion** focused on other factors that might affect the possibilities of Russia achieving its development goals.

- Failure of administrative reform and poor quality of civil service: has an indirect effect. Poor policy implementation prevents institutional reforms.
- Corruption: Dmitriev noted that this factor also indirectly affects institutional reforms by hampering policy implementation.
- Weak Civil Society and lack of competition in the political system: has minimal impact on policy-making.

A theme throughout the presentations and discussions was the **impact of the current crisis** in Georgia and relations between Russia and the West on policy-making. Rather than relegating it to a secondary priority, the crisis makes the 2020 strategy all the more relevant. The

economic ramifications of the crisis have been tremendous: capital outflow in the third week of August was greater than that seen following the crisis in August 1998, and the stock market has lost nearly 10% of its value since the hostilities began.

One of the most significant intervening variables between economic performance and policy change is the popularity of the Russian leadership. Under conditions of a high presidential approval rating, the leadership is unlikely to embark on painful reforms. A new study by Daniel Treisman, cited by Dmitriev in his presentation, found that the popularity of Russian presidents “closely followed perceptions of economic performance, which, in turn, reflected objective economic indicators.” In other words, the all-important presidential approval rating appears to depend directly on the Russian people’s sense of material wellbeing, which reflects their relatively accurate perception of the state of the economy; “most other factors invoked by commentators” – such as the war in Chechnya in the case of Vladimir Putin in 1999 – “had only marginal, temporary effects.”<sup>1</sup>

Even before the crisis in Georgia, there were clear indications that confidence was on the decline; for example, wage growth, which had been at 15% in real terms per annum, appears to be closer to 4% this

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<sup>1</sup> Daniel Treisman, “The Popularity of Russian Presidents,” presentation at the Frontiers of Political Economics conference, New Economic School, Moscow, May 30-31, 2008.

year, while double digit inflation has drastically increased the cost of living. The current crisis is likely to worsen these problems or at least expose them sooner than under normal economic and political conditions, and the impact on economic confidence, and thus the approval rating, could be swift. The implication is that policy change could be more likely in the medium term. As Åslund put it, “the question is how much pain the Russian economy can take without reacting.”

In the short term, Dmitriev noted that the crisis could produce either rational or irrational policy responses. The current government is reasonably pragmatic, and the response may well be rational, spurring institutional reform. Even irrational responses could perversely have a positive effect in that under conditions of decreasing commodity prices feedback will be immediate.

**Key Takeaways:**

1. According to Dmitriev, Russia faces severe challenges in meeting its 2020 goals. On the scale of dreams versus reality, he would put the country’s chances of achieving its goals more towards the realm of dreams, but with the right policies and structural reforms it could reverse course.
2. His top three policy recommendations:

- a. Protection of property rights via comprehensive reform of the judiciary and legal system.
- b. Increasing regulatory capacity in the financial sector.
- c. Wholesale reform of policy-making and policy-implementation systems. This will directly affect the capacity to implement reforms.