CAN RUSSIA GROW FASTER THAN 4 PERCENT? YES, IF....

By Michael S. Bernstam and Alvin Rabushka

On some preliminary reports, Russia's gross domestic product (GDP) grew 7.6% in 2000, the highest in 25 years or so. Industrial production increased 9.2%. Capital investment rose 17.2%. All in all, 2000 was the best economic year since Russia emerged as a separate country in 1991, reversing a 45% decline in GDP during 1990-1998.

Estimates for 2001 are less optimistic. Economic experts forecast GDP growth of 4% and industrial production growth of 4.5%. At these lower rates, it will take about 15 years to restore Russia's GDP to 1990 levels.

The International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, and some Russian policy makers have all complained that Russia missed an opportunity in 2000 to implement needed structural reforms.

President Vladimir Putin expressed his displeasure with the growth projection for 2001. On January 3, 2001, he assembled his economic team, including the Prime Minister and the Chairman of the Central Bank, and instructed it to develop a plan to lift growth above 4 percent. While this sounds like an attempt to order the economy to grow by sheer dint of will, or a return to central planning, the task is not so difficult as it seems.

It's important to understand why Russia grew 7.6% in 2000. The answer is an interaction of two factors.

> First, rising export revenues indirectly, and in a rather unique way, revived domestic industry. The price of oil, gas, and other natural resources was substantially higher in 2000 than in 1999. Since Russia exports substantial natural resources, its foreign currency earnings rose sharply. To be sure, an improvement in the terms of trade does not increase real GDP evaluated at constant prices. But, if (a crucial if) foreign exchange revenues are repatriated, they help dissipate domestic arrears. This accelerates payments, which, in turn, facilitates production, given vast idle capacity. We discussed this mechanism in detail in Chapter 1 of our e-book *From Predation to Prosperity: Breaking Up Enterprise Network Socialism in Russia*.
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> Second, the Central Bank of Russia imposed a 75% conversion requirement of foreign currency earnings into rubles. The two factors taken together, the increased earnings from exports translated into a substantial increase in foreign exchange reserves of the Central Bank and the supply of domestic rubles. The increase in money financed a reduction in payroll, business, and tax arrears. What happened, technically, is that the weighted average of the age of outstanding invoices fell sharply. This resulted in an increase in cash flow relative to outstanding receivables throughout the economy. The payment jam that we described in Chapter 1 of our e-book, *From Predation to Prosperity: Breaking Up Enterprise Network Socialism in Russia*, was considerably eased, thus facilitating an increase in output. Forcible repatriation of foreign exchange earnings was crucial. If the money was

> left abroad, an increase in energy prices would have been largely irrelevant. (For a detailed discussion of the broad importance of this Central Bank policy, see our article "How Big Are Russia's Foreign Exchange Reserves?") Moreover, given the high volume of Russian energy exports and capital outflow, forcible repatriation of revenues would have contributed to growth even without world price increases. The latter's contribution was quantitative, not qualitative. The policy of the Central Bank of Russia was more important than oil. Oil prices were the grease, policy was the wheel.

Oil prices have come off their high of 2000. If prices remain at lower levels, the growth of cash flow relative to receivables outstanding will slow and, with it, production. If oil prices decline further, 4% growth might turn out to be optimistic. What is to be done?

We addressed this issue in Chapter 1 of our e-book on pages 23-25. Russian industry is characterized, in large measure, by value subtraction. That is, the value of material inputs in production is greater than the market value of the output. The elimination of value subtraction would, by itself, add value, generating one-time economic growth. Nor would this growth require any new investment. Simply closing down value-subtracting enterprises and industries and reallocating resources wasted by them would automatically generate growth.

If negative value-added constitutes about a third of the value of resources inputs, which we have discussed as a reasonable estimate, eliminating value-subtracting economic activity would produce instant 50% growth. The savings in ending the subsidization of current value-subtracting activity are sufficient to pay workers 100% of their wages for not working and retraining as well as release resources for reallocation to value-adding activities. 2001 would be a good time to undertake this effort.