Getting the Macroeconomic Balances Right? Or Achieving High Growth? Are the Two Compatible in Russia?

By Michael S. Bernstam and Alvin Rabushka

It is generally agreed that the chief goal of economic policy is growth. Sustained high growth increases living standards and enables the government to collect sufficient revenues to finance essential public services. Slow growth impedes both objectives, starving the private and public sectors.

Since 1978, China has grown at 8% on average in real terms. Russia, in marked contrast, initially underwent a great contraction of up to 40% of GDP during 1991-1998. Following the Great Default of August 17, 1998, Russia has experienced four years of continuous growth, albeit declining in each of the past three years, from 9% in 2000 to 5% in 2001 to an estimated 3-4% in 2002.

The view that growth is the chief goal of economic policy wasn't universally held at the beginning of Russia's reform process. Numerous Russian officials, economic experts, and advisers believed that reform itself, the achievement of the triad of privatization, liberalization, and stabilization— the descriptors of a market economy—was a worthy objective. They felt that contraction was an inevitable phase of the transition from post-Communist central planning to a market economy. Growth would follow, after perhaps a decade or even a generation, upon the completion of a set of prescribed reforms.

Not every analyst shares this retrospective assessment. In Chapter 1 of *From Predation to Prosperity*, we argue that Russia could have, indeed should have, experienced as much as 50% immediate growth just by closing its antiquated, value-subtracting industrial enterprises. Contraction was not a necessary consequence of reform or transition.

Putting aside the above dispute, let's take 1998 as a starting point. As noted above, the Russian economy has suffered diminishing annual growth since 2000, while China continues to grow at a torrid 8% annual pace, now in its 24th year. To see why this is so, examine Figure 2.1 in Chapter 2 of *From Predation to Prosperity*, which displays cumulative economic growth in 42 post-Communist economies during 1990-1999. The list includes all of the post-Soviet Central and East European countries along with a number of Asian, African, Middle Eastern, and Latin American countries. High growth predominates among these latter countries, while low growth characterizes most post-Soviet Central and East European economies.

As we explained in Chapter 2, the post-Soviet countries strove to follow the International Monetary Fund's dictum of getting the macroeconomic balances right. The underlying notion is that getting the macroeconomic balances right will lead, automatically, to profitable investment, risk-taking, hard work, and rising output.

Individual incentives are not woven into the fabric of macroeconomic balances. In the world of macroeconomic balances, high tax rates that achieve fiscal balance can be seen as desirable. Low tax rates that might encourage entrepreneurship, but which result in fiscal deficits, are often frowned upon.

Israel is obsessed with macroeconomic balances. Its economists and central bank governors are regarded as among the world's most distinguished macro-economists. Despite billions of dollars in foreign aid and the arrival of one million immigrants from the former Soviet Union since 1991, growth has slowed. Even as Israeli policy makers strive to achieve balance across the macroeconomic spectrum, the country is deep in fiscal deficit, high inflation, rising unemployment, a depreciating currency, and an absence of entrepreneurship. It is barely noticed that Israel has the highest individual tax rates and tax burden among all OECD countries. Pursuing macroeconomic balance has produced neither balance nor growth.

Russian policy makers emulate Israel in their effort to achieve macroeconomic balance. Russian government officials attribute low and slowing growth to high inflation and low investment. High inflation is presumed to result in real appreciation of the ruble, which is said to damage the internal and external competitiveness of Russian industry. (See "What Real Appreciation of the Ruble?" "Can More Liberal Subsidies Spur Growth and Reduce Inflation?" "The Dutch Disease: Peter the Great's Real Legacy?" "Appreciating Ruble Appreciation," "Too Many Dollars?")

Reliance on exports (in which Russia enjoys some comparative advantage) is seen to be a detriment to growth. Russian officials say that labor productivity is stagnant due to inefficient old industry, and that new investment is required to modernize the economy. A primary production economy based on natural resources is regarded as primitive and incapable of sustained growth (even though high world oil prices have been the principal engine of growth in the past few years). Russian officials want the country to develop a modern, Western-style industrial structure as the means to achieve sustained GDP growth.

We argued in an article posted to this web site (see "How Much Growth is Normal? In Russia? Elsewhere?") that increasing the share of private income in GDP is the quickest path to higher growth. This requires breaking down the network of enterprise socialism, which thrives on the issue of receivables and subsequent arrears, that continues to dominate the Russian economy. Achieving balance across the full spectrum of macroeconomic indicators has little or no effect on breaking up the network, which transforms private income into common income. So long as the network enjoys its subsidy and self-subsidy powers, Russia will be hard pressed to turn in sustained high growth.