

# The Status of the Russian Economy

## Testimony of [Keith Bush](#)

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before the Committee on Banking and Financial Services  
United States House of Representatives

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Mr. Chairman and Members of the Committee,

I would like to commend the Chairman and his Committee for holding this hearing at a critical time not only for the Russian economy but also for formulating an appropriate response from its Western creditors. The Soviet, and then the Russian, economy has been at a critical juncture for as long as I can remember, but the current situation is precarious to say the least.

In August 1998, the Russian government defaulted on its short-term ruble-denominated domestic debt that was estimated, prior to the devaluation of the ruble, at some \$40 billion. It has started to default on its Soviet-era debt (i.e., incurred prior to January 1992) amounting to some \$103 billion. And it is evident that it will face severe problems in servicing its "Russian" debt, i.e., incurred after December 1991, valued at about \$50 billion. Indeed, it is possible, although not probable, that the Russian government will be unable to service even its debt to the IMF (\$4.6 billion is due in the next 18 months), a situation which would consign Russia to the doghouse of financial pariah states such as Sudan, Liberia, Congo, Somalia, Yugoslavia, Iraq, and Afghanistan. In the near future, after the IMF has approved its first tranche, international financial institutions, Western governments, and Western banks will probably have to decide on a fresh rescue package for Russia.

I have been asked to discuss the growth performance of the Russian economy in the recent past and to suggest the parameters of its likely growth in the near future. The details and the sources for the following are contained in my monthly review entitled The Russian Economy in June 1999, which has been made available to you.

### The Eleven-Year Depression

The gross domestic product (GDP) of the Russian Soviet Federal Socialist Republic (RSFSR), and successor Russian Federation, has declined each year since 1989, apart from a meager 0.8 percent increase in 1997. The current GDP is about 55 percent of the 1989 level. This represents a steeper fall than was registered during the Great Depression in the United States in the early 1930s. New productive capital investment in 1998 was less than one-fifth of the 1989 level. The Russian government is projecting a GDP of 4 trillion rubles in 1999. At the current official rate of exchange of about 25 rubles to the US dollar, this is equivalent to \$160 billion, or less than 2 percent of the US GDP that amounted to about \$8.5 trillion in 1998. At purchasing power parity, according to the World Bank, Russia's GDP in 1999 will be equivalent to \$617 billion.

Now it is evident to any visitor to Moscow or any other Russian city that a great deal of economic activity goes unrecorded (and untaxed). The official Russian statistical authority, *Goskomstat*, is aware of this gray, black, or shadow economy, and factors in an additional 25 percent of the value of the formal economy to cover its activity. Other observers go as high as 50 percent. Yet countering this *understatement* of the scale of the GDP is the fact that up to 70 percent of transactions within the economy are, it is reported, conducted in the form of barter, the value of which is notoriously *overstated*. And so the actual GDP may indeed be of the order of \$160-200 billion at the official rate of exchange, which puts Russia into the same ballpark as Portugal, Austria, and Sweden.

Although the current GDP of Russia may be just over one-half of the size of the RSFSR's GDP in 1989, its composition has changed appreciably to the benefit of the consumer. In 1989, for instance, more than 20 percent of GDP was devoted to defense. The defense allocation for 1999 was set at 107 billion rubles, i.e., 2.7 percent of GDP and \$4.3 billion at the official rate of exchange. The goods in Russian stores now reflect consumer demand rather than planners' preferences.

### **Recent Developments**

The Stepashin administration is the fourth Russian government within fourteen months — hardly conducive to strategic planning. Yevgeni Primakov was in office for eight of those months. His greatest single accomplishment was to stabilize the political situation, but he achieved this by deliberately avoiding the necessary economic restructuring. The 1999 federal budget, for example, was approved by the Duma in remarkably short time, but its assumptions and provisions were wholly unrealistic. Virtually nothing was done to put the banking system on a sound basis, even though the majority of the 1,500 commercial banks were rendered technically insolvent by the August 1998 devaluation. Very few manufacturing firms were declared bankrupt, despite the fact that several thousand value-subtracting enterprises continue to operate. Meanwhile, the overall economy continued to decline, although a few sectors took advantage of the devaluation of the ruble to substitute for imported goods.

### **Prospects**

Grigori Yavlinsky famously observed: "Anyone who tries to forecast what will happen next in Russia is an idiot." With this caution in mind, the following will merely suggest some likely parameters to Russian economic growth in the near future.

The Russian manufacturing industry now constitutes a gigantic rust belt. The average age of plant and equipment is roughly three times higher than the OECD average. The only Russian manufactured products that are competitive on the world market are military hardware, nuclear power plants, and space engineering. The domestic demand for these products is severely restricted by budgetary constraints and the overseas market is limited.

To update or replace this aged plant and equipment will require tens, and perhaps hundreds, of billions of dollars. But the domestic ruble money supply is equivalent to less than \$10 billion, while the estimated \$30 billion in hard currency (now stored largely under mattresses) is unlikely to be entrusted to domestic banks until or unless Western banks are given guaranteed and secure access to the Russian retail banking system and provided with sufficient incentive to do so. The bulk of investment capital must therefore come from abroad in the form of foreign direct investment (FDI).

Russia is currently attracting less than one percent of the world's FDI. In 1998, net FDI in Russia amounted to about \$2 billion, out of a global total of \$420 billion (China drew more than \$40 billion). The reasons are well-known: they include political instability; virtual absence of corporate governance; capricious and exorbitant taxes; the lack of commercial infrastructure; poor protection of property rights; pervasive corruption; and the depredations of organized crime. This hostile environment will take many years to correct, and thus FDI in Russian manufacturing capacity is unlikely to grow substantially in the near future. (More attractive prospects prevail for the extractive sectors, after recent progress in advancing production-sharing agreements (PSAs) and enabling legislation).

With domestic and foreign capital wholly inadequate to finance the necessary reconstruction and re-equipment of the manufacturing sector, former First Deputy Prime Minister Yuri Maslyukov promised — until he was fired in May — that state funding would be forthcoming. Yet all available government funding will have increasingly to be devoted to countering the acute deterioration of the nation's health, to combating environmental disruption, and to restoring an educational system that was perhaps the most positive legacy of the Soviet era.

With its vast natural resources and its highly educated workforce, Russia's economy will surely experience the boom or *chudo* (miracle) predicted for it by many informed observers. But this will not happen anytime soon.